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SM/84/32
Correction 1

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INFORMATION

March 12, 1984

To: Members of the Executive Board
From: The Secretary
Subject: Japan - Staff Report for the 1983 Article IV Consultation

The following corrections have been made in SM/84/32 (1/30/84):

Page 2, line 3: for "2.7 percent" read "2.6 percent"

Page 4, second full para., line 4: for "1 percent" read "2 percent"

Page 6a, Chart 5, lower panel: for "Nominal exchange rate (US\$/yen)"
read "Nominal exchange rate (yen/US\$)"

Page 17, para. 1, line 3: for "on dutiable imports"
read "on the products covered by the tariff
cuts from"

Page 23, columns 3 and 4, line 13: for "0.5" and "-0.7"
read "1.8" and "2.2"

column 3, line 14: for "2.6" read "2.7"

column 4, line 20: for "2.7" read "2.6"

Corrected pages are attached.

Att: (5)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

JAPAN

Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives for the
1983 Consultation with Japan 1/

Approved by P. R. Narvekar and Subimal Mookerjee

January 27, 1984

I. Introduction 2/

The adjustment of the Japanese economy to the economic disturbances of the 1970s has been remarkably successful and has resulted in better fundamental conditions in Japan than in other major industrial countries. Inflation has remained below 3 percent for more than two years and expectations of any significant acceleration of prices are widely believed to be absent. Although the terms of trade loss resulting from the first oil price increase was accompanied by a sharp increase in wages, that resulting from the second oil price increase was absorbed to a far greater extent by labor; consequently, the share of capital in manufactured value added was held constant and cost conditions remain relatively favorable (Chart 1). The sizable current account deficits that emerged in the wake of both episodes were quickly reversed owing to the competitiveness of Japanese exports and successful energy conservation efforts. The large central government budget deficit remains a problem, but since 1981 there has been progress in reversing the growth of both expenditure and the deficit as a proportion of GNP. More generally, growth and employment have been substantially better in recent years in Japan than in other industrial countries.

Nevertheless, economic growth was weak during 1980-83. The annual growth rate of real GNP slowed from 5.2 percent in 1979 to an estimated

1/ Consultation discussions were held in Tokyo from November 22-December 2, 1983 with officials of the Ministries of Finance and International Trade and Industry, the Economic Planning Agency, and the Bank of Japan. The staff team comprised Messrs. Narvekar, Boorman, and Hides, Ms. Schadler, Mr. Kashiwagi (all of ASD), Ms. Eken (ETRD), and Mrs. Tighe (TRE). Mr. Hirao, Executive Director, attended the meetings as observer.

2/ This report was prepared before the 1984/85 budget (fiscal year ending March 31, 1985) and the official forecasts for 1984/85 were released publicly. A supplement containing an assessment of the budget and forecasts will be presented after their release.

3.1 percent in 1983 and that of total domestic demand from 6.4 percent to an estimated 2.0 percent; the rate of unemployment increased from 2.0 percent to 2.6 percent; and the annual growth of real private fixed investment declined from over 11 percent to an estimated 1.6 percent. These trends were rooted in both domestic and international developments. The rapid restoration of credible price stability has not yet had the generally expected beneficial effects on growth. Low wage increases were an important factor behind the strong cost position of industry, but also tended to dampen the growth of incomes. The resulting slow growth of private expenditure weakened profits during most of the period. Despite the sluggishness of private sector growth, the Government's commitment to reducing the large fiscal deficit translated into a considerable withdrawal of fiscal stimulus. Net foreign demand, which accounted for over 60 percent of growth during the first two years after the second oil price increases, fell in late 1981 and continued weak throughout 1982, though there has been a substantial pickup more recently.

In an effort to bolster domestic demand, monetary policy was eased between mid-1980 and late 1981. The persistence of high interest rates overseas and the associated weakness of the yen, however, led the authorities to tighten monetary policy somewhat during 1982 and have since limited the scope for increasing support for domestic demand through an easing of monetary conditions. Real interest rates in Japan remain very high.

