

MASTER FILES

ROOM C-120

01

SM/83/36

Correction 1

CONTAINS CONFIDENTIAL
INFORMATION

April 5, 1983

To: Members of the Executive Board
From: The Secretary
Subject: Japan - Staff Report for the 1982 Article IV Consultation

The following corrections have been made in SM/83/36 (2/18/83):

Page 7: figures in Table 1 have been revised.

Page 8, footnote 1, penultimate line: for "¥ 7.1 trillion, or 3.2 per cent"
read "¥ 6.3 trillion, or 2.9 per cent"

Page 11, column 3, lines 6-8: for "2.5," "-0.3," "--"
read "3.3," "-0.2," "0.1"

Page 18, last para., penultimate line: for "additional 85 items;"
read "additional 86 items;"

Pages 25 and 26: figures in the Basic Data table have been revised and updated.

Corrected pages are attached.

Att: (6)

Other Distribution:
Department Heads

THE UNIVERSITY OF CHICAGO PRESS

Table 1. Japan: The Exchange Rate of the Yen and International Reserves, October 1978-January 1983

(End of period) 1/

	Exchange Rates						Real effective rate 2/ (1975=100)	International Reserves (US\$ bn.) 3/
	¥/US\$	¥/DM	¥/FF	¥/£	¥/Sw F	MERM (1975=100)		
October 1978	176.0	101.3	44.1	367.8	119.4	159.5	113.6 4/	29.6
1980								
March	249.7	128.6	55.8	541.0	136.3	118.3	94.4	18.9
December	203.0	103.6	45.0	484.2	115.1	144.5	97.6	-25.7
December 1981	219.9	97.5	38.3	419.6	122.3	145.0	102.8	29.2
1982								
March	246.5	102.1	39.5	439.2	127.4	134.4	99.7	28.1
June	254.0	103.3	37.2	441.5	120.8	133.0	98.9	26.4
September	269.4	106.6	37.7	456.2	124.3	127.3	96.9	24.9
October	277.3	108.1	38.2	464.4	125.2	125.2	...	23.8
November	253.1	101.8	36.1	408.0	118.4	136.1	...	23.9
December	235.0	98.9	34.9	379.4	117.8	144.9	...	24.3
January 1983	237.9	97.2	34.3	364.2	119.0	144.9	...	24.6
Percentage change between (- = depreciation):								
October 1978 and March 1980	-29.5	-21.2	-21.0	-32.0	-12.4	-25.8	-16.9 5/	
March 1980 and December 1980	23.0	24.1	24.0	11.7	18.4	22.1	3.3	
December 1980 and December 1981	-7.7	6.3	17.5	15.4	-5.9	0.3	5.3	
December 1981 and October 1982	-20.7	-9.8	0.3	-9.6	-2.3	-13.7	...	
October 1982 and December 1982	18.0	9.3	9.5	22.4	6.3	15.7	...	
December 1982 and January 1983	-1.2	1.7	1.7	4.2	-1.0	--	...	

Source: IMF, International Financial Statistics.

1/ Calculated using representative rates.

2/ Relative manufacturing export unit values. Quarterly average data for quarter ending in the month specified.

3/ Including gold (national valuation).

4/ Average for the third quarter of 1978.

5/ Change between Qtr. 3, 1978 and Qtr. 1, 1980.

favor of Japanese assets and following the earlier sharp advance in the U.S. stock market--which often is followed by a similar rise in the Tokyo market--there has been renewed foreign interest in Japanese securities. Especially earlier in the year, there were exceptionally large purchases of foreign securities--bonds, in particular--by Japanese investors. Again, these flows slowed substantially after August.

IV. Report on Policies

Following the successful containment by mid-1980 of the inflationary impact of the second round of oil price increases, economic policy has been directed towards three major goals: restoration of steady, noninflationary expansion of the private domestic economy; reduction of the large fiscal deficits which had emerged in the mid- and late 1970s; and continuation of the successful structural adjustment strategies begun in the period between the energy price increases. Growth was to be restored primarily through the establishment of the appropriate financial environment to facilitate and encourage private sector activity. This was seen to encompass an easing of monetary policy--including a reduction of interest rates; restoration of a sound fiscal position--including administrative reform of the government sector, reduced growth of public expenditures, avoidance of major tax increases, and lower deficits; and continued moderate strengthening of the yen, reflecting relatively low domestic inflation and steadily improving fundamentals of the economy.

On almost all fronts, policy strategies have been frustrated and established goals have proved elusive. Adverse conditions in the world economy have played an important role in forcing an alteration of policy settings; unexpected weaknesses in certain domestic sectors have aggravated the situation; and the persistent weakness of the yen is viewed by the authorities as having had a primarily detrimental impact on the economy. In these circumstances, policy evolved rather differently during 1982 than was expected at the time of last year's consultation.

