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INFORMATION

April 26, 1989

To: Members of the Executive Board

From: The Secretary

Subject: Japan - Staff Report for the 1989 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1989 Article IV consultation with Japan, which is tentatively scheduled for discussion on Friday, May 26, 1989.

Mr. Aghevli (ext. 7177) or Mr. Marquez-Ruarte (ext. 7180) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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Department Heads

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INTERNATIONAL MONETARY FUND

JAPAN

Staff Report for the 1989 Article IV Consultation

Prepared by the Asian Department

(In consultation with other Departments)

Approved by P.R. Narvekar and L.A. Whittome

April 25, 1989

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I. Introduction

The 1989 Article IV consultation discussions with Japan were held in Tokyo from January 30 to February 15, 1989. 1/ Discussions were held with senior officials of the Ministry of Finance, the Bank of Japan, the Economic Planning Agency, the Ministry of International Trade and Industry, and other government departments and agencies. Mr. Yamazaki, the Executive Director for Japan, and Mr. Yoshikuni, the Alternate Executive Director, were present during the discussions.

II. Background to the Discussions

In concluding the previous Article IV consultation with Japan in March 1988, Executive Directors commended the authorities for the strong performance of the Japanese economy. Directors expected the economy to remain on its noninflationary growth path with domestic demand continuing to outpace the growth of output. They agreed that the accommodative stance of financial policies was appropriate from both domestic and international perspectives, and that a continuation of these policies, together with a further opening of Japan's markets and other structural reforms, would sustain the external adjustment. In the event, even this sanguine assessment of economic prospects fell short of the actual outcome in 1988: for the second year in a row, Japan achieved the highest rate of GNP growth and the lowest rate of inflation among the major industrial countries, with a substantial further reduction in its current account surplus (Table 1).

Japan's economic growth, which had rebounded to 4 1/2 percent in 1987, soared to 5 3/4 percent in 1988 (Table 2 and Chart 1). Stable financial conditions, together with the lagged effects of the yen appreciation, added further impetus to the process of economic restructuring that was already in full swing by mid-1987. Real domestic demand rose by 7 3/4 percent in 1988, while the external sector withdrew stimulus from output growth by the equivalent of 2 percentage points. Private consumption and residential investment increased sharply in response to the steady growth of disposable income, a renewed surge in equity share prices, and progressive improvements in the terms of trade. Business investment rose at an exceptionally high rate reflecting a pickup in fixed investment in the manufacturing sector and, to a lesser extent, an increase in inventory accumulation. Government expenditure rose by 4 1/2 percent in 1988, although it decelerated during the latter half of the year as envisaged in the budget.

1/ The mission consisted of Messrs. Narvekar, Aghevli, Marquez-Ruarte, Lipton, Dicks-Mireaux, Watanabe, Corker (all ASD), and Miss Boyd (secretary, ETR).

Table 1. Seven Major Industrial Countries:
Indicators of Economic Performance, 1985-90

	Actual			Projected	
	Average 1985-86	1987	1988	1989	1990
	(Annual growth rates, in percent)				
Real GNP/GDP					
Japan	3.7	4.5	5.7	4.5	4.4
United States	3.1	3.4	3.9	3.1	2.5
Germany, Fed. Rep. of	2.1	1.8	3.4	2.4	2.9
Canada, France, Italy, and United Kingdom 1/	2.8	3.2	3.6	2.9	2.6
Seven countries 2/	3.1	3.4	4.2	3.4	3.0
Real domestic demand					
Japan	4.0	5.2	7.7	5.0	4.9
United States	3.7	3.0	3.0	2.8	2.6
Germany, Fed. Rep. of	2.2	3.1	3.5	2.2	3.3
Canada, France, Italy, and United Kingdom 1/	3.5	4.0	4.3	3.3	2.6
Seven countries 2/	3.6	3.8	4.4	3.4	3.2
GNP/GDP deflator					
Japan	1.6	-0.2	0.5	1.4	1.2
United States	2.8	3.3	3.4	4.7	4.5
Germany, Fed. Rep. of	2.7	2.0	1.5	2.5	2.5
Canada, France, Italy, and United Kingdom 1/	5.3	4.3	4.4	4.7	4.0
Seven countries 2/	3.2	2.7	2.9	3.8	3.5
	(As percent of GNP/GDP)				
General government financial balance					
Japan	-0.9	0.6	1.1	1.6	2.0
United States	-3.3	-2.3	-1.8	-2.2	-1.7
Germany, Fed. Rep. of	-1.2	-1.8	-2.0	-0.6	-1.2
Canada, France, Italy, and United Kingdom 1/	-5.6	-4.6	-3.7	-3.6	-3.3
Seven countries 2/	-3.3	-2.3	-1.7	-1.5	-1.2
Private savings minus investment					
Japan	4.9	3.1	1.7	1.1	0.8
United States	0.3	-1.1	-1.0	-0.4	-1.1
Germany, Fed. Rep. of	4.7	5.8	6.0	4.7	5.0
Canada, France, Italy, and United Kingdom 1/	5.5	3.9	2.3	2.1	1.8
Seven countries 2/	2.7	1.5	1.0	1.1	0.7
Current account balance					
Japan	4.0	3.6	2.8	2.7	2.8
United States	-3.1	-3.4	-2.8	-2.7	-2.8
Germany, Fed. Rep. of	3.5	4.0	4.0	4.1	3.9
Canada, France, Italy, and United Kingdom 1/	-0.1	-0.5	-1.1	-1.2	-1.1
Seven countries 2/	-0.4	-0.4	-0.4	-0.4	-0.5

Source: Staff estimates for the world economic outlook exercise.

1/ Composites for the country groups are averages of individual countries weighted by the average U.S. dollar value of their respective GNPs over the preceding three years.
2/ Includes statistical discrepancies.

Table 2. Japan: Principal Indicators, 1986-89

	Calendar years				Fiscal years 1/		
	1986	1987	1988 2/	1989 2/	1987/88	1988/89 2/	1989/90 2/
Production, demand, and prices							
Real GNP (percent change)	2.5	4.5	5.7	4.5	5.2	5.0	4.6
Domestic demand	4.1	5.2	7.7	5.0	6.3	6.8	5.1
Private consumption	3.1	4.2	5.0	3.9	4.5	4.9	4.4
Residential investment	8.3	22.2	13.4	-0.8	25.6	2.4	0.7
Plant and equipment investment	5.8 3/	8.0	15.9	11.6	10.0	16.4	10.3
Government expenditure	5.3 3/	3.1	4.1	1.0	3.9	2.1	2.0
Stockbuilding 4/	-0.1	-0.4	0.2	0.2	-0.2	0.3	0.1
Net exports 4/	-1.4	-0.6	-1.9	-0.5	-1.1	-1.8	-0.5
GNP deflator (percent change)	1.8	-0.2	0.5	1.4	-0.2	0.6	1.5
CPI (percent change)	0.6	0.1	0.7	1.3	0.5	0.8	1.5
Industrial production (percent change)	-0.2	3.4	9.4	7.9	5.9	8.4	7.9
Unemployment rate (percent)	2.8	2.8	2.5	2.4	2.8	2.5	2.4
National saving (percent of GNP)	32.3	32.6	33.5	33.9	32.9	33.4	34.0
Gross investment (percent of GNP)	28.0	29.0	30.7	31.2	29.6	30.8	31.2
Fiscal and monetary indicators							
Central government balance (percent of GNP) 5/	...	...	...	...	-2.2	-2.3	-1.8
General government balance (percent of GNP)	-0.9	0.6	1.1	1.6	0.8	1.2	1.8
M2 plus CDs (percent change) 6/	8.2	11.5	10.4	10.0	11.8	10.1	10.0
Short-term nominal interest rate (average, percent)	5.0	3.9	4.1	5.0	3.8	4.3	5.0
Long-term nominal interest rate (average, percent)	4.9	4.2	4.3	5.3	4.2	4.5	5.3
Balance of payments							
Current account balance							
Billions of dollars	85.8	87.0	79.6	84.0	84.5	76.0	88.0
Trillions of yen	14.2	12.5	10.2	10.5	11.3	9.7	11.0
Percent of GNP	4.3	3.6	2.8	2.7	3.3	2.6	2.8
Trade data (percent change)							
Export volume	-0.6	0.3	5.1	5.9	0.7	5.8	6.1
Import volume	9.5	9.3	16.7	8.2	12.6	14.1	8.2
Export unit values (U.S. dollars)	19.7	9.2	10.8	5.2	9.9	8.4	5.3
Import unit values (U.S. dollars)	-10.9	8.1	7.7	5.4	14.6	5.0	4.6
Average exchange rates							
Yen per dollar	168.5	144.6	128.2	...	138.3	128.3	...
Nominal effective rate (MERM, 1985 = 100)	126.6	136.9	151.8	...	141.6	152.9	...
Relative normalized unit labor costs (1985 = 100)	121.4	124.1	130.6	...	126.4	...	...