II. Background to the Discussions

After more than three years of erratic but generally declining growth, the first signs of a pickup in activity have appeared in recent months. Thus far, this pickup has reflected primarily an improvement in external factors. In real terms, net foreign demand (GNP basis) accounted for about 60 percent of the 3.8 percent growth of GNP (annual rate) during the first three quarters of 1983 (Chart 2). The staff estimates that the current account surplus increased from \$7 billion in 1982 to \$21 billion (1.9 percent of estimated GNP) in 1983 (Table 1). After a severe deterioration during 1982, the value of exports rebounded in early 1983, despite an extension and broadening of voluntary export restraints. Volume growth was robust owing to a strong recovery in North American and Southeast Asian export markets, considerable excess capacity in industry in the face of weak domestic demand, and the lagged effects of the depreciation of the yen through October 1982. However, while export performance has been strong, only a little more than half the improvement in the current account balance in 1983 derives from higher export receipts. Of the estimated \$14 billion improvement in 1983, \$7 billion stems from a decline in fuel import payments, owing to reductions in both price and volume. Weak domestic demand contributed to stagnant non-fuel imports during the first half of the year,

although during the third quarter these imports picked up with the growth of industrial activity.

Table 1. Japan: Current Account Developments, 1982-83

	1982	1983 <u>1/</u>
<u>(In billions of U.S. dollars)</u>		
Current account	6.9	21.1
Exports	137.7	145.7
Imports	-119.6	-114.0
Of which: fuels	-65.6	-58.5
Services and transfers	-11.2	-10.6
<u>(Percentage change)</u>		
Export volume	-2.3	7.9
Import volume	-0.5	0.2
Of which: fuels	-3.5	-1.8
Export dollar unit value	-6.8	-1.4
Import dollar unit value	-7.7	-4.3
Terms of trade	1.0	3.0

1/ Staff estimates.

Given the favorable cost/price structure of industry, the recovery of export demand elicited a strong rebound in industrial production early in 1983, ending a year of stagnation. This, in turn, translated into an increase in overtime work and an improvement in capacity utilization with an accompanying increase in business fixed investment. Nevertheless, as exports account for about one half of manufactured output and manufacturing comprises only about 30 percent of GNP, the effect of exports on domestic incomes and growth has thus far been limited.

The growth of private domestic demand, which was maintained rather steadily at an annual rate of just under 4 percent throughout 1982, fell sharply in early 1983 as a result of weakness in all sectors, but then recovered to an annual rate of about 3.5 percent in the third quarter. The slowdown in growth of private consumption reflected the effects on disposable income of the low wage settlement for employees of major

