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February 18, 1988

To: Members of the Executive Board

From: The Secretary

Subject: Japan - Staff Report for the 1987 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1987 Article IV consultation with Japan, which has been tentatively scheduled for discussion on Monday, March 21, 1988.

Mr. Aghevli (ext. 7177) 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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JAPAN

Staff Report for the 1987 Article IV Consultation

Prepared by the Asian Department

(In consultation with other Departments)

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

February 16, 1988

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I. Introduction

The 1987 Article IV consultation discussions with Japan were held in Tokyo from November 19 to December 4, 1987. The discussions were concluded by the Managing Director in meetings with the Deputy Prime Minister and Minister of Finance, the Governor of the Bank of Japan, and the Vice-Minister of Finance for International Affairs. A staff team returned to Tokyo during January 25-February 1, 1988 to review the budget for the coming fiscal year. The missions held policy discussions 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. 1/ Mr. Yamazaki, Executive Director, attended the meetings in November-December, and Mr. Adachi, Assistant to the Executive Director, attended the meetings in January.

At the time of the previous Article IV consultation with Japan, held in March 1987, the Japanese economy was in the early stage of recovery from the slowdown induced by the sharp appreciation of the yen, and there were doubts that the economy would rebound strongly. At the same time, there were serious concerns about the prospects for growth in the industrial world as a whole and for the orderly adjustment of international payments imbalances. In this environment, Executive Directors generally agreed that the central policy issue facing the Japanese authorities was to strengthen domestic demand and avoid an undesirable economic downturn, while progressing with orderly external adjustment. Directors emphasized that achieving the objectives of growth and adjustment would require carefully balanced policy choices by Japan. At the same time, other countries also needed to take appropriate actions. In this context, Directors welcomed the commitments made at the Louvre meeting by Japan and the other major industrial countries. Directors also expressed the hope that financial flows from Japan to developing countries would grow rapidly in coming years.

In the event, Japan's economic performance far surpassed expectations. Despite a further withdrawal of external stimulus, output growth accelerated to almost 4 percent in 1987, among the highest for the major industrial countries (Table 1). External adjustment also proceeded steadily. These favorable developments reflected the economy's quick response to market signals as well as the effects of supportive financial policies. Pursuant to its policy commitments under the Louvre

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1/ The first mission consisted of Messrs. Narvekar (head), Aghevli, Marquez-Ruarte, Lipton, Corker, and Watanabe, and Miss Moran (all ASD); Mr. Frenkel also attended the final meetings. The second mission consisted of Messrs. Aghevli, Marquez-Ruarte, Lipton, and Watanabe, and Mrs. Martini (all ASD).

Table 1. Seven Major Industrial Countries:
Indicators of Economic Performance, 1984 to 1992

	Actual			Projected		
	Average 1984-85	1986	1987	1988	1989	Average 1990-92
	(Annual growth rates, in percent)					
Real GNP/GDP						
Japan	5.0	2.4	3.8	3.7	3.6	3.6
United States	4.9	2.9	2.8	2.6	2.8	2.8
Germany, Fed. Rep. of	2.6	2.5	1.7	1.7	1.7	2.3
Canada, France, Italy, and United Kingdom 1/	3.0	2.8	3.0	2.2	2.2	2.4
Seven countries 1/	4.2	2.8	2.9	2.7	2.7	2.8
Real domestic demand						
Japan	3.9	4.0	4.7	5.3	4.4	4.1
United States	6.2	3.9	2.3	1.6	2.2	2.7
Germany, Fed. Rep. of	1.5	3.7	2.8	2.7	2.0	2.4
Canada, France, Italy, and United Kingdom 1/	3.0	3.7	3.8	2.7	2.4	2.5
Seven countries 1/	4.5	3.8	3.1	2.7	2.7	2.9
GNP/GDP deflator						
Japan	1.3	2.0	-0.1	1.6	1.5	1.5
United States	3.5	2.6	3.1	3.6	3.7	3.7
Germany, Fed. Rep. of	2.1	3.1	2.1	2.0	2.0	2.3
Canada, France, Italy, and United Kingdom 1/	6.3	4.8	4.3	3.9	3.8	3.4
Seven countries 1/	3.7	3.1	2.7	3.2	3.1	3.0
	(As percent of GNP/GDP)					
General government finance balance						
Japan	-1.7	-0.6	-0.8	-0.8	-0.7	-0.7
United States	-3.1	-3.5	-2.3	-2.0	-1.7	-0.7
Germany, Fed. Rep. of	-1.5	-1.2	-1.6	-2.7	-2.3	-2.7
Canada, France, Italy, and United Kingdom 1/	-5.8	-5.4	-4.8	-4.3	-4.4	-4.1
Seven countries 1/	-3.4	-3.2	-2.5	-2.4	-2.2	-1.8
Private savings minus investment 2/						
Japan	4.9	4.9	4.4	3.5	3.3	2.9
United States	0.2	0.2	-1.3	-1.0	-1.0	-1.8
Germany, Fed. Rep. of	3.4	5.3	5.5	6.0	5.4	5.7
Canada, France, Italy, and United Kingdom 1/	5.9	5.2	4.2	3.7	3.7	3.3
Seven countries 1/	2.7	2.6	1.7	1.7	1.8	1.4
Current account balance						
Japan	3.2	4.3	3.6	2.7	2.6	2.2
United States	-2.9	-3.3	-3.6	-3.0	-2.8	-2.5
Germany, Fed. Rep. of	1.9	4.1	3.9	3.3	3.1	3.0
Canada, France, Italy, and United Kingdom 1/	--	--	-0.5	-0.6	-0.7	-0.8
Seven countries 1/	-0.8	-0.2	-0.4	-0.4	-0.4	-0.4