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

1/ April-March.
2/ Staff estimates and projections; actual data if available.
3/ Growth rates were affected by the transfer of two large public enterprises to the private sector in April 1985.
4/ Contribution to GNP growth.
5/ General account.
6/ On the basis of the average level for the last month of each year.

Prices continue to be stable in Japan, but the underlying situation is becoming less favorable. After showing little change from early 1986 to early 1988, the consumer price index began to edge up slightly in mid-1988; it rose by 1 percent during the 12-month period ended in February 1989. Wholesale prices, which had declined sharply during 1985-87, stabilized in 1988 and began to rise modestly in early 1989. Furthermore, downward movements of import prices and production costs, which had contributed substantially to price stability in recent years, are being reversed. With the relative stability of the yen since early 1988, domestic prices of imported goods have begun to reflect more closely the continued increase in foreign prices. Unit labor costs in manufacturing, which also declined significantly during 1987-88, have stabilized. At the same time, domestic supply constraints have become more binding. The unemployment rate has remained at about 2 1/2 percent since early 1988, while the ratio of job offers to applicants has registered exceptionally high levels since mid-1988. Capacity utilization in manufacturing has increased steadily since early 1987, reaching record levels in late 1988. On the positive side, the profit position of the corporate sector has remained strong and is serving to cushion cost increases.

The adjustment of the external sector continued in 1988, although its pace slowed in the latter half of the year (Chart 2). With import volume rising by 17 percent, the ratio of imports to GNP (in 1985 prices) rose by over 1 percentage point in 1988. Particularly significant was the rise in imports of manufactures (30 percent), which further increased the share of this category of imports in the total to 50 percent--compared with only 30 percent in 1985. Export volume, which had stagnated during 1986-87, rose by 5 percent owing to strong world demand for capital goods, particularly machinery and office automation equipment, of which Japan is a major producer. Overall, the real trade surplus (in 1985 prices) fell by a further 1 1/4 percent of GNP, bringing the cumulative decline since 1985 to 3 1/2 percent of GNP. However, higher prices of traded goods limited the decline in the nominal trade surplus to only 3/4 percent of GNP. The deficit in the invisibles account widened sharply as a result of a substantial increase in travel payments which more than offset a rise in investment income. The current account surplus further declined to 2 3/4 percent of GNP ($80 billion) in 1988, signifying substantial adjustment in relation to the peak surplus of 4 1/2 percent of GNP ($86 billion) in 1986.

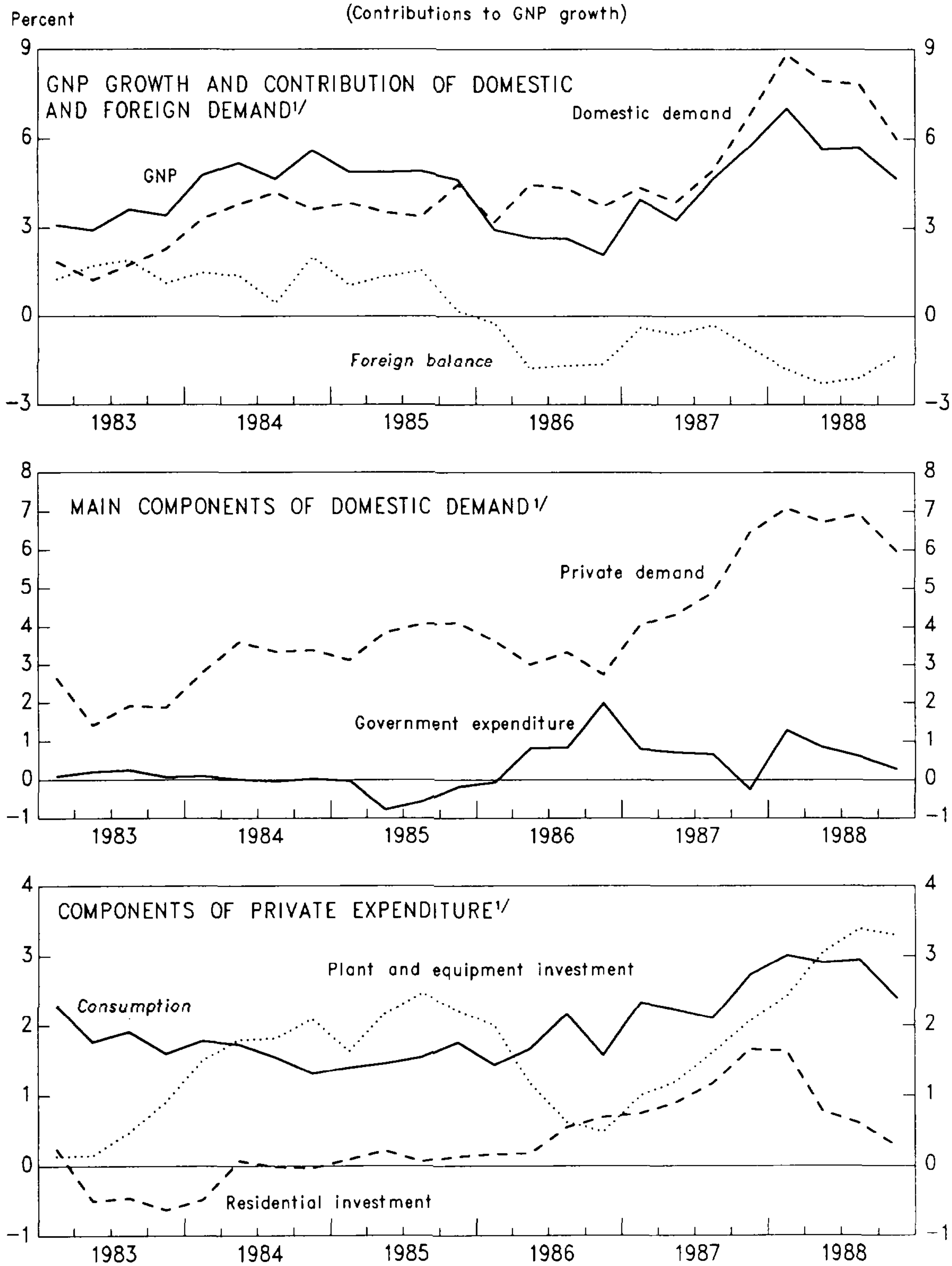
The capital account continued to be characterized by a sizable deficit in long-term flows and a substantial surplus in short-term flows. The long-term deficit remained at about $130 billion in 1988, with investment in securities comprising the largest component of these flows. Japanese residents added to their portfolio of foreign securities, mainly in the form of bonds, in the amount of $87 billion. At the same time, foreigners increased their holdings of Japanese securities by $20 billion. Also notable was the expansion of Japanese direct investment abroad, which rose by three fourths to $34 billion in

CHART 1

JAPAN

SELECTED GNP AGGREGATES, 1983-88

(Contributions to GNP growth)



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

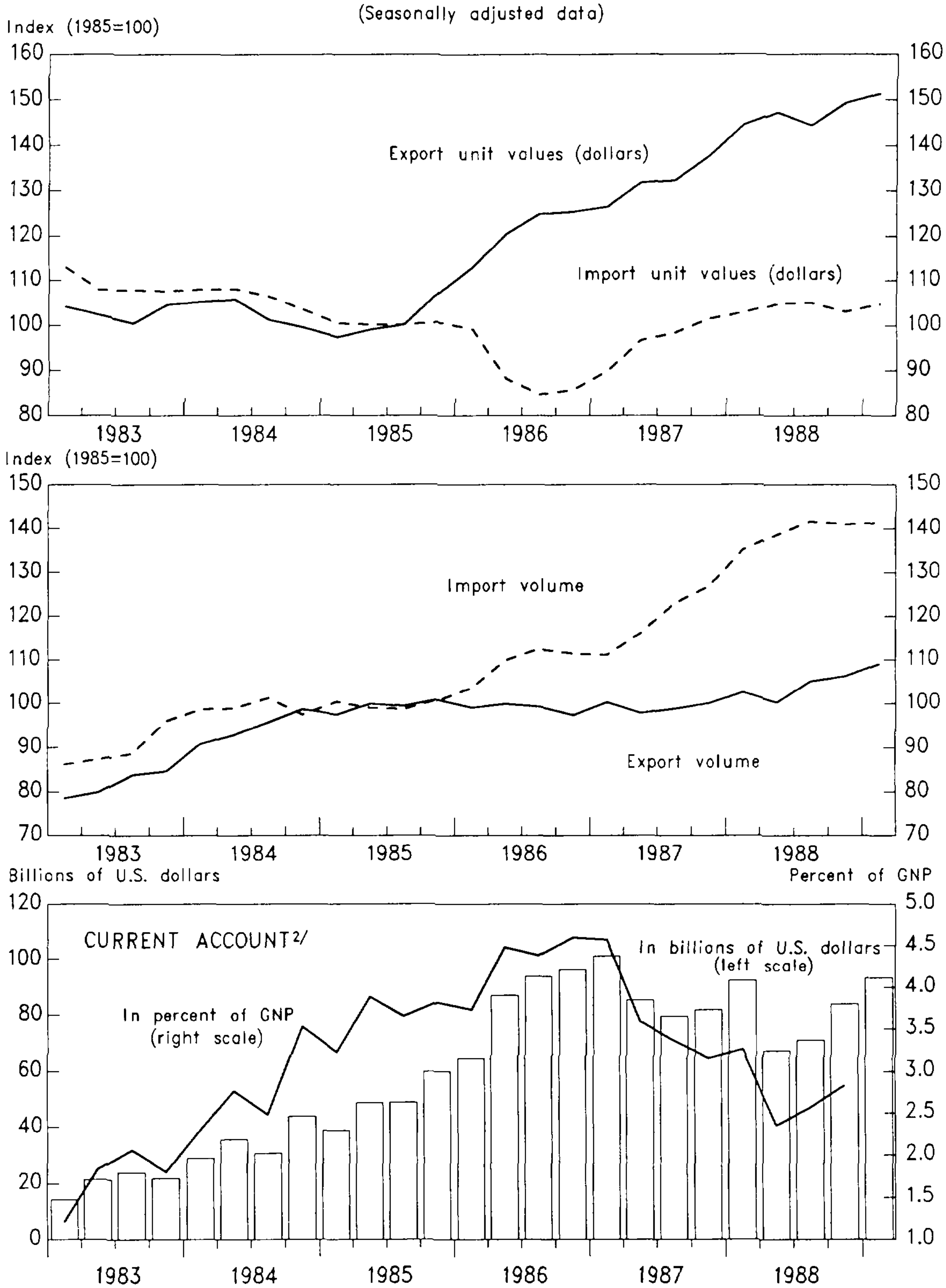
1/ Change from same quarter of previous year as percent of GNP in the base period