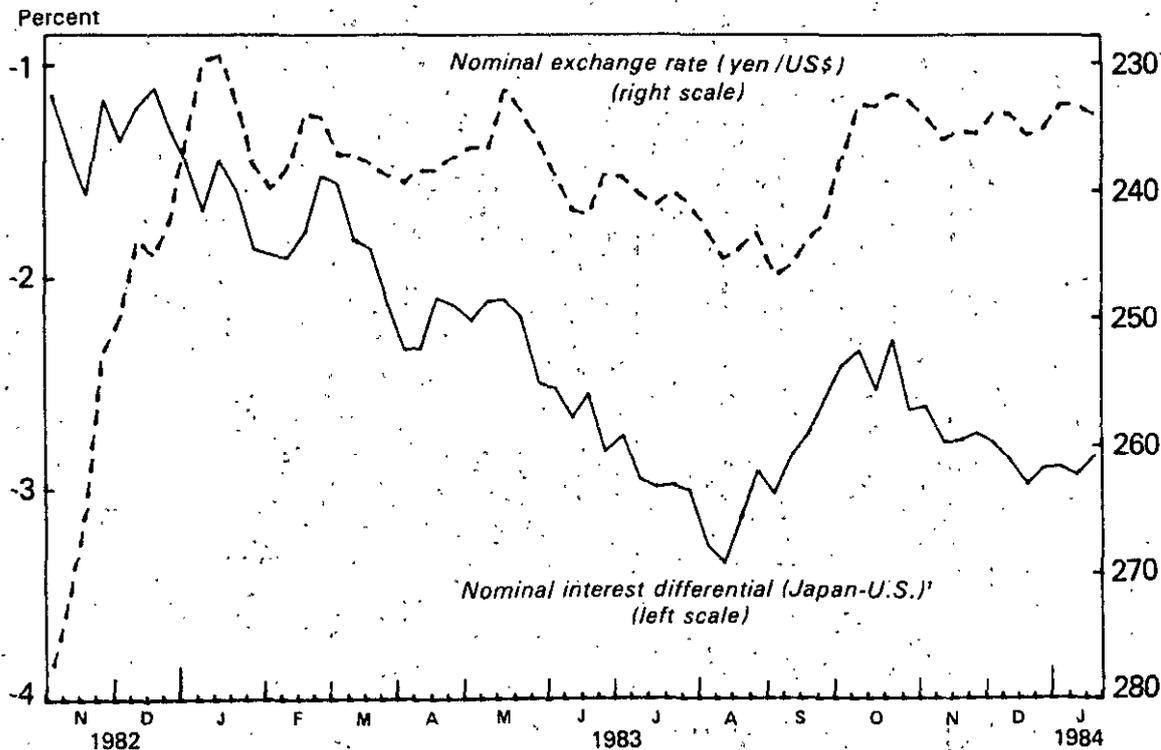
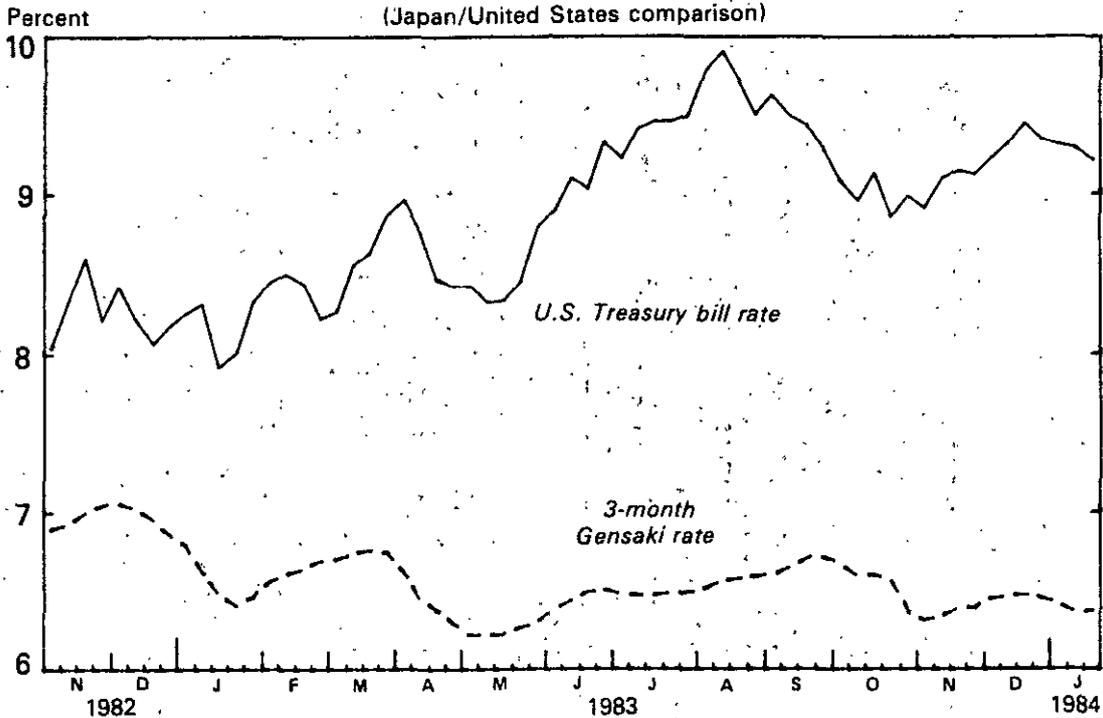
corporations in 1983/84, a decline in corporate profits during the second half of 1982/83 and the first half of 1983/84, and unusually low *semi-annual bonus payments to employees*. The *savings ratio*, which had been declining since the mid-1970s, appears to have stabilized, at least temporarily, in 1983. Consumption growth increased in the third quarter largely as a result of the removal of temporary factors that had depressed growth earlier in the year. After a brief, but strong spurt during the second half of 1982, residential investment declined sharply during the first half of 1983 owing to the termination of temporary, favorable factors and continuing structural imbalances in the housing market. A moderate rebound in housing investment occurred in the third quarter. Plant and equipment investment declined during late 1982 and early 1983 but has since picked up considerably. Developments in inventory accumulation have been mixed but generally weak during 1983.