1. Fiscal policy in the recent past

In 1979, faced with unprecedented budgetary deficits--reaching 6.4 per cent of GNP for the Central Government--the authorities believed that action to reduce the size of those deficits was necessary if flexibility were to be restored to fiscal policy; if the private sector were not to be squeezed out of the financial markets as the expected recovery gained momentum; and if the budget were to be prepared for the inevitable increase in social spending which would accompany the projected rapid aging of the population later in this decade. Consequently, with the 1980/81 budget, the authorities announced a medium-term financial plan to eliminate the issuance of deficit financing bonds by the Central Government by 1984/85.^{1/} This was to be

^{1/} Deficit financing bonds are issued to cover expenditures other than on public works projects, which are financed by so-called construction bonds. By law, deficit financing bonds are to be redeemed "in cash" at maturity. Such bonds were first issued in 1975 with 10-year maturity. In 1979/80, deficit financing bond issues totaled ¥ 6.3 trillion, or 2.9 per cent of GNP.

Table 3. Japan: GNP, Price, and Balance of Payments Projections, 1982/83-1983/84

	Staff Projections		Official Projections	
	1982/83	1983/84	1982/83	1983/84
Aggregate demand (In real terms, percentage changes)				
GNP	3.0	2.7	3.1	3.4
Private final demand	3.3	3.1	3.5	3.6
Of which:				
Consumption	4.1	3.3	4.3	3.9
Housing	0.1	2.0	0.5	2.6
Plant and equipment	2.0	2.9	2.0	2.9
Government final demand	2.5	-0.7	3.3	-0.7
Private inventory ^{1/}	-0.3	0.1	-0.2	0.2
Foreign balance ^{1/}	0.2	0.4	0.1	0.6
Prices				
Consumer prices	2.6	2.6	2.7	3.3
Wholesale prices	1.6	1.1	1.6	1.1
GNP deflator	2.0	2.2	2.0	2.2
Balance of payments (In bn. of US\$)				
Exports	136.0	150.0	136.0	141.0
Imports	-117.0	-124.0	-117.0	-121.0
Of which: Oil (volume increase)	(-8.0)	(-3.0)	(...)	(...)
Trade balance	19.0	26.0	19.0	20.0
Services and transfers	-11.0	-12.0	-12.0	-11.0
Current balance	8.0	14.0	7.0	9.0
(Per cent of GNP)	(0.8)	(1.2)	(0.7)	(0.8)

Sources: Data provided by the Japanese authorities and staff estimates.

^{1/} Contribution to GNP.

The revised budget for 1982/83 indicates an increase in the Central Government deficit from a planned level of ¥ 10.7 trillion to ¥ 14.6 trillion, or from 4.0 to 5.5 per cent of GNP. Moreover, other measures taken by the authorities will increase deficit financed expenditures at various levels of government by more than an additional ¥ 3 trillion.^{1/}

2. Prospects for the economy

For the next fiscal year, the authorities project GNP growth at 3.4 per cent (Table 3). Private consumption is expected to slow somewhat but all categories of private investment are expected to strengthen modestly and the external balance is expected to improve, making a moderate contribution to growth. The authorities expressed a high degree of confidence in the strengthening of the economy, pointing to an improvement in most of the fundamental factors operating in the economy which will work in favor of a recovery of private sector activity. The favorable factors cited by the authorities include the stabilization of inflation at a low rate; the appreciation of the yen; potential reductions in real interest rates as and when the yen strengthens further; and prospects for a modest recovery of world trade. With the expected improvement in the world economy, a reversal of the decline in exports is projected. However, increased domestic demand and somewhat higher raw material prices are expected to raise imports, leading to only a moderate increase in the current account surplus to about \$9 billion.

The authorities note that domestic growth at about the forecast rate would represent performance at near the estimated potential growth rate of the economy. In view of the new price relationships in the economy, including the lower rate of return on capital and the higher cost of energy, and the other changes that have occurred over the past decade, the authorities estimate that the potential rate of growth has declined dramatically from its level of over 10 per cent during the 1960s. For example, the Economic Planning Agency (EPA), which revised downward its projected growth rate for the economy to about 6 per cent in the mid-1970s, has recently suggested that the economy can grow at an annual rate of only 4-5 per cent under the new circumstances; this view is supported by some private analysts. Ministry of Finance estimates suggest a somewhat sharper decline in the growth potential of the economy to a level nearer to 3 per cent. These differences reflect almost entirely different perceptions as to the contribution that technological progress can make to growth in the coming years.