CHART 2

JAPAN

BALANCE OF PAYMENTS, 1983-89 1/

(Seasonally adjusted data)



Sources: Data provided by the Japanese authorities; and IMF, *International Financial Statistics*.

1/ First quarter 1989 values are based on data for January-February 1989.

2/ Quarterly data at seasonally adjusted annual rates.

1988. The available data suggest that, in recent years, more than half of direct investment has taken place in the United States, with much smaller shares (15-20 percent) invested in Europe and Asia. Within Asia, direct investment has been concentrated in China, the newly industrializing economies, and other exporters of manufactures in Southeast Asia. A considerable portion of the long-term deficit was financed through short-term borrowing ($64 billion) by domestic commercial banks, highlighting the large scale of financial intermediation undertaken by Japanese institutions in world capital markets.

The increase in official international reserves was limited to $16 billion in 1988, down sharply from the $39 billion increase in 1987, reflecting a smaller scale of intervention in a relatively calm foreign exchange market. Following the turbulent period of 1985-87, the yen has fluctuated against the U.S. dollar in a relatively narrow range of 120-135. Nevertheless, on an annual average basis, it still appreciated by about 6 percent in real effective terms in 1988 (Chart 3).

Asset prices increased sharply during 1988. Stock prices began to recover in early 1988 and, by the end of March 1988, the Nikkei 225 Stock Index had returned to the level prevailing before the stock market decline of October 1987. In the following 12 months, the Nikkei index rose by a further 25 percent. Land prices have also increased substantially. Although the market for land has turned down in central Tokyo, price pressures have intensified in other large cities. The price of urban land in residential areas of the six largest cities increased by almost 20 percent during 1988, bringing the cumulative increase since 1985 to over 100 percent. It is difficult to explain the dramatic rise in asset prices in Japan entirely by reference to economic fundamentals, but the following factors have probably played significant roles: the underlying strength of the economy; the relatively low level of interest rates; and, in the case of real estate, the increased demand for office space and the housing boom.

III. Financial Policies and Short-Term Prospects

The main policy challenge facing the authorities is to preserve the conditions for sustained growth while pushing ahead with structural reforms that will improve welfare at home and promote international harmony. Prudent financial policies and the underlying strength of private domestic demand will likely maintain the economy on its noninflationary growth path. External adjustment, however, is slowing perceptibly in Japan as in the other major industrial countries. The strategy for external adjustment in Japan will necessarily have to give consideration to the policy environment in deficit countries, as well as to the strength of demand and price pressures at home. While economic policies must help sustain an adequate growth of domestic demand, efforts by Japan to reduce its surplus through expansionary financial policies, particularly fiscal stimulus, could be counterproductive as they would result in upward pressures on prices and interest rates in Japan and abroad. By contrast, there is substantial scope for infusing new vigor into the implementation of structural policies.

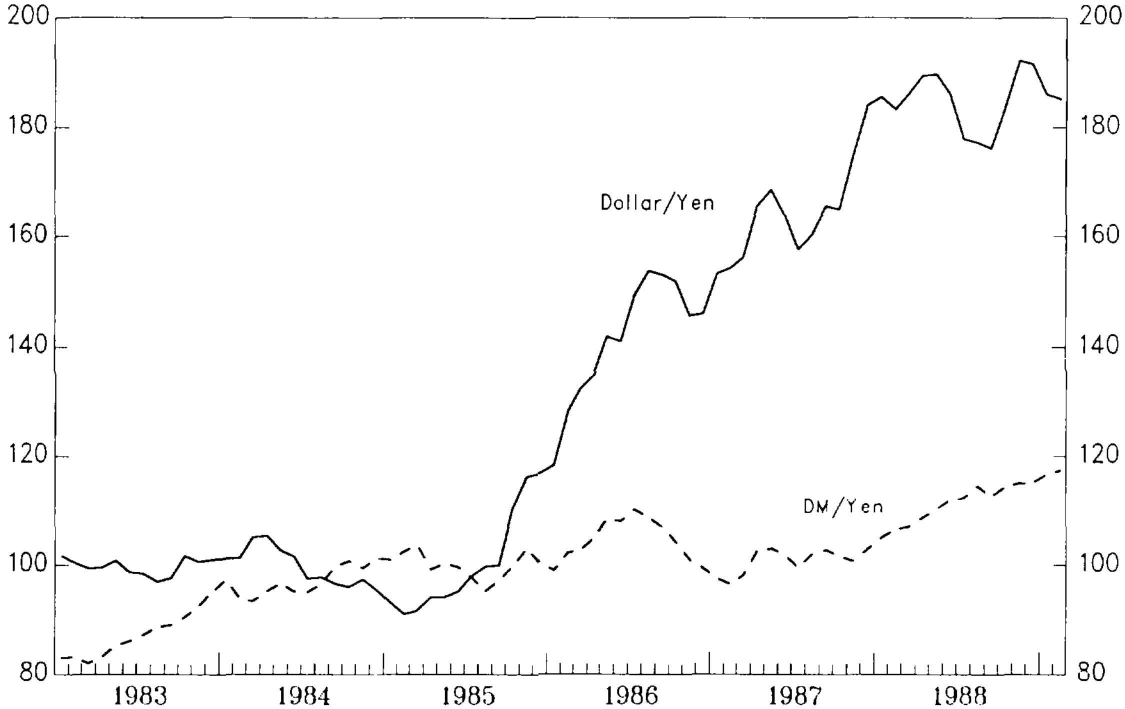
1. Fiscal policy

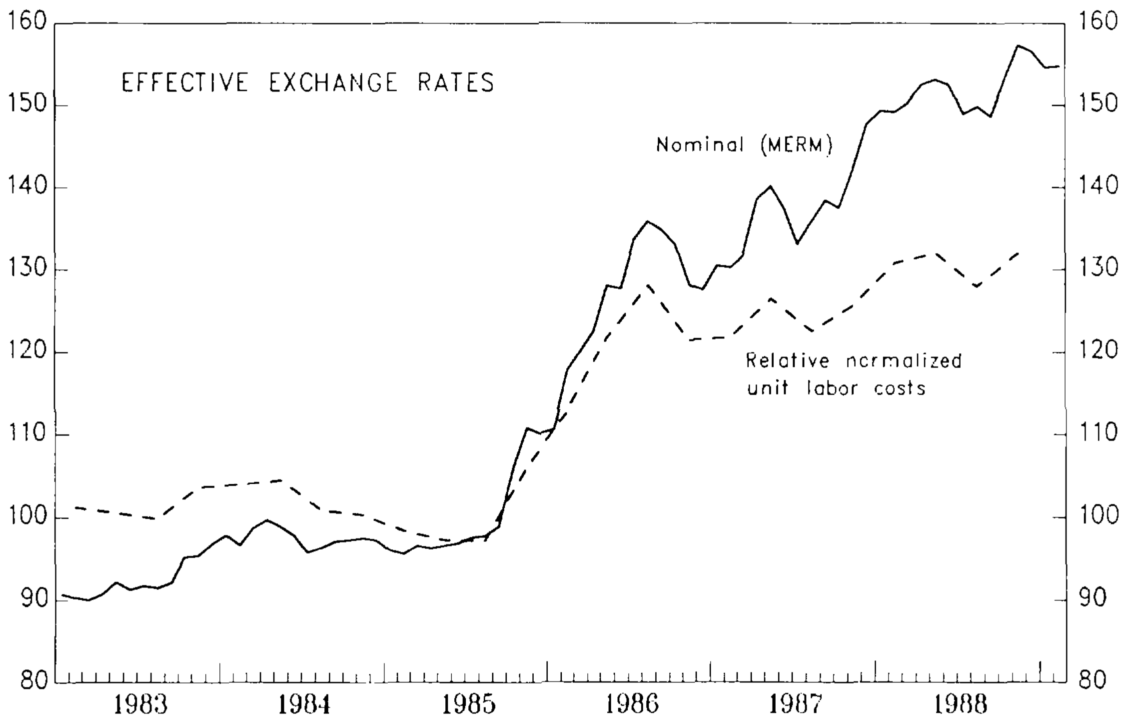
Fiscal policy has been remarkably successful during the 1980s in redressing the sharp deterioration in the Government's financial position that had occurred in the late 1970s. The general government balance has improved progressively from a deficit of 4 1/2 percent of GNP in 1979/80 (April-March) to an estimated surplus of 1 1/4 percent in 1988/89. 1/ This improvement has mirrored a rise of over 6 percentage points in the revenue-GNP ratio that has been associated with the high elasticity of the tax system and increased social security contributions. While efforts have been made to restrain spending, the ratio of general government spending to GNP has increased slightly because of nondiscretionary expenditures, including interest and social security payments.