The rate of unemployment, though considerably lower than in other industrial countries, reached a post-war record of 2.8 percent in September 1983 but subsequently fell to 2.6 percent (Chart 3). The rise during 1983 reflected an acceleration of labor force growth and a somewhat slower rise in employment. Nevertheless, the recorded rate of unemployment appears to understate the degree of labor market slack since there exists considerable hidden unemployment in the form of labor hoarding by firms. In the face of deteriorating labor market conditions, weak profits and lower inflation, wage behavior has been moderate. The 4.4 percent increase in average wage rates agreed to in the 1983 wage negotiations for employees of major corporations is the lowest in the 27-year history of the negotiations. Consequently, with the resumption of output and productivity growth in manufacturing, unit labor costs have fallen considerably in recent months and profits appear to be recovering.

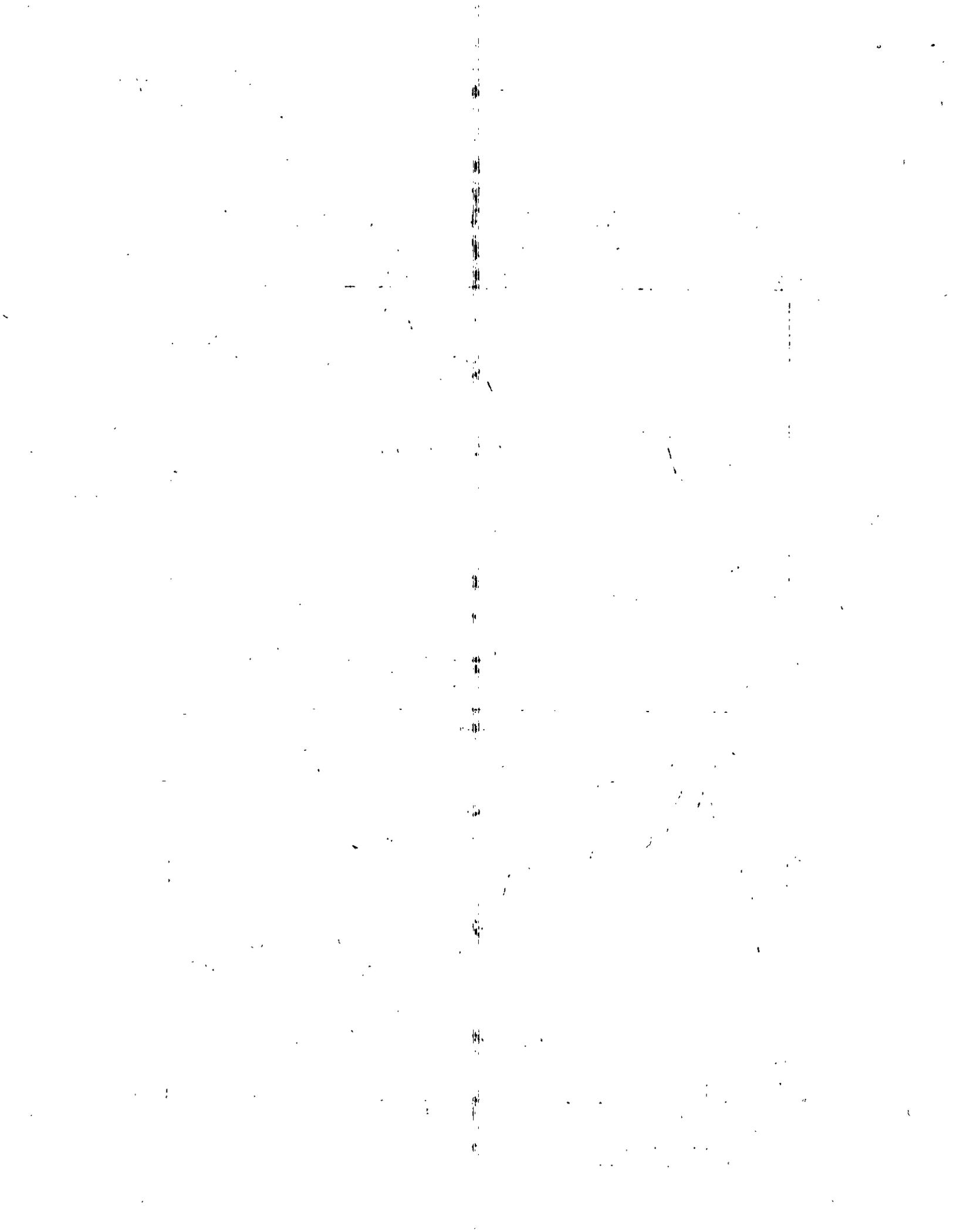
Prices have changed little during 1982 and 1983 reflecting the decline in energy prices as well as the weakness of domestic demand. Wholesale prices, which increased by 0.9 percent during 1982, fell by more than 2 percent during the year to October 1983 (Chart 4). Consumer price increases slowed from 1.8 percent during 1982 to 1.4 percent during the year to October 1983.