^{1/} These measures include reduction of transfers of tax revenue to local governments amounting to ¥ 1.7 trillion which will be supplanted by additional lending to local governments by the Trust Fund totaling ¥ 1.5 trillion; suspension of transfers to the sinking fund by the general account of the Central Government of ¥ 1.2 trillion; and additional public works to be financed primarily by bond issues by local governments amounting to about ¥ 0.5 trillion.

of a still stronger yen. In this light, the monetary growth projection was reduced somewhat further for the first quarter of 1983 to 7-8 per cent. The authorities explained that this projected rate of monetary expansion was viewed as sufficiently accommodative not to thwart the forecast growth of the economy. The authorities again stated that despite the growing pressure from various segments of the domestic economy, the official discount rate would not be adjusted until a persistent firming trend of the yen was confidently perceived. While there had been some softening of interest rates between November and late January, both short-term and long-term rates were still at the levels that had prevailed in early 1982 and only about one half to three quarters of a percentage point below the peak level reached in mid-year. Thus, most of the substantial decline which had occurred in overseas rates since mid-1982 was reflected in a sharply narrower interest differential against the yen. Real interest rates remained at historically high levels, somewhat above the levels prevailing in the other major industrial countries.

5. The exchange rate

The authorities attributed the weakness of the yen during 1982--which brought it to a five year low against the U.S. dollar in early November (¥ 278/US\$1)--primarily to the large interest differential which prevailed against yen assets during much of the year. They cited the interest differential as one of the primary factors behind the more than doubling of net long-term capital outflows during the first 9 months of 1982 from their level in the same period of 1981. With only relatively minor adjustments in nominal interest rates in Japan during this period, it was not until U.S. interest rates began to fall sharply after mid-year that the differential narrowed, eventually reducing net capital outflows. Other factors thought to have weakened the yen during this period were the sharp drop in Japanese exports and the consequent smaller than expected improvement in the current account. The formal and informal restrictions and "voluntary restraints" placed on Japanese exports may have aggravated this situation. The delay in the strengthening of the yen following the narrowing of interest differentials is attributed partly to the political uncertainties that may have been raised by the prospect of an election for Prime Minister in October and partly to the general strength of the dollar against all major currencies during that period. Since the yen began to strengthen in early November, it has appreciated by 17 per cent against the dollar and 15 per cent in effective terms. The authorities have very much welcomed this appreciation, seeing in it the removal of an emerging threat to price stability and the potential for improving the extremely weak profit situation in import processing industries and strengthening the tone of domestic financial markets. Notwithstanding the recent appreciation, however, at recent exchange rates for the yen, the competitive position of Japanese industry remains highly favorable--at near the levels prevailing during 1975-77.

During the course of 1982, the authorities intervened heavily at times to support the yen by selling dollars in the exchange markets to stabilize disorderly conditions in those markets and to signal the market as to their

view that the yen was undervalued. Intervention in support of the yen amounted to over \$8 billion between January and October; its effect on the domestic money stock was routinely sterilized by other actions of the Bank of Japan, however. The authorities noted that, while this intervention was sometimes effective in moderating the depreciation of the yen, that effectiveness was limited by the lack of participation by other monetary authorities. There was no intervention by the authorities to support the dollar after the yen began to strengthen in early November despite the sometimes large daily movements in the exchange rate. The authorities explained that their reluctance to intervene at that time reflected several considerations, including their desire to avoid any misunderstanding about their approval of the strengthening of the yen and their view that, in light of the excessive weakness which had developed, a strong and rapid reversal was not surprising.

6. Trade and capital market policies

In discussing the rising trend in protectionism, the authorities linked it to the weak state of the world economy and thought it was likely to be halted and reversed only after a recovery was evident. In the meantime, recognizing the political reality of protectionist sentiment, they stressed that whatever trade restrictive measures governments felt necessary to impose should at least be temporary and transparent so as to be more easily removed when the recovery comes.

At the present time, about 14 per cent of Japanese exports are subject to some kind of protectionist action or voluntary restraint, although the authorities noted that these measures restricted exports only in the case of a few items, including automobiles, color TVs and video recorders and only in specific markets. They feared, however, that even in the early phases of a recovery, particularly if employment should lag behind the rebound in spending, protectionist action in some of Japan's markets could persist. In principle, the Government would like to work toward a free trading system and felt that it should not impose export restraints. However, the authorities recognized that a heavy concentration of exports of specific items could cause problems in certain markets, and they were prepared to help avoid these situations.

During the course of 1982, the authorities took various measures to further open up domestic markets to imports.^{1/} As part of these measures, the Ministry of Finance had prepared for submission to the Diet a list of 228 items, accounting for about 9 per cent of non-oil imports, on which tariffs would be either substantially reduced or eliminated in April 1983. At the same time, quantitative restrictions on some of the 27 items still subject to such restraint would be eased. In early January 1983, the authorities took additional measures aimed at further opening the domestic market. These included actions to improve import testing and approval procedures; tariff reductions or eliminations on an additional 86 items; relaxation of import restrictions on certain agricultural products; and efforts to

^{1/} Details of these measures were reported in: "Japan: Recent Economic Developments" (SM/83/17, 1/26/83).