Within the overall framework of consolidation, fiscal policy in recent years has been directed to support the process of economic restructuring that was kindled by the sharp appreciation of the yen since late 1985. Following the economic slowdown in 1986, the authorities undertook to promote economic recovery and external adjustment by introducing, in May 1987, a stimulus package. This package, which amounted to over 1 1/2 percent of GNP, included additional public investment and lending as well as a tax cut. The expansion of public investment, however, was combined with continued restraint in consumption expenditure. Moreover, revenue rose much faster than expected, largely because of a surge in asset prices and trading volumes. As a result, the general government balance swung from a small deficit to a surplus of nearly 1 percent of GNP in 1987/88 (Table 3). In view of the strong recovery of the private sector in late 1987 and the subsequent economic boom, the 1988/89 budget envisaged a slowdown in the growth of government spending--both consumption and investment. Subsequently, as an early step in the process of comprehensive tax reform, a substantial income tax cut was introduced in July 1988. Government revenue, however, remained relatively buoyant because of rapid economic growth. Staff estimates suggest that the general government surplus increased by 1/2 percent of GNP in 1988/89.

1/ The general government balance is available up to 1987/88 from official national accounts data; for 1988/89, this balance is estimated by the staff on the basis of the budgets for the General Account of the central government and the Fiscal Investment and Loan Program (FILP), the Finance Plans for local governments, and various special accounts, including social security funds.

CHART 3
JAPAN
EXCHANGE RATE DEVELOPMENTS, 1983-89
(Index. 1985=100)





Sources: IMF, *International Financial Statistics*; and staff calculations

Table 3. Japan: Selected Fiscal Indicators, 1984/85-1989/90

	1984/85	1985/86	1986/87	1987/88	1988/89 1/	1989/90 1/
			(Percentage changes)			
General government						
Expenditure	3.9	4.9	5.2	4.6	2.8	4.6
Consumption	5.3	4.1	5.7 2/	1.4	2.5	3.7
Investment	-1.8	2.0	5.4	13.6	2.0	2.8
Revenue	7.6	8.6	6.7	8.4	3.9	6.7
Central government general account						
Expenditure	6.4	3.0	1.2	5.5	4.9 3/	1.7 4/
Revenue	7.4	6.6	8.1	11.1	3.9 3/	4.9 4/
			(In percent of GNP)			
General government						
Expenditure	32.4	32.1	32.4	31.3	32.4	31.0
Of which: Consumption	9.8	9.7	9.7 2/	9.4	9.1	8.9
Investment	5.0	4.8	4.9	5.3	5.1	4.9
Revenue	30.6	31.3	32.1	33.2	32.6	32.8
Balance	-1.8	-0.8	-0.3	0.8	1.2	1.8
Central government general account						
Expenditure	17.0	16.5	16.0	16.1	16.0	15.3
Revenue	12.6	12.7	13.1	13.9	13.7	13.5
Deficit	4.4	3.8	2.9	2.2	2.3	1.8
Of which:						
Deficit financing bonds	2.1	1.9	1.5	0.7	0.5	0.3
Public sector balance	-4.1	-2.9	-2.3	-0.9	...	...

Sources: Ministry of Finance, Financial Monetary Statistics Monthly, April issues, 1985-88; and Economic Planning Agency, Annual Report on National Accounts, 1989; and staff estimates and projections.

1/ Staff estimates and projections for general government.
2/ Government consumption was affected by large purchases of gold for the minting of commemorative coins.
3/ Revised budget for 1988/89 over 1987/88 settlement.
4/ Proposed budget for 1989/90 over revised budget for 1988/89.

An important achievement has been the comprehensive reform of the tax system which was approved by the Diet in December 1988, following several unsuccessful attempts by previous governments. A consumption (value-added) tax of 3 percent has been imposed on goods and services (effective April 1989); this tax has replaced most of the selective commodity taxes which applied primarily to consumer durables. A number of revisions in direct taxes, which are expected to reduce revenue on a net basis by about 1 percent of GNP (full-year basis), also have been introduced. The personal income tax has been rationalized through reductions in both the number of tax brackets and the top marginal rate (from 60 percent to 50 percent), as well as through raising exemptions and deductions; part of this reform was introduced in July 1988, on a temporary one-year basis. The corporate tax rate has been reduced from 42 percent to 40 percent in 1989/90, and will fall further to 37.5 percent in 1990/91. The inheritance tax structure also has been adjusted through raising the threshold level, widening the tax brackets, and lowering the maximum rate. In addition, capital gains from stock transactions have been made subject to the personal income tax, at special rates. While broadening the tax base, the reform is expected to lower revenue, on balance, by 1/2 percent of GNP a year once the reform is fully implemented. 1/

The reform was designed to address a number of problems that had emerged with the tax system since its inception in 1950. The system had become unduly reliant on direct taxation, placing a heavy burden on middle-income salaried workers. There had also been a growing concern that a large number of self-employed persons were evading their tax liabilities. Furthermore, the system of selective indirect taxes had become increasingly outdated because of the widening range of consumer goods and the growing importance of services. By broadening the tax base, eliminating most selective taxes, and reducing the level and dispersion of tax rates, the reform has enhanced the neutrality and the horizontal equity of the system. The reduction in the income tax burden has increased neutrality with respect to the work-leisure choice, and brought corporate tax rates more in line with those in the other industrial countries. Furthermore, the new consumption tax has spread the burden of taxation more evenly. It has also increased the Government's flexibility in raising the necessary resources to meet higher future outlays associated with the aging of the population.

The recent improvements in the fiscal position have placed well within reach the Government's objective of ending, by 1990/91, the reliance on bond financing of the current deficit of the central government general account. Such borrowing has been reduced rapidly from 3 percent of GNP in 1980/81 to an estimated 1/2 percent of GNP in 1988/89. As a result, the ratio of deficit financing bonds to GNP has

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1/ The forthcoming report on recent economic developments contains a more detailed description of the tax reform.

stabilized at about 18 1/2 percent. Nonetheless, the authorities believe that the fiscal position will remain under considerable strain over the coming years. They believe that the recent budgetary improvements are largely associated with transitory factors: tax revenues have been high because of exceptionally active stock and real estate trading, while expenditures have been restrained, in part, by measures to defer spending. They are also concerned that the present high level of national government debt--equivalent to 43 percent of GNP--restricts their flexibility in fiscal management. Furthermore, social security costs are expected to increase substantially over the longer term owing to demographic factors. Therefore, the authorities see a continued need for fiscal restraint over the medium term.

In line with the authorities' consolidation objectives over the medium term, and in light of the anticipated strength of private domestic demand in the short term, fiscal policy is expected to remain broadly neutral during 1989/90. Both current and capital expenditures are budgeted to rise moderately, but to fall slightly in relation to GNP. Revenue is expected to grow broadly in line with GNP. Staff estimates of the general government balance for 1989/90 indicate that the surplus would increase further by 1/2 percent of GNP to over 1 3/4 percent of GNP.

During the discussions, the authorities expressed reservations about the appropriateness of the general government balance for analyzing fiscal developments in Japan. In their view, this concept understates the severity of Japan's fiscal situation because it includes the social security funds, which enjoy large surpluses at this time, but excludes the public enterprise sector, which has a large deficit. The staff noted that the deficit of the public enterprise sector, while substantial, has remained within a narrow range of 2-2 1/2 percent of GNP during the 1980s. 1/ The overall position of the public sector has, therefore, moved broadly in line with that of the general government.