Source: Staff estimates for the World Economic Outlook.

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.

Accord, the Government announced in May 1987, and began to implement in the following months, an extensive package of economic measures geared toward supporting domestic demand and facilitating the flow of resources to developing countries.

The robust recovery of the Japanese economy has made a major contribution to sustaining the world economic expansion, and Japanese capital outflows have remained an important source of funds, alleviating pressures on international interest rates. The international economy, however, continues to face serious problems, including the prospect of a weakening of growth in the industrial countries, historically large external imbalances, continued trade frictions, and severe debt difficulties of many developing countries. The resolution of these problems will depend, to a large extent, on policies and developments outside Japan, but Japan would be expected to continue to play an important role in facilitating international adjustment and enhancing financial stability. Against this background, discussions focused on the financial and structural policies needed to sustain noninflationary growth in Japan and to promote continued external adjustment.

II. Background to the Discussions

1. Recent developments

The Japanese economy has emerged with vigor from the severe slowdown that began in late 1985. Real GNP growth, which was halved to 2 1/2 percent in 1986 because of a withdrawal of foreign demand, recovered to close to 4 percent in 1987 on the strength of brisk domestic demand (Table 2 and Chart 1). At the same time, substantial economic restructuring has taken place in response to both market forces and policy initiatives: production and investment have been reoriented toward the domestic sector; imports, particularly of manufactured goods, have increased sharply; and the relocation of production facilities to other countries has accelerated.

The process of economic restructuring was sparked by the sizable appreciation of the yen that began in 1985 and by the weakness of world commodity prices, particularly oil. Japan's external competitiveness 1/ declined by over 25 percent from mid-1985 to the end of 1987 (Chart 2). Export prices increased sharply in U.S. dollar terms, although the increase fell short of the full extent of the yen appreciation owing to the lower cost of imported inputs, the structure of supply and demand relationships in international trade, and lags in the adjustment of production capacity. In 1987, the pass-through of the

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1/ Measured in terms of the effective exchange rate adjusted by relative normalized unit labor costs.