JAPAN

Basic Data

Population

Total population (June 1982) 118,378,000
GNP per capita (1982) US\$8,965 1/

	1981 (Per Cent Share)	1979	1980	1981	1982 <u>2/</u>
--	--------------------------	------	------	------	----------------

GNP

(In trillions of yen)

At constant 1975 prices	181.1	189.8	197.1	202.4
At current prices	218.9	235.8	251.3	264.3

(Percentage changes over previous year
in constant prices)

Private consumption	52.0	5.9	1.3	0.5	3.8
Private residential investment	5.5	-1.0	-9.4	-2.6	-1.9
Private equipment investment	17.2	11.8	8.0	5.6	2.0
Government consumption	9.5	4.3	2.9	4.6	3.0
Government investment	9.5	3.1	-3.2	5.3	0.6
Stockbuilding <u>3/</u>	0.6	0.5	-0.1	-0.2	-0.1
Total domestic demand	94.3	6.4	1.2	1.9	2.6
Foreign balance <u>3/</u>	5.7	-1.0	3.5	2.1	0.2
Real GNP	100.0	5.2	4.8	3.8	2.7
Nominal GNP	...	8.0	7.7	6.5	5.2

Prices and income

(Percentage changes over previous year)

Wholesale prices	7.3	17.8	1.4	1.8
Consumer prices	3.6	8.0	4.9	2.7
GNP deflator	2.6	2.8	2.6	2.5
Nominal wages <u>4/</u>	5.8	5.7	5.2	5.1
Real wage <u>4/5/</u>	2.1	-2.2	0.3	2.4
Real disposable income <u>5/6/</u>	2.4	-1.4	-1.0	3.6
Average propensity to consume (in per cent) <u>6/</u>	77.6	77.9	79.2	79.2

Manufacturing (period average)

Employment of regular workers	-0.5	1.0	1.1	0.7
Production	8.4	7.1	3.2	1.1
Productivity	7.7	5.6	2.3	0.8
Unit labor cost	-1.5	1.5	3.5	4.4
Unemployment (in per cent)	2.1	2.0	2.2	2.4
Inventory ratio (in per cent) <u>7/</u>	77.4	85.4	89.3	90.8

Basic Data (concluded)

	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u> 2/
<u>Financial aggregates</u>	<u>(Percentage changes over previous year)</u>			
M2 8/	11.9	9.2	8.9	9.2
Domestic credit 9/	8.4	8.4	10.0	8.2
Public sector	10.5	9.1	13.0	5.2
Private sector	7.9	8.3	9.3	9.0
<u>Central Government budget 10/</u>	<u>(Fiscal year basis, in trillions of yen)</u>			
Revenues 11/	25.5	28.9	31.4	33.0
Expenditures	39.8	43.4	46.9	47.6
Deficit (-)	-14.3	-14.5	-15.5	-14.6
Fiscal investment and loan program	16.2	18.1	19.4	20.6
Deficit/GNP (in per cent)	6.4	6.0	6.1	5.5
<u>Balance of payments</u>	<u>(In billions of U.S. dollars)</u>			
Exports	101.2	126.7	149.5	137.7
Imports	-99.4	-124.6	-129.5	-119.5
Trade balance	1.8	2.1	20.0	18.2
Services and transfers	-10.6	-12.9	-15.2	-11.3
Current balance	-8.8	-10.7	4.8	6.9
Long-term capital 12/	-13.0	2.3	-9.7	-15.0
Japanese	-16.3	-10.8	-22.8	-27.5
Foreign	3.3	13.1	13.1	12.5
Basic balance	-21.8	-8.4	-4.9	-8.1
Short-term capital	9.1	13.2	9.1	3.2
Nonbank 13/	5.1	--	2.7	3.2
Bank	4.0	13.1	6.4	--
Overall balance	-12.7	4.8	4.2	-4.9
<u>Gross official reserves 14/</u>	<u>(At end of period, in billions of U.S. dollars)</u>			
Total reserves	20.6	25.7	29.2	24.3
In months of imports of goods and services	1.8	1.8	1.9	1.7

1/ At an exchange rate of US\$1 = ¥ 250.

2/ Staff estimates.

3/ Contribution to real GNP.

4/ Manufacturing sector.

5/ Deflated by CPI.

6/ Workers' households.

7/ Index of producers' inventory ratio to shipment.

8/ Period average.

9/ End of period.

10/ Settlement basis for FY 1979 to FY 1981 and revised budget for FY 1982.

11/ Excluding sale of financial assets.

12/ Excluding Gensaki transactions.

13/ Including Gensaki transactions and errors and omissions.

14/ Including gold (national valuation).