2. Monetary and exchange rate policies

Domestic interest rates have remained low, and broadly stable, since early 1988. The official discount rate, which was last lowered in February 1987, remains at 2.5 percent. The rate on three-month certificates of deposits has fluctuated within a range of 4-5 percent since the end of 1987. This rate has generally risen in periods of depreciation of the yen and fallen in periods of appreciation, responding to changes in monetary conditions abroad as well as to shifts in investors' demand for yen-denominated assets. The term structure of interest rates has not changed significantly: long-term rates have

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1/ In 1987/88, the deficit of the public enterprise sector declined to below 2 percent of GNP, partly reflecting the privatization of the Japan National Railways.

generally exceeded short-term rates by 1/2-1 percentage point (Chart 4).

The rate of growth of broad money (M2 plus CDs), which had picked up from about 8 1/2 percent in 1986 to over 12 percent in early 1988 (year-on-year), eased to 10 1/2 percent in early 1989. The sharp increase in the demand for broad money has been due to the rapid growth of real income and wealth, as well as effects of financial liberalization, particularly the relaxation of rules relating to the maturity and size of bank deposits with market-related yields. 1/ In the absence of significant inflationary pressures, the authorities have tolerated the relatively high rates of monetary expansion, while maintaining a constant watch on price developments. During the discussions, Bank of Japan officials expressed some concern that the high level of monetary holdings could fuel inflation should inflationary expectations rise. Monetary expansion is anticipated to decelerate somewhat in 1989 as the recent steep increases in income and wealth level off, although the demand for deposits with market-related yields should remain strong owing to the latest liberalization measures.

Price stability will continue to be the primary objective of monetary policy. With subdued price pressures in recent years, the authorities have been able to maintain domestic interest rates at a relatively low level, thus supporting domestic demand. However, Bank of Japan officials noted that their freedom to pursue a relaxed monetary policy had diminished considerably because of the substantially increased potential for inflation in 1989. They did not see, at the time of the discussions, a need to follow the other major industrial countries in tightening their monetary stance, given inflation and exchange rate developments. While higher interest rates on U.S. dollar-denominated assets could put downward pressure on the yen, these pressures were likely to be short-lived in view of the inflation differential between Japan and the United States. The authorities also ruled out the likelihood of a significant yen appreciation, which they viewed to be counterproductive, given the substantial appreciation of the yen since 1985. They emphasized that exchange rate policy will continue to be managed within the framework of policy coordination among the Group of Seven countries, which was regarded to have been instrumental in stabilizing exchange rates.

The Bank's ability to conduct monetary policy has been enhanced by the introduction, in November 1988, of a reform of the interbank market and related changes in the Bank's operating procedures. Prompted by increasing difficulties in influencing domestic interest rates through its customary operations in two-month private bills, the Bank removed maturity restrictions within the interbank market and shifted the focus

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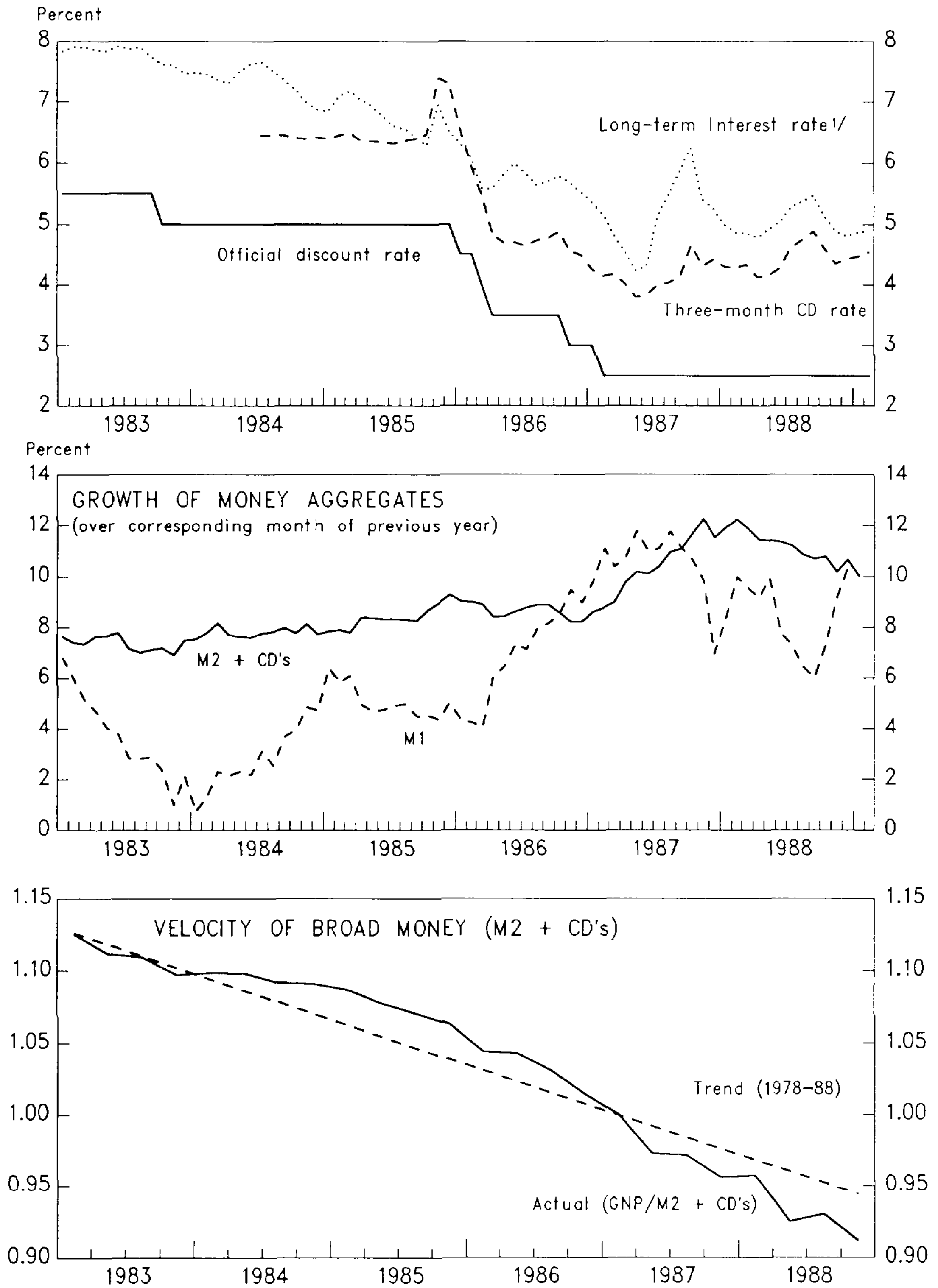
1/ The forthcoming report on recent economic developments describes in more detail the factors underlying the demand for broad money.

CHART 4
JAPAN
INDICATORS OF THE STANCE OF MONETARY POLICY, 1983–89



Sources: Data provided by the Japanese authorities; Nihon Keizai Shimbun databank; and staff estimates.

1/ Nikkei index of long-term bond yield in secondary markets.

of its operations to assets with shorter maturities (one to three weeks). The authorities expect that these changes will promote a closer interest rate arbitrage between interbank and open markets, as well as between domestic and offshore markets. They also intend to manage the official discount rate more flexibly in the future, thus strengthening its role.

3. Short-term prospects

Staff projections for 1989, which are based on the global assumptions of the World Economic Outlook, place real GNP growth at about 4 1/2 percent. Domestic demand is projected to grow by 5 percent on the basis of stable growth of consumption, some slowdown in residential and business investment, and little growth in government spending. The external sector would continue to withdraw stimulus, albeit by only 1/2 percent of GNP. With the unemployment rate staying at about 2 1/2 percent, wage increases would accelerate slightly (to 5 percent), but remain close to productivity growth; as a result, unit labor costs would be stable. Consumer price inflation would pick up temporarily because of the introduction of the consumption tax in April and higher import prices. However, given the solid profit position of enterprises, the inflation rate should be contained to below 2 percent in 1989.

The external current account surplus, according to the staff projections, would rise to $84 billion in 1989, but remain stable in relation to GNP. The reversal in the recent declining trend of the nominal surplus reflects a tapering off of the effects of relative price adjustments as well as the slowdown in domestic demand. The staff projection envisages an acceleration in export volume growth to 6 percent, and a deceleration in import volume growth to 8 percent in 1989--despite some allowance made for improvements in the access of exports to the Japanese market. This convergence of the rates of volume growth, together with an increase of about 5 percent in both export and import prices, results in a small widening of the trade surplus to $98 billion. Finally, an increase in net investment income receipts is expected to offset a significant rise in travel payments, so that the invisibles deficit declines slightly.

The authorities have expressed reservations about the staff projections for 1989. In their view, the rate of growth of output will be closer to 4 percent (fiscal year basis) on account of a somewhat weaker expansion of domestic expenditure--particularly for private fixed investment--and a stronger withdrawal of external stimulus than in the staff forecast. They also project the current account surplus to decline to $71 billion in 1988/89. The authorities expect import volume to rise faster than that projected by the staff owing to structural changes, including an increase in the income elasticity of import demand and greater penetration of exports from the Asian NIEs and from overseas subsidiaries of Japanese producers. In addition, they expect non-oil commodity prices to rise faster, and investment income slower, than in the staff projections.