On the basis of these developments, the staff concurs with the authorities' estimates that GNP growth will be about 3.5 percent in 1983/84 as compared to 3.3 percent in 1982/83. However, the staff estimates that half of this growth will be accounted for by net foreign demand, while the authorities expect that this sector will account for no more than a third. The staff expects export growth to remain strong throughout the fiscal year and imports to pick up moderately during the second half; the current account surplus therefore is projected to reach \$24 billion in 1983/84. The pickup in domestic demand that occurred in the September quarter should continue, though at a moderate pace, through the remainder of this fiscal year. The increase in industrial

CHART 5
JAPAN
NOMINAL INTEREST RATES AND THE NOMINAL
EXCHANGE RATE, 1982-84



Sources: IMF data fund and data provided by the Japanese authorities.
1 Gensaki rate less the U.S. Treasury bill rate.



5. Commercial policy

Two sets of market opening measures, announced in May 1982 and January 1983, were implemented in April 1983. Together, these reduced the average tariff on the products covered by the tariff cuts from 7.7 percent to 4.5 percent, relaxed import quotas on a wide range of agricultural products, simplified import testing procedures and liberalized government procurement policies and trade in services. Further tariff reductions and steps to promote imports through concessional import financing were announced in October. These measures were expected to have some impact, particularly on imports of manufactured goods, but, because nearly two thirds of imports are energy products and raw materials with relatively inelastic demand, the effect on total imports was expected to be small.