Table 2. Japan: Principal Indicators, 1985-88

	Calendar Years				Fiscal Years 1/		
	1985	1986	1987 2/	1988 2/	1986/87	1987/88 2/	1988/89 2/
Production, demand, and prices							
Real GNP (percent change)	4.9	2.4	3.8	3.7	2.6	3.7	3.7
Domestic demand	4.0	4.0	4.7	5.3	4.3	5.1	5.0
Private consumption	2.7	3.2	3.9	3.9	3.3	3.6	4.0
Residential investment	2.5	8.4	16.8	6.3	10.9	10.4	3.7
Plant and equipment investment	12.7 3/	6.1 3/	7.3	8.0	4.5	8.1	7.8
Government expenditure	-1.9 3/	5.4 3/	2.8	4.6	6.7	3.5	3.0
Stockbuilding 4/	0.4	-0.3	-0.3	0.4	-0.3	-0.1	0.4
Net exports 4/	1.1	-1.4	-0.9	-1.6	-1.5	-1.4	-1.3
GNP deflator (percent change)	1.3	1.9	-0.1	1.6	1.6	0.3	1.6
CPI (percent change)	2.0	0.6	0.1	1.1	-0.1	0.8	0.9
Industrial production (percent change)	4.6	-0.4	4.0	8.4	-0.5	6.5	6.7
Unemployment rate (percent)	2.6	2.8	2.8	2.8	2.8	2.8	2.8
Total saving (percent of GNP)	32.1	32.3	32.3	32.5	32.5	31.9	31.7
Total investment (percent of GNP)	28.4	27.9	28.7	29.8	27.9	28.7	29.0
Fiscal and monetary indicators							
Central government balance (percent of GNP) 5/	...	...	...	...	-2.9	-3.5	-2.5
General government balance (percent of GNP)	-1.0	-0.6	-0.9	-0.8	-0.5	-0.9	-0.7
M2 plus CDs (percent change) 6/	8.7	9.2	11.5	9.0	9.0	10.0	8.5
Short-term nominal interest rate (average, percent)	6.5	5.0	3.9	5.0	4.5	3.8	5.0
Long-term nominal interest rate (average, percent)	6.3	4.9	4.3	5.5	4.6	4.5	5.5
Balance of payments							
Current account balance							
Billions of dollars	49.3	85.8	86.7	77.1	94.1	81.9	74.7
Trillions of yen	11.5	14.2	12.5	9.8	15.1	11.3	9.4
Percent of GNP	3.6	4.3	3.6	2.7	4.5	3.3	2.6
Trade data (percent change)							
Export volume	4.4	-1.3	-1.7	-3.6	-1.6	-2.5	-3.7
Import volume	0.4	12.5	7.4	13.2	13.5	10.2	10.3
Export unit values (U.S. dollars)	-1.1	20.6	11.7	14.1	19.4	12.4	11.6
Import unit values (U.S. dollars)	-5.4	-13.3	9.4	7.2	-15.7	16.7	4.4
Exchange rate (¥/$, average)	238.5	168.5	144.6	...	159.8	...	...
Nominal effective exchange rate (MERM, average)	127.1	161.0	174.2	...	165.7	...	...
Real effective exchange rate (average)							
Relative normalized unit labor costs	100.2	121.6	125.2	...	123.8	...	...
Relative export unit values	99.4	105.8	...	...	106.3	...	...

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

1/ April-March.

2/ Staff estimates or projections; actual data if available.

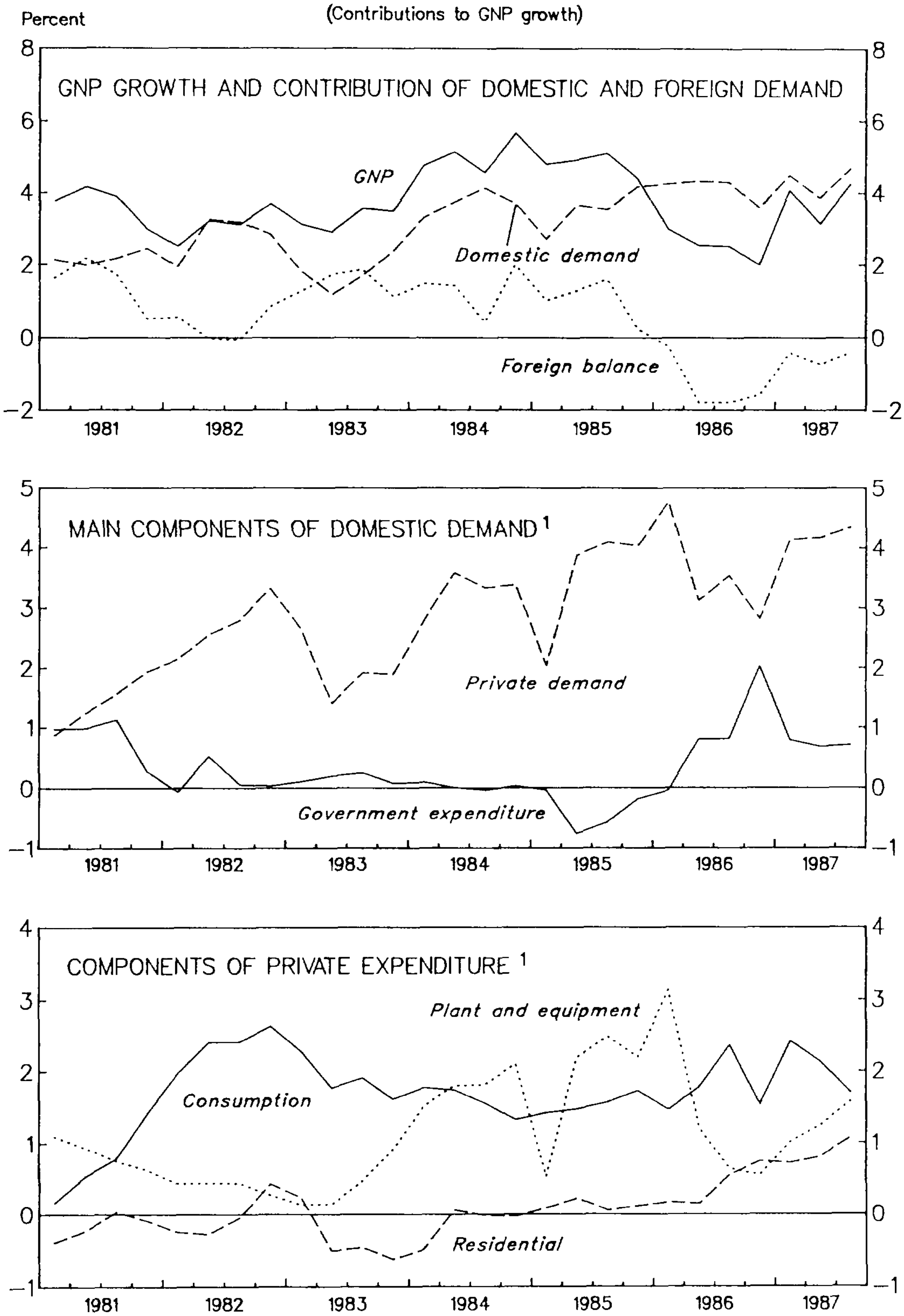
3/ Growth rates are affected by the transfer of two large public enterprises to the private sector in April 1985.