The staff acknowledged that its projections were subject to uncertainties emanating from both external and domestic sources. In particular, every $1 per barrel increase in petroleum prices over the WEO assumption of $15 would reduce the surplus by about $1 1/4 billion, while every 1 percentage point fall in world interest rates would reduce it by about $4 billion. There is also uncertainty about import demand, which has increased rapidly in recent years owing partly to structural shifts. These shifts, however, appear to be mainly associated with an increase in the relative-price elasticity, rather than the income elasticity of import demand. 1/ Consequently, in the absence of further relative price or structural changes, imports are unlikely to continue to grow at the pace of recent years.

IV. Structural Policies

The Five-Year Economic Plan (1988/89-1992/93) issued in May 1988 fully endorsed the earlier recommendations on structural reforms contained in the Mayekawa Commission's pioneering study (issued in May 1986) and, subsequently, in the Economic Council's report (May 1987). The Plan sought the removal of various deficiencies in the tax system, the financial sector, social infrastructure, land management and housing, and the trade and distribution systems. The Plan also called for an increased flow of financial resources to the developing countries. Substantial progress has already been made in the areas of tax reform (as already discussed) and financial liberalization, but reforms in other areas have been more limited. The authorities recognize the pressing need for accelerating the pace of implementation of structural policies in order to improve economic efficiency and growth and the quality of life, as well as to facilitate external adjustment.

1. Financial liberalization

The authorities have pressed ahead with their program of financial liberalization by progressively relaxing the restrictions on the size and maturity of instruments that bear market-related interest rates. During 1988, the Government further reduced the limitations on bank deposits that are issued at market interest rates. The minimum denomination for certificates of deposit and for large time deposits has been lowered substantially. Also, under a new system that will be phased in between June and October of this year, commercial banks as well as the postal savings system (PSS) will be allowed to issue small-scale money market certificates. In addition, the permissible maturity range of these three instruments has been extended significantly. On the lending side, commercial banks introduced, in early 1989, a new

1/ This point is discussed in more detail in the forthcoming report on recent economic developments.

arrangement for the determination of the short-term prime rate. This rate, which was previously set at 7/8 of a percentage point over the official discount rate, is now linked to a basket that contains both market and regulated interest rates. Another significant measure has been the introduction (in April 1989) of a competitive bidding system in the primary market for ten-year government bonds.

A full liberalization of interest rates will require a further reform of the postal savings system. Under current regulations, the PSS, which is under the jurisdiction of the Ministry of Posts and Telecommunications, enjoys a number of advantages over banks in offering higher yields on small deposits, although it is subject to certain restrictions on the investment of its funds. Officials of the relevant ministries are exploring various means of removing existing distortions in the flow of funds to the PSS and private financial institutions.

2. Social infrastructure

Investments in social overhead capital--which have declined significantly in relation to GNP during the 1980s--appear to offer an attractive social rate of return. Indeed, the Five-Year Economic Plan places particular emphasis on social overhead investments to remove deficiencies in important areas, including roads, air transport, and certain public amenities. Investment in these areas would help ensure an adequate stock of social overhead capital in the longer term when demand for social services is expected to increase and the savings rate to decline because of demographic factors. While the private sector will continue to contribute to improvements in the social infrastructure, the Government will need to take the lead--either directly through additional public investment or indirectly through the provision of adequate incentives--in those areas in which the social rate of return is high but cannot be fully captured in the market. The staff agreed with the authorities that, under present capacity constraints, it would not be advisable to speed up public investment in the short term. Any increase in public investment would have to be planned in a medium-term context with due regard to supply constraints.

3. Land management and housing policies

The scarcity of land is a key obstacle to improvements in the quality of life in Japan. The effects of land scarcity are magnified by the heavy concentration of population and economic activity in a few metropolitan areas, particularly Tokyo, as well as by distortions arising from regulations governing the use and taxation of land. As regards the problem of concentration, a basic goal of the Fourth Comprehensive National Development Plan, adopted in June 1987, is to establish alternative foci for economic activity so as to relieve pressures on existing centers. Accordingly, the Act for Establishing the Multipolar Pattern of Land Use was passed in 1988; this law is aimed at promoting the relocation of state and private facilities, the development of rural areas, and the establishment of an efficient transportation network. To realize these objectives, the Government will provide low interest loans and tax incentives and undertake public infrastructure investment.

A more efficient allocation of land will also require changes in the regulatory and tax framework. The "Basic Law on Land," currently under preparation, is expected to give particular attention to the public nature of land and its implications for social welfare. During the discussions, government officials indicated three aspects of the regulatory framework that needed to be reviewed: zoning regulations designating land for urban development or agricultural use; zoning regulations applying to already established urban areas; and building codes restricting the ratio of floor space to lot size. They also felt that legal practices regarding the leasing of land needed to be examined to ensure that privileges extended to tenants do not inhibit the active utilization of land. As for taxes, the Mayekawa and other reports have emphasized that the present structure of land taxes acts as an additional impediment to the development of urban land. Both property and inheritance taxes are substantially lower for agricultural land than for residential land. This tax treatment provides an incentive for maintaining agricultural land in prime urban areas rather than developing it for housing or office use.

4. Trade system

Earlier staff reports on Japan, document the substantial liberalization of trade in manufactured goods during recent years, which has virtually eliminated formal restrictions on these goods. However, there are still heavy restrictions applying to trade in agricultural goods, particularly cereals. 1/ Protection of agriculture has preserved a costly system of farming characterized by a multitude of inefficiently cultivated small plots, and has driven up domestic prices to levels well in excess of international prices.

The authorities recognize the need for the reform of the agricultural sector. The stage for such a reform has been set by the Government's acceptance of the principle that the differential between domestic and international prices should be reduced, and the subsequent lowering of administrative prices for many commodities, including rice. Other important recent steps include decisions to gradually abolish import quotas for beef, oranges, and other products and to lower tariffs on tropical products. It is evident, however, that a much fuller agricultural reform is needed to improve domestic resource allocation and consumer welfare as well as to ease trade tensions with the other countries.

1/ The forthcoming report on recent economic developments provides a more detailed discussion of Japan's agricultural policies.

In the area of trade in manufactured goods, the staff expressed concern about a recent arrangement under which Korean exports of knitwear to Japan are subject to voluntary restraints. The authorities indicated that this arrangement had been worked out by the respective Korean and Japanese industries and did not involve the Japanese Government. They considered the restraint on Korean exports of knitwear to be an exceptional case and unlikely to be emulated by other industries.

For their part, the authorities were worried about the increasing number of anti-dumping cases that were being considered by the European Community (EC) against Japanese exports. The continuing trade frictions, particularly the dispute over local sourcing of parts, were likely to discourage Japanese direct investment in the EC. As for trade with the United States, the authorities expressed the hope that the U.S. Government would enforce the provisions of the new trade bill prudently and avoid a protectionist interpretation that could adversely affect Japanese exports.

In discussing the current Uruguay Round of GATT negotiations, the authorities noted that substantial progress had been made in many areas during the mid-term review in Montreal last year, including trade in tropical products, tariff reform, and trade in services. Following these meetings, Japan had offered to liberalize imports of 180 tropical products by reducing tariffs and lifting quantity restrictions. These liberalization measures became effective in April 1989. Japan had also pushed for an ambitious target for tariff reductions during the Uruguay Round; the authorities were satisfied with the agreed target, which aims at a reduction equal to that agreed at the Tokyo Round. The Montreal meeting had also yielded a significant agreement on the general principles that should govern trade in services.

5. Distribution system

Japan's complicated distribution system is often blamed for adding to costs and prices of domestic goods and for inhibiting market access. The higher level of prices in Japan relative to the other industrial countries is partly attributable to the differential in the quality of goods (including aftersale service). But rigidities in the distribution system also add to domestic costs and prices. These rigidities are, to a large extent, a by-product of long-standing customs and voluntary practices that are changing gradually in the wake of economic restructuring. The authorities cited the rapid growth of consumer imports in recent years as evidence that the distribution system did not discriminate against imports.

The authorities are nonetheless cognizant of the need to deregulate the distribution system. One key area is the reform of the Large-Scale Retail Store Law, which has inhibited the entry and expansion of large stores and possibly led to diseconomies associated with a retail system dominated by small stores. The Government is preparing to streamline the administration of the law, and a joint council comprised of representatives from both industry and retailers is currently formulating specific recommendations.

6. Flow of financial resources to the developing countries

As a prosperous nation with a large external surplus, Japan has a special responsibility to provide, and facilitate the flow of, financial resources to the developing countries. Japan's official development assistance (ODA) has increased broadly in line with GNP in recent years. In 1987, Japan's ODA amounted to 0.31 percent of GNP, compared with an average of 0.35 percent for the OECD countries. With the substantial appreciation of the yen since 1985, the dollar value of ODA disbursements rose sharply to $7.5 billion in 1987, placing Japan as the second largest donor. The Fourth Mid-Term Target for ODA, established in June 1988, calls for disbursements of $50 billion during 1988-92, which would broadly maintain the ratio of ODA to GNP at its current level. The authorities also intend to continue to improve the financial terms of ODA, including the grant element of aid to the least developed countries which has been below that provided by the other major donors.