The Japanese Government has met international criticism of the growing exports by acceding to an increasing number of requests for voluntary export restraints. It is estimated that about 40 percent of Japan's exports to the United States and the European Community are in categories subject to some sort of restraint. The authorities viewed these arrangements as the best means of supporting the free trade system when industries in trading partner countries suffer from structural problems. In such situations, import restrictions imposed by importing countries would tend to be more severe and to remain in effect for longer periods than voluntary restraints by exporting countries. It was important, however, in the view of the authorities, that export restraints be coupled with adjustment measures in the importing countries. The restraint agreements were not seen as permanent, and some had already been eliminated. The authorities were concerned, about the recent increase in pressure for protection to nurture high-technology industries. Whereas protectionist measures in industrial countries have traditionally been based on the need to facilitate structural adjustments, the extension of protection to high-technology infant industries was believed to pose a serious threat to the future expansion of world trade which was expected to be concentrated in this area.

The authorities said that voluntary export arrangements had probably dampened domestic investment growth somewhat and increased direct investment abroad. There were no quantitative estimates of the impact of the agreements on export volume growth but there had probably been some depressing effect, particularly on exports of automobiles and video tape recorders. To some extent, especially for automobiles, these effects had been offset by the export of higher value-added items. The effects of the arrangements on the value of the yen were uncertain, though it was thought that the yen might have been somewhat stronger had the arrangements not been in effect.

The authorities believed that with the world recovery trade volume growth would pick up and tend to lessen protectionist pressures during

the coming year. Nevertheless, in countries with weak recoveries and where structural adjustment has been slow, such pressures could remain strong. The Japanese Government has recently proposed a new round of multilateral trade negotiations.

IV. Staff Appraisal

Since the mid-1970s, Japan has proved highly capable of adjusting to disruptions in the world economy. External price increases have not been permitted to distort the domestic price and wage structure and the adaptation of industry to structural changes has proceeded rapidly. This performance reflects the timely and efficient response of policy to changing circumstances and the ability of the society to effect an acceptable apportionment of the adverse impact of external shocks among its various groups.

These fundamental strengths of the Japanese economy have contributed to higher growth and lower unemployment during recent years than in other industrial countries. The containment of domestic costs and prices and the ability of industry to respond to changes in the structure of demand have sustained and enhanced the strength of the Japanese economy in international trade, but the positive influence of these developments on domestic demand has been weaker than expected. As a result, there have been periods of weak domestic demand--such as in 1980, mid-1981 and again during early 1983--when growth has been sustained largely by trade performance.

Final private domestic demand declined in the first half of 1983 although the support provided by the public sector and an upturn in inventory accumulation led to a slight expansion of total domestic demand. Some of the weakness in the economy was due to temporary factors and their removal, along with the beneficial impact of the recent export expansion, produced a rebound in the growth of private domestic demand in the third quarter. While this rebound was broad-based, developments in some of the factors underlying the performance of private consumption and residential investment--in particular disposable income growth, the savings ratio and structural aspects of the housing market--remain uncertain. It is also disquieting that inventory accumulation has been rather slow. Nevertheless, industrial activity and the growth of exports remain strong, and a pickup in profits and business fixed investment has already commenced. If these trends persist, they should eventually translate into higher disposable income and consumption. Given these mixed signals, the staff is optimistic--but cautiously so--on the strength of the recovery of domestic demand expected during the next year.

JAPAN

Basic Data

Population

Total population (June 1983) 119,190,000
GNP per capita (1983) 1/2/ US\$9,811

	1981 (Percent Share)	1980	1981	1982	1983 <u>2/</u>
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(In trillions of yen)

GNP

At constant 1975 prices	189.8	197.3	202.9	210.3
At current prices	235.8	251.8	264.8	274.9

(Percentage changes over previous year
in constant prices)

Private consumption	52.0	1.3	0.7	4.2	3.4
Private residential investment	5.5	-9.4	-2.5	-0.7	-5.2
Private equipment investment	17.2	8.0	5.6	3.5	1.7
Government consumption	9.5	2.9	5.2	2.3	2.3
Government investment	9.5	-3.2	3.9	-0.2	0.3
Stockbuilding <u>3/4/</u>	0.6	-0.1	-0.2	0.1	-0.5
Total domestic demand	94.3	1.2	2.0	3.2	1.6
Foreign balance <u>3/</u>	5.7	3.5	2.1	0.3	1.6
Real GNP	100.0	4.8	4.0	3.4	3.1
Nominal GNP	...	7.7	6.8	5.2	3.8