4/ Contribution to GNP growth.

5/ General account.

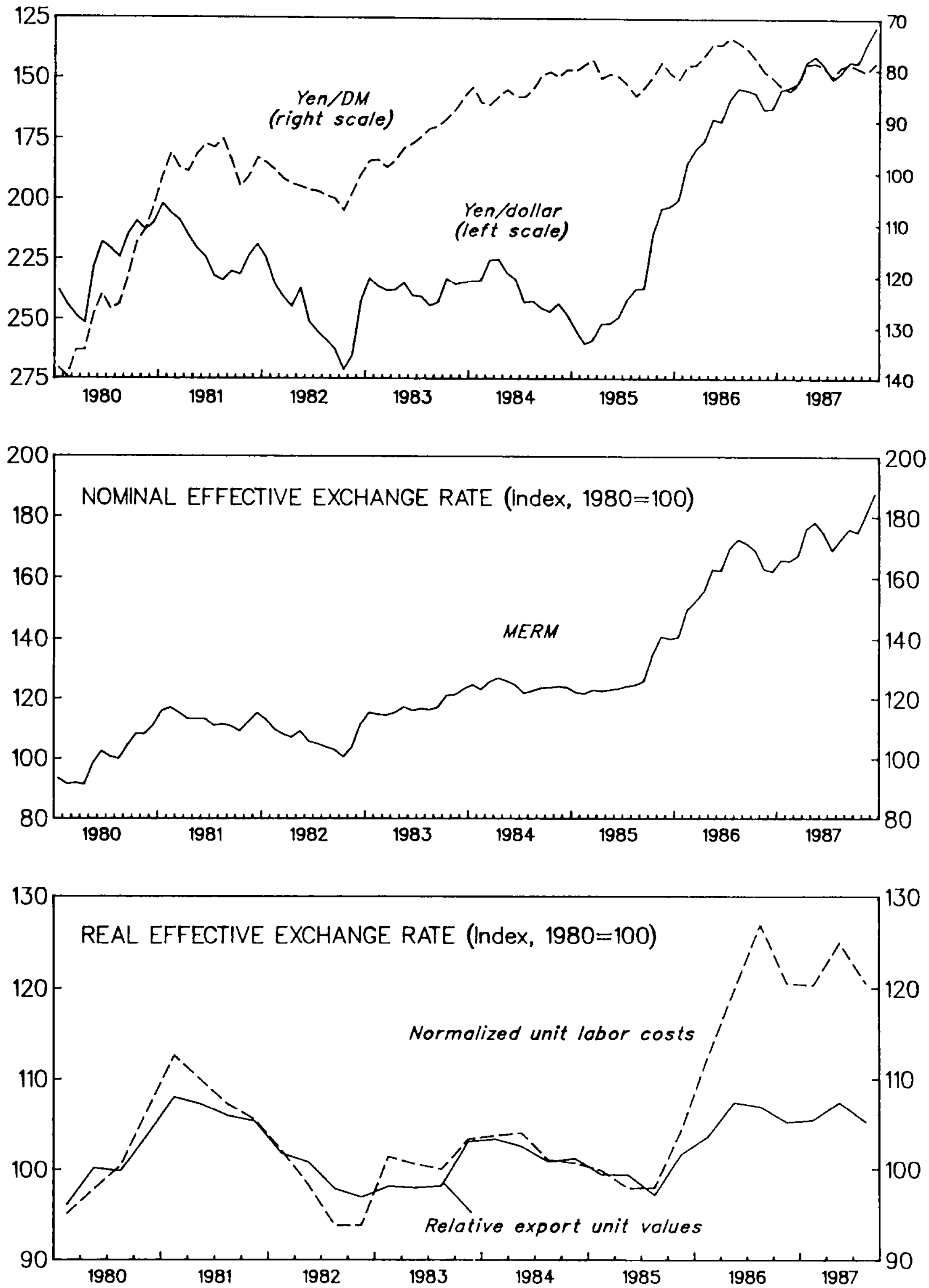
6/ On the basis of the average level for the last month of each year.