The authorities have also made a strong effort to increase financial flows other than ODA, and to contribute to finding a solution to the international debt problem. To this end, they have steadily implemented the $30 billion recycling plan which was introduced in May 1987; by early 1989, 85 percent of the funds allocated to the recycling plan had been committed. They have also provided major support to the multilateral institutions through contributions to the enhanced structural adjustment facility of the Fund and the Special Facility for sub-Saharan Africa of the World Bank, and through arrangements to provide parallel financing to countries undertaking structural adjustment efforts.

V. Medium-Term Outlook

Japan has great potential for sustaining its noninflationary growth over the medium term while achieving further external adjustment. The extent to which this potential will be realized will depend, inter alia, on developments in international markets and on the pace of structural reforms. The effects of structural reforms are particularly difficult to quantify because these reforms alter the very nature of the structural relationships that form the basis of any projection exercise. Nevertheless, the staff has constructed two scenarios that are designed to illustrate the possible effects of structural policies on the rate of growth and the balance of payments in Japan.

Both scenarios incorporate the world economic outlook assumptions for the international economy. On the domestic front, the first scenario assumes a continuation of prudent financial policies and moderate improvements in the area of structural reforms. Under this scenario, real GNP would rise by an annual average of 4 1/4 percent during 1990-94, without an appreciable change in the rate of inflation. The current account surplus would remain at about 2 1/2 percent of GNP, as domestic investment and savings patterns remain unchanged; in nominal terms, the surplus would rise to about $125 billion by 1994 (Table 4).

The alternative scenario differs from the first only in that it assumes a faster implementation of structural reforms discussed in the previous section. 1/ These reforms would all have a positive effect on Japan's economic growth and welfare, but their impact on the external position would depend on the specific nature of reform. Higher investments in social infrastructure would narrow the investment-savings gap and thus reduce the surplus. Reforms relating to the distribution system and to trade in agriculture would prompt a shift in the pattern of demand in favor of imports and reduce the surplus in the short term. However, with the resumption of resources released from the domestic sector into the export sector, the current account balance is likely to gradually revert to its initial position. The effect of land policies on the external position is less clear cut: on the one hand, better land management would encourage investment in housing and urban development and thereby reduce the surplus; on the other hand, any resulting decline in the price of housing would reduce wealth and thereby consumption, leading to an increase in the surplus.

The alternative scenario envisages three structural shifts to result from the implementation of reforms. First, the ratio of investment to GNP is assumed to rise by 1 percentage point during 1990-94 because of higher levels of investment in social overhead capital, including housing (Table 5). Second, with reforms in the distribution system and in agricultural trade, a higher share of consumption is to be satisfied by imports. Third, the rate of productivity growth is assumed to rise by 1 1/4 percentage points during the period because of the improved efficiency resulting from all of the reforms. In comparison with the baseline scenario, the level of real GNP would be higher by about 1 percentage point by 1994, while the ratio of the current account surplus to GNP would be lower by the equivalent of 1 percentage point. The external adjustment envisaged in this scenario is accompanied by a moderate real appreciation of the yen.

1/ This scenario was developed in consultation with the Research Department, using MULTIMOD. For a description of the model, see MULTIMOD: A Multi-Region Econometric Model, Working Paper 88/23, March 4, 1988.

Table 4. Japan: Illustrative Medium-Term Scenario, 1988-94

	1988	1989	1990	1991	1992	1993	1994
			(In percent of GNP)				
Gross investment	30.7	31.2	31.5	31.8	31.9	32.0	32.1
National savings	33.5	33.9	34.3	34.5	34.6	34.7	34.8
Current account	2.8	2.7	2.8	2.7	2.7	2.7	2.7
Of which:							
Merchandise exports	9.1	9.4	9.4	9.4	9.5	9.5	9.6
Merchandise imports	5.8	6.2	6.3	6.4	6.6	6.7	6.9
General government financial balance 1/	1.1	1.6	2.0	2.0	2.0	2.0	2.0
			(Percentage change)				
Real GNP	5.7	4.5	4.4	4.2	4.2	4.2	4.2
GNP deflator	0.5	1.4	1.2	1.2	1.2	1.2	1.2
Real domestic demand	7.7	5.0	4.9	4.6	4.5	4.5	4.5
Export volume	5.1	5.9	5.8	5.0	5.0	5.0	5.0
Import volume	16.7	8.2	8.5	7.5	7.0	7.0	7.0

Source: Staff estimates and projections.

1/ Land acquisition and capital transfers are recorded as capital expenditure and, therefore, this line is not equal to government saving less investment; these outlays have been equivalent to about 1 percent of GNP in recent years.

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

	1990	1991	1992	1993	1994
			(In percent of GNP)		
Gross investment	0.1	0.3	0.5	0.8	1.1
National savings	0.1	0.2	0.3	0.5	0.7
Current account	-0.1	-0.2	-0.4	-0.6	-0.9
			(Percentage deviation)		
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 international adjustment, while improving welfare at home, by accelerating its own pace of structural reforms.

The importance of structural reforms is well recognized in the Five-Year Economic Plan (1988/89-1992/93) which has fully endorsed the recommendations of the Mayekawa and other commissions. Progress in the implementation of these recommendations has been most evident in the areas of tax and financial reform. Substantial liberalization of interest rates and of financial markets has enhanced the intermediation process and facilitated the effectiveness of monetary management. While a further reform of the postal savings system is still necessary, it is clear that financial liberalization is on the right track and moving ahead rapidly. Progress in the implementation of other structural policies, however, has been more limited.

Investments in Japan's social overhead capital present an excellent vehicle for attaining two important objectives: improving the quality of life by removing well-recognized deficiencies in certain areas; and reducing the external surplus over the medium term. While the present supply constraints limit the scope for accelerating domestic investment in the short run, there should be ample room for improving the provision of public goods over the medium term without undermining the fiscal position.

Land management in Japan presents a complex and politically difficult problem. The Five-Year Economic Plan recognizes the need for the implementation of prompt and forceful measures to rationalize the use of land, but such measures are yet to be introduced. A comprehensive land policy should be adopted to remove distortions arising from regulations governing the taxation and use of land.

In the area of trade, it is only proper that Japan adheres to the highest standards in allowing access to its markets. While trade in manufactured goods is virtually free of formal border restrictions, a development of concern has been the arrangement under which Korean exports of knitwear have become subject to voluntary export restraints. Arrangements of this type, however exceptional, mar Japan's record and could provoke charges that exports to Japan are subject to informal barriers. Furthermore, imports of agricultural goods remain subject to quotas and high tariffs. The lowering of administered prices for some commodities, as well as the decision to gradually abolish import quotas for beef, oranges, and other products are important first steps. But a much fuller agricultural reform is needed to promote international adjustment and harmony as well as to improve domestic resource allocation and consumer welfare. Noneconomic objectives should not be pursued through policy measures that distort trade or resource allocation.

Access to Japan's markets would be further enhanced by a streamlining of the distribution system. To be sure, the distribution sector is already undergoing significant adjustment in response to market forces, but this adjustment would be accelerated by the relaxation of government regulations, notably the Large-Scale Retail Store Law, that may be restricting competition.

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In concluding this Article IV consultation, it would probably be of interest to Directors if it were recalled that this year marks the twenty-fifth anniversary of Japan's formal integration into the world economy and its emergence as a potential world economic power. It was effective April 1, 1964, that Japan ceased to avail itself of the transitional arrangements of Article XIV and assumed the obligations of Article VIII, Sections 2, 3, and 4, of the Articles of Agreement then extant. The staff identified on that occasion two restrictions as requiring approval under Article VIII: a bilateral payments agreement with Korea and a limitation of $500 per person per trip per year on tourist allowances. These restrictions have since been removed.

Much else also has changed. In the ten years or so preceding its formal forswearing of the use of exchange restrictions to deal with payments difficulties, Japan had experienced three different occasions of severe payments difficulties. The last of these Japan had weathered without any intensification of restrictions. Nevertheless, as it moved to Article VIII, Japan thought it a good precaution to request, and the Fund thought it appropriate to grant, a stand-by arrangement as a sort of safety net on the basis of Japan's existing policies. This was an arrangement in the amount of U.S. dollars (the SDR having been conceived but not yet born) 305 million; its full use would bring the Fund's holdings of yen to 125 percent of Japan's quota of $500 million.

The circumstances under which Japan would again make use of the Fund's resources may not be totally without interest today. Nevertheless, it is Japan's lending to the Fund, parallel to the Fund, and outside the Fund--as also its growing grant aid to the developing world--that now holds the most attention and for which appreciation must be expressed. In the Executive Board meeting twenty-five years ago which noted the move to Article VIII and approved the stand-by arrangement, one Director remarked on the "Asian economic miracle" that was already becoming evident. But few foresaw Japan as the huge purveyor of savings that it was to become. Nor was there concern about the ability of the rest of the world to absorb without friction the flow of exports in which the savings flow would be embodied.