Prices, income and employment

(Percentage changes over previous year
except where indicated)

Wholesale prices	17.8	1.4	1.8	-2.2
Consumer prices	8.0	4.9	2.7	1.8
GNP deflator	2.8	2.7	1.7	0.7
Hourly compensation <u>5/</u>	7.4	5.5	5.6	3.0
Real hourly compensation <u>5/6/</u>	-0.5	0.5	2.8	1.4
Real disposable income <u>6/7/</u>	-1.4	-1.0	3.0	1.0
Average propensity to consume (in percent) <u>7/</u>	77.9	79.2	78.3	79.1
Unemployment (in percent)	2.0	2.2	2.4	2.6

Manufacturing

Employment of regular workers	1.1	1.1	0.7	-0.1
Output	4.7	1.0	0.3	3.4
Productivity	3.7	--	0.1	3.0
Unit labor cost	3.6	5.5	5.5	--
Inventory ratio (in percent) <u>8/</u>	100.0	104.9	105.3	98.9

Basic Data (concluded)

	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u> ^{2/}
<u>Financial aggregates</u> (Percentage changes over previous year)				
M2 ^{9/}	9.2	8.9	9.2	7.4
Domestic credit ^{10/}	8.4 ^{4/}	10.0	8.2	7.1
Public sector	9.1 ^{1/}	13.0	5.2	3.0
Private sector	8.3	9.3	9.0	8.0
<u>Fiscal Aggregates</u> (Fiscal year basis, in trillions of yen)				
Central Government				
Revenues ^{11/}	28.9	31.4	33.2	35.0 ^{11/}
Expenditures	42.4	45.9	47.1	48.4 ^{11/}
Deficit (-)	-13.5	-14.5	-13.8	-13.3 ^{11/}
Deficit/GNP (in percent)	-5.6	-5.7	-5.2	-4.8 ^{11/}
Fiscal investment and loan program	18.1	19.4	20.6	20.7
General government				
Deficit/GNP (in percent)	-4.0	-3.7	-3.5	...
<u>Balance of payments</u> (In billions of U.S. dollars)				
Exports	126.7	149.5	137.7	145.7
Imports	-124.6	-129.5	-119.6	-114.0
Trade balance	2.1	20.0	18.1	31.7
Services and transfers	-12.9	-15.2	-11.2	-10.6
Current balance	-10.7	4.8	6.9	21.1
Net long-term capital ^{12/}	2.3	-9.7	-15.0	-17.6
Japanese	-10.8	-22.8	-27.4	-30.9
Foreign	13.1	13.1	12.4	13.3
Basic balance	-8.4	-4.9	-8.1	3.5
Net short-term capital	13.2	9.1	3.2	-2.3
Nonbank ^{13/}	-	2.7	3.2	2.2
Bank	13.1	6.4	-	-4.5
Overall balance	4.8	4.2	-4.9	1.2
<u>Gross official reserves</u> ^{14/} (At end of period, in billions of U.S. dollars)				
Total reserves	25.7	29.2	24.3	26.0
In months of imports of goods and services	1.8	1.9	1.7	2.7

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- 1/ At an exchange rate of US\$1 = ¥ 235.
2/ Staff estimates.
3/ Contribution to real GNP.
4/ Includes public and private.
5/ Regular employees in the manufacturing sector.
6/ Deflated by CPI.
7/ Workers' households.
8/ Index of the ratio of producers' inventory to shipment.
9/ Period average.
10/ End of period.
11/ Revised budget.
12/ Excluding Gensaki transactions.
13/ Including Gensaki transactions and errors and omissions.
14/ Including gold (national valuation).