CHART 1
JAPAN
SELECTED GNP AGGREGATES, 1981-87
(Contributions to GNP growth)



Source: Data provided by the Japanese authorities; and staff estimates.
[1]Contribution of demand components to GNP growth.

CHART 2
JAPAN
EXCHANGE RATE DEVELOPMENTS, 1980–87



Source: IMF; IFS; and staff calculations.

yen appreciation to export prices accelerated sharply. 1/ During 1986-87, the terms of trade improved by over 40 percent, raising the purchasing power of exports by the equivalent of 5 1/2 percent of GNP. The terms of trade gains were reflected in lower wholesale prices and higher corporate profits in domestic manufacturing and service sectors.

The terms of trade gains, low domestic interest rates, and the cyclical rebound of business investment brought about an acceleration in the growth of domestic demand in 1987. The pace of private consumption picked up significantly because of the fast growth of real disposable income and a rise in private wealth that was associated with a steep increase in share and land prices. The same factors, together with low mortgage interest rates and the underlying strength of housing demand, propelled residential investment to record levels. Business fixed investment revived after the correction of capacity in export-oriented sectors, while stockbuilding quickened following the completion of inventory adjustment. Domestic demand was also bolstered by a much more rapid expansion of government expenditure than in the several preceding years. 2/

Manufacturing production rebounded in 1987 after a sharp decline in 1986. After the initial adjustment to a loss in export sales, production began to increase on the strength of rapidly growing domestic demand. Because of the high unemployment and low profits prevailing in early 1987, the spring round of wage negotiations yielded a historically low level of wage increases, but real wages rose by 3 percent owing to the decline in inflation. With the recovery in the manufacturing sector over the course of the year, the rate of unemployment, which had peaked at 3.2 percent in May 1987, declined to 2.6 percent by the end of the year.

The wholesale price index fell in 1986 and early 1987 because of the yen appreciation and the weakness of world commodity prices. With the buildup of demand pressures in mid-1987, particularly in the construction sector, domestic prices of steel, lumber, and other construction materials rose steeply. Consequently, the wholesale price index rose during the middle quarters of 1987. However, it resumed its

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1/ The pass-through coefficient rose from 50 percent in 1986 to 70 percent in 1987. For a more detailed analysis of the movements in export prices, see the forthcoming report on recent economic developments.

2/ The pattern of government spending in 1986/87 and 1987/88 as shown by numbers in Table 2 is distorted by the large issuance of commemorative coins amounting to about 1 1/2 percent of total government spending.

decline in the last quarter as imports of construction materials supplemented domestic supplies; the index declined by 1 percent during the year. Consumer prices remained broadly stable throughout 1986-1987.