In its report on the Article XIV consultation submitted to the Executive Board at that time, the staff opined--with some concern for the large deficit in invisibles--that it would be desirable for Japan to pursue policies conducive to creating a relatively large trade surplus and thus eliminate the current account deficit as soon as possible. The staff recognized the obstacles which continued to exist in some markets for certain Japanese exports. Nevertheless, the staff thought the achievement of a trade surplus was "reasonably feasible."

Japan--Basic Data

Area	145,900 square miles
Total population (mid-1988)	122.9 million
Natural rate of increase (1987)	0.5 percent
Life expectancy at birth (1986)	
Male	75.2 years
Female	80.9 years
Physicians per 1,000 inhabitants (1984)	1.5
GNP per capita (1988)	US$23,300

	1985	1986	1987	1988 1/
	(Percentage change)			
GDP at constant market prices	4.7	2.5	4.2	...
Agriculture, forestry, and fishing	-0.6	-3.5	4.5	...
Mining and manufacturing	6.9	0.5	7.0	...
Services	4.1	3.9	2.7	...
Other	-7.3	4.2	1.4	...
GNP				
At constant 1980 prices	291.8	299.0	312.4	330.1
At current prices	317.4	331.3	345.3	366.5
Real GNP	4.9	2.5	4.5	5.7
Domestic demand	4.0	4.1	5.2	7.7
Personal consumption	2.7	3.1	4.2	5.0
Residential investment	2.5	8.3	22.2	13.4
Plant and equipment investment	12.7	5.8	8.0	15.9
Government consumption	1.7	6.2	-0.7	2.1
Government investment	-6.4	4.3	8.3	6.5
Stockbuilding 2/	0.4	-0.1	-0.4	0.2
Foreign balance 2/	1.1	-1.4	-0.6	-1.9
Nominal GNP	6.3	4.4	4.2	6.1
	(Percentage change except where indicated)			
Prices, incomes, and employment				
Wholesale prices	-1.1	-9.1	-3.7	-1.0
Consumer prices	2.0	0.6	0.1	0.7
GNP deflator	1.4	1.8	-0.2	0.5
Hourly compensation 3/	3.8	2.3	1.2	3.3
Real hourly compensation 4/	1.7	1.7	1.0	2.6
Real disposable income 4/, 5/	1.9	0.9	1.9	4.1
Average propensity to consume (in percent) 5/	77.5	77.4	76.4	75.7
Unemployment (in percent, period average)	2.6	2.8	2.8	2.5

Basic Data (continued)

	1985	1986	1987	1988 1/
Manufacturing				
Employment of regular workers	2.4	1.2	-1.5	0.6
Output	3.7	-0.2	3.5	9.5
Productivity	1.9	-0.6	4.5	7.6
Unit labor cost	1.2	2.1	-2.7	-2.8
Inventory ratio to shipments	4.2	1.6	-6.4	-4.2
Financial aggregates (end of period)				
M2 plus CDs 6/	9.3	8.2	11.5	10.4
Domestic credit	8.8	9.1	9.5	10.6
Public sector	-0.9	6.9	0.2	8.2
Private sector	10.8	9.5	11.2	10.9
Fiscal aggregates (fiscal year beginning April)	(In trillions of yen)			
Central government				
Revenue	40.7	44.0	48.9	50.8
Expenditure	53.0	53.6	56.6	59.4
Deficit (-)	-12.3	-9.7	-7.7	-8.6
Deficit/GNP (-, in percent)	-3.8	-2.9	-2.2	-2.3
Fiscal investment and loan program	20.5	21.5	24.3	25.3
General government				
Deficit/GNP (-, in percent)	-0.8	-0.3	0.8	1.2
	(In billions of U.S. dollars)			
Balance of payments				
Exports	174.0	205.6	224.6	259.8
Imports	-118.0	-112.8	-128.2	-164.8
Trade balance	56.0	92.8	96.4	95.0
Services and transfers	-6.8	-7.0	-9.4	-15.4
Current balance	49.2	85.8	87.0	79.6
Net long-term capital	-64.5	-131.5	-136.5	-130.9
Japanese	-81.8	-132.1	-132.8	-149.9
Foreign	17.3	0.6	-3.7	19.0
Basic balance	-15.4	-45.6	-49.5	-51.3
Net short-term capital 7/	13.9	59.4	91.8	66.8
Bank	10.8	58.5	71.8	44.5
Nonbank 7/	3.1	0.9	20.0	22.3
Overall balance	-1.5	13.7	42.3	15.5
Export volume (percentage change)	4.6	-0.6	0.3	5.1
Import volume (percentage change)	0.4	9.5	9.3	16.7
Gross official reserves, minus gold				
End of period, in billions of U.S. dollars	26.7	42.3	81.0	96.7

Basic Data (concluded)

	1985	1986	1987	1988 1/
Exchange rates (period average)				
Yen per U.S. dollar	238.5	168.5	144.6	128.2
Nominal effective exchange rate (MERM; 1985 = 100)	100.0	126.6	136.9	151.8
Real effective exchange rate (relative normalized unit labor costs; 1985 = 100)	100.0	121.4	124.1	130.6

1/ Staff estimates, or actual data if available.
2/ Contribution to GNP growth.
3/ Regular employees in the manufacturing sector.
4/ Deflated by the consumer price index.
5/ Workers' households.
6/ On the basis of December averages.
7/ Includes errors and omissions.

Japan--Fund Relations

(As of February 28, 1989; in millions of SDRs)

I. Membership Status

(a) Japan became a member of the Fund on August 13, 1952.
(b) Japan has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement.

A. Financial Relations

II. General Department (General Resources Account)

(a)	Quota:	SDR 4,223.3 million.
(b)	Total Fund holdings of Japanese yen:	SDR 1,936.2 million (45.8 percent of quota).
(c)	Fund credit:	None.
(d)	Reserve tranche position:	SDR 2,287.1 million.
(e)	Current Operational Budget (maximum use of currency):	
	Purchases:	SDR 278.8 million
	Repurchases:	SDR 138.4 million

(f) Lending to the Fund (amounts):

	Limits	Outstanding	Uncalled
GAB	2,125.0	--	2,125.0
SFF	900.0	117.4	--
Bilateral arrangement	3,000.0	15.0	2,985.0

III. Current Stand-By or Extended Arrangement and Special Facilities

No use of Fund credit during the last ten years.

IV. SDR Department

(a)	Net cumulative allocation:	SDR 891.7 million.
(b)	Holdings:	SDR 2,029.4 million (227.6 percent of net cumulative allocation).
(c)	Current Designation Plan (amount of maximum designation):	None.

V. Administered Accounts

Not applicable.

VI. Overdue Obligations to the Fund (actual amounts and dates due)

None.

VII. Lending to the ESAF Trust

Limit	Drawn to Date
2,200.0	55.625

Note: Funds are provided by the Export-Import Bank of Japan. An additional amount of SDR 300 million could be provided if additional subsidy amounts become available to reduce the interest rate on these resources for borrowing countries to 0.5 percent per annum.

B. Nonfinancial Relations

VIII. Exchange Rate Arrangement

The authorities in Japan do not maintain margins in respect of exchange transactions, and exchange rates are determined on the basis of demand and supply conditions in the exchange market. However, the authorities intervene from time to time to maintain orderly conditions in the exchange market. There are no taxes or subsidies on purchases or sales of foreign exchange. On February 28, 1989, the exchange rate of the yen, as determined by the Fund under Rule O-2(b), was SDR 0.00595839 per Japanese yen.

IX. Last Article IV Consultation

The staff report for the 1987 Article IV consultation with Japan (SM/88/44) was considered by the Executive Board at EBM/88/42 and EBM/88/43 (March 21, 1988). Japan is on a 12-month consultation cycle.

X. Technical Assistance

Not applicable.

XI. Resident Representative

Not applicable.

Japan--Statistical Issues

1. Outstanding statistical issues

a. Government finance

The Japanese authorities are unable to provide data on the operations of the social security funds and it is thus impossible to provide internationally comparable data on a consolidated central government basis for Japan. The most recent data published for Japan in the GFS Yearbook are for 1985.

2. Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published in the country page for Japan in the April 1989 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Bank of Japan which, during the past year have been provided on a regular basis.

Status of IFS Data

			Latest Data in April 1989 IFS
Real Sector	- National Accounts		Q3 1988
	- Prices:	CPI	January 1989
		WPI	February 1989
	- Production (industrial)		January 1989
	- Employment		Q1 1988
	- Earnings		Q2 1988
Government Finance	- Deficit/Surplus		n.a.
	- Financing		n.a.
	- Debt		n.a.
Monetary Accounts	- Monetary Authorities		October 1988
	- Deposit Money Banks		October 1988
	- Other Financial Institutions		Q2 1988
Interest Rates	- Discount Rate		December 1988
	- Bank Lending/Deposit Rate		Dec./Nov. 1988
	- Bond Yield		January 1989
External Sector	- Merchandise Trade:	Value	February 1989
		Prices	Q1 1988
		Unit values	Q2 1988
	- Balance of Payments		October 1988
	- International Reserves		February 1989
	- Exchange Rates		February 1989