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SM/89/75  
Correction 1

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INFORMATION

June 6, 1989

To: Members of the Executive Board  
From: The Acting Secretary  
Subject: Japan - Staff Report for the 1989 Article IV Consultation

The following corrections have been made in SM/89/75 (4/26/89):

Page 19, Table 5, line 2, columns 1-5: for "0.1 0.2 0.3 0.5 0.7"  
read " -- 0.1 0.1 0.2 0.2"

A corrected page is attached.

Att: (1)

Other Distribution:  
Department Heads

Table 5. Japan: Alternative Scenario--  
Deviations from Baseline, 1990-94

	1990	1991	1992	1993	1994
	<u>(In percent of GNP)</u>				
Gross investment	0.1	0.3	0.5	0.8	1.1
National savings	--	0.1	0.1	0.2	0.2
Current account	-0.1	-0.2	-0.4	-0.6	-0.9
	<u>(Percentage deviation)</u>				
Real GNP	0.2	0.4	0.7	0.8	1.1
GNP deflator	-0.1	-0.3	-0.6	-0.9	-1.3
Real domestic demand	0.2	0.6	1.1	1.5	2.1
Export volume	1.1	1.5	1.9	2.4	2.9
Import volume	1.2	2.6	4.2	5.7	7.3

Source: Staff projections.

## VI. Staff Appraisal

The Japanese economy has, once again, confounded even the most optimistic of forecasters: real GNP rose by nearly 6 percent in 1988, the highest rate in 15 years, despite a significant further withdrawal of external demand and without generating inflation. In the present environment of financial stability engendered by prudent policies, domestic demand and economic growth should remain strong. The pace of external adjustment, however, is expected to slow, or even come to a halt, owing largely to the dissipation of the effects of the earlier yen appreciation. While inflation does not pose an immediate threat, there is evidence of tightening in the goods and labor markets. Consequently, there is no case in Japan at present for action in the macroeconomic area to promote external adjustment. The authorities' intention of maintaining a neutral stance of financial policies in the period ahead is entirely appropriate.

The authorities have successfully taken advantage of the favorable revenue performance in recent years to advance fiscal consolidation. In addition, the Government has accomplished the long-sought objective of comprehensive tax reform which is expected to substantially improve the fairness and neutrality of the tax system. Notwithstanding the tax reform, staff estimates of the general government balance suggest that the surplus will still increase somewhat in 1989/90. This broadly neutral fiscal policy would be in line with the anticipated strength of domestic demand. Over the medium term, the authorities' cautious approach to fiscal management will help avoid a deterioration in the fiscal position arising from demographic factors.

Monetary policy has continued to be managed skillfully. While maintaining price stability, the monetary authorities have been able to keep domestic interest rates at relatively low levels, thereby helping to sustain domestic demand. Most recently, the tightening of monetary policy and the consequent rise of interest rates in the other major industrial countries has put downward pressure on the yen. However, so long as price stability is not undermined by the weakening of the yen, there is no compelling reason for the authorities to undertake similar monetary tightening. The longer-term movements of the exchange rate are difficult to anticipate. Given the large external imbalances among the major industrial countries and the favorable growth and inflation performance of Japan, upward pressures on the yen could well re-emerge. These pressures should not be resisted at the expense of price stability.

The correction of the global external imbalances will ultimately require adjustments in financial policies of the major deficit countries. Unilateral action by Japan to reduce its surplus would not be desirable from an international perspective, as the resulting rise in world interest rates would worsen economic conditions in industrial and developing countries alike. But Japan can reinforce the process of