The external sector has undergone considerable adjustment since 1985. Declining competitiveness and buoyant domestic demand have led to a halt in export volume growth and a rapid rise in import volume. Measured in 1980 prices, merchandise exports fell by the equivalent of 1 1/2 percent of GNP during 1985-87, while imports rose by the equivalent of 2 percent almost entirely on account of a jump in imports of manufactured goods and food (Chart 3). Thus, the real trade account moved from a surplus equivalent to 3 1/2 percent of GNP in 1985 to near balance in 1987. Nonetheless, chiefly because of terms of trade gains, the nominal current account surplus rose to 4 1/4 percent of GNP ($86 billion) in 1986, before declining to 3 1/2 percent ($87 billion) in 1987. The direction of trade also changed dramatically. In particular, imports from the newly industrialized Asian economies increased significantly owing to changes in competitiveness, the substitution of imported inputs, and closer commercial relationships engendered by Japanese direct investment in those countries. The latter factor was partly responsible for an even greater increase in Japanese exports to the newly industrialized Asian countries. On the services account, a sharp acceleration in net investment income (which reached $17 billion in 1987) was offset by a striking increase in transport and tourism payments.

Japan's current account surplus in recent years has made it the largest international lender. Net outflows of long-term capital have generally exceeded the current account surplus, as net inflows of short-term capital funded a significant part of longer-term overseas investment. 1/ Private net capital outflows dominated movements in the capital account until mid-1986. Since then, however, official outflows have played a significant role as the authorities undertook large intervention in foreign exchange markets in the middle of 1986, the first half of 1987, and the final months of 1987.

A remarkable development in the past two years has been the sharp rise in asset prices. Share prices--as measured by the Nikkei 225 Stock Index--increased by nearly 50 percent in 1986, and by an additional 30 percent in the first three quarters of 1987. Land prices in metropolitan areas rose by more than 60 percent in the two years ended in September 1987, owing to heavy demand for office and other commercial space and relaxed monetary conditions. The sharp rise in both share and land prices was halted in October with the worldwide crash in stock markets. The Nikkei index declined by 10 percent in the fourth quarter,

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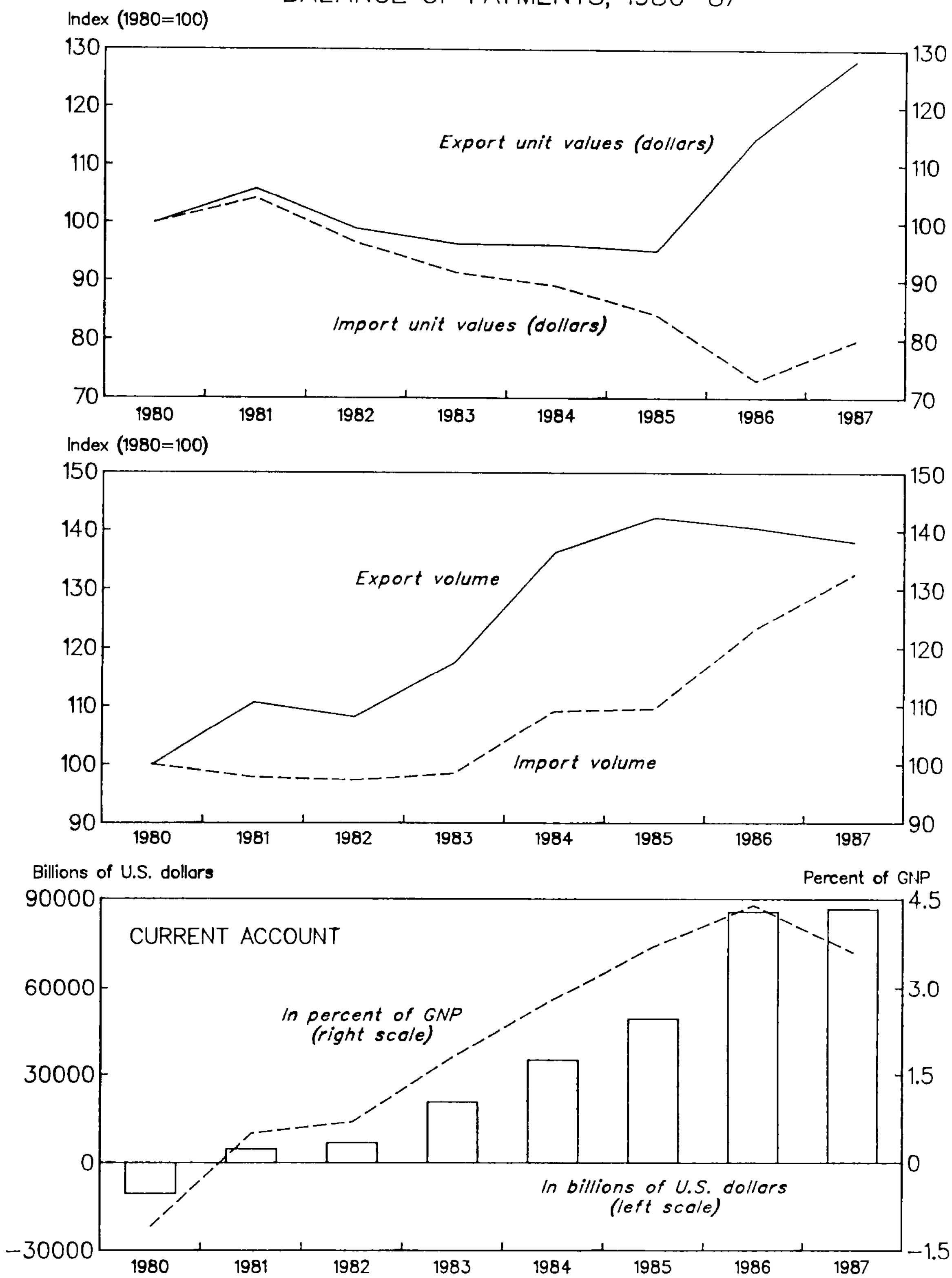
1/ For a more detailed analysis of Japanese capital flows, see the supplement to the report on recent economic developments, "Japanese Capital Flows--Factors Affecting Recent Developments."

CHART 3

JAPAN

BALANCE OF PAYMENTS, 1980–87



Sources: Data provided by the Japanese authorities and IMF, *IFS*.

returning to the level that had been reached in April 1987, and land prices in metropolitan areas stabilized. The decline in stock prices in Japan was smaller than in other major industrial countries, perhaps reflecting the underlying strength of the Japanese economy. The structure of the market also may have played a role: program trading is not as widespread in Japan as in other major markets; corporate shareholders hold the major portion of the outstanding stock in an interlocking pattern; and there are limits set on daily price swings.

2. Short-term prospects

There is a broad consensus among official and private forecasters that present economic trends will continue in 1988. Staff projections, which are similar to official forecasts, place GNP growth at about 3 3/4 percent on the strength of domestic demand; net exports are expected to decline further. Domestic prices are likely to rise by 1-2 percent, reflecting a more moderate appreciation of the yen in 1987 and the working-off of excess capacity. The rate of unemployment is projected to remain stable at about 2 3/4 percent. Real domestic demand is expected to continue to rise by about 5 percent, with sustained growth of private consumption and investment and a continuation of the upward phase of the stockbuilding cycle; the growth of expenditure on residential investment would decelerate markedly from the very high rate of 1987.

The external current account surplus is projected by the staff to decline by $10 billion in 1988 to about $77 billion (2 3/4 percent of GNP). This projection is based on the assumption that the real effective exchange rate and the world oil price in U.S. dollar terms will remain constant at their levels of late 1987. The trade surplus is also projected to fall by $9 billion to $88 billion, mainly on account of a 3 1/2 percent decline in export volume and a 13 percent increase in import volume. The terms of trade would improve by about 7 percent, reflecting the continued upward adjustment of export prices. The deficit on invisibles transactions should remain unchanged, as a sharp increase in investment income would be mostly offset by increases in payments on other services.

III. Policy Issues

In the past few years, the main objective of government policies has been to encourage a restructuring of the economy in order to restore noninflationary growth and reduce international tensions. Recognizing that the rapid increase in Japan's exports and in the current account surplus had become rallying points for protectionist sentiment abroad, the Japanese authorities embarked on a course of action designed to reduce the surplus and foster domestic-based growth. The authorities have adopted a comprehensive policy approach consisting of an expansion of public investment, a relaxation of monetary conditions, and a range of structural measures aimed at eliminating distortions in production and investment. These policies have helped bolster domestic demand and increased the internal absorption of national savings. The authorities are determined to persevere with their policy strategy in the period ahead: the accommodative stance of demand management policies will be maintained and structural reforms accelerated in order to sustain noninflationary growth.

1. Fiscal policy

In recent years, a main objective of fiscal policy has been to strengthen the financial position of the Government, which had deteriorated substantially in the second half of the 1970s. The medium-term goal of fiscal consolidation has been formulated as ending the Government's reliance by 1990/91 1/ on deficit financing bonds, which are issued to finance the current deficit of the central government general account. The authorities made substantial progress toward this goal during 1979/80-1986/87, principally through spending restraint. The issuance of deficit financing bonds was halved during the period to 1 1/2 percent of GNP, as the deficit of the central government general account was reduced from 5 1/2 percent of GNP to 3 percent. With accompanying improvements in the positions of the social security funds and the local governments, the deficit of the general government declined over the period from 4 1/2 percent of GNP to 1/2 percentage point.

During the last Article IV consultation, most Executive Directors supported--as they had done in previous years--the authorities' longer-run objective of fiscal consolidation, but stressed that fiscal policy should be implemented with due regard to the (then prevailing) weakness of the economy. Directors also welcomed the tax reform proposals then under consideration by the Diet, and some Directors expressed the view that the reform might be implemented in such a manner as to impart a stimulus to the economy.

The implementation of fiscal policy in the past year has been consistent with the views expressed by Directors. The authorities proposed, in May, a comprehensive set of stimulus measures involving the central government, the local governments, and the public enterprises. The package amounted to ¥ 6 trillion (1.7 percent of GNP), including an increase in public investment and lending of ¥ 5 trillion and a tax cut of ¥ 1 trillion. The Diet approved, in July 1987, the budgetary outlays for the central government portion of the stimulus package (¥ 2.1 trillion) and an augmentation of the Fiscal Investment and Loan Program (¥ 0.8 trillion). The remaining public works spending was to be carried out by the local governments.

1/ The fiscal year begins on April 1.

The May measures also included important elements of the tax reform that had been proposed by the Government in February 1987. The original tax reform had encountered strong opposition, centering upon a proposed sales tax, and did not receive the approval of the Diet during its regular session in the spring of 1987. In mid-September, however, the Diet adopted several of the items in the original tax reform agenda. These included an income tax cut (mainly by means of a less progressive rate structure), the abolition of tax exemptions for interest earned via the small saver schemes, and the imposition of a flat 20 percent tax on all interest income--the two latter changes to become effective in April 1988. 1/ The reform of the indirect tax system and a major revision of corporate taxes were left for future consideration. Changes in the tax system contained in the bill are estimated to lower tax revenues of the central government general account by about ¥ 1.3 trillion in 1987/88, somewhat more than the amount foreseen in May.

With the implementation of supplementary public works spending, expenditures of the general account are estimated to increase by more than 5 percent in 1987/88, significantly faster than envisaged in the initial budget. Despite the tax cut, total revenues are expected to rise by 2 1/2 percent because of an unexpected buoyancy of tax revenues, emanating mainly from the surge in asset prices and trading volumes, and the proceeds from the privatization of two public enterprises. This rise in revenues, together with restraint in current spending, is likely to reduce the Government's reliance on deficit financing bonds to about 1 percent of GNP--thus improving significantly the prospect for the attainment of the medium-term goal of eliminating the issuance of such bonds by 1990/91. The deficit of the central government general account is expected to rise by 1/2 percentage point to 3 1/2 percent of GNP (Table 3).

Up-to-date consolidated data for the general government are not available, but staff estimates suggest that investment spending of the general government would grow by more than 10 percent in 1987/88. Many local governments announced supplementary budgets of record size in the fall of 1987, incorporating their share of the additional expenditures envisaged in May. Government consumption, however, is expected to rise only modestly, in line with the fiscal consolidation efforts. Taking into account the revenue of the central and local governments, the staff expects the the general government deficit to rise by 1/2 percentage point to about 1 percent of GNP in 1987/88.

As foreseen in the December 22 statement of the Group of Seven, the 1988/89 budget preserves the higher level of capital spending in the general account that had been reached with the July 1987 supplementary budget. The growth of current spending will slow with further fiscal

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1/ For details on the tax reform, see the forthcoming report on recent economic developments.

Table 3. Japan: Central Government General Account Budget, 1/ 1985/86-1988/89

	1985/86	1986/87		1987/88		1988/89
	Settlement	Initial	Settlement	Initial	Revised	Proposed
			(In trillions of yen)			
Expenditure	53.0	53.7	53.6	54.1	57.1	56.7
General expenditure	33.1	32.6	33.2	32.6	33.7	33.0
No-interest lending program	--	--	--	--	0.5	1.3
Interest payments	10.2	10.9	10.7	11.3	11.9	11.5
Tax transfers to local governments	9.7	10.2	9.7	10.2	11.1	10.9
Revenue	40.7	42.9	44.0	43.3	45.1	47.7
Of which:						
Share sale proceeds 2/	--	--	--	0.3	0.8	1.5
Deficit	12.3	10.8	9.7	10.8	12.0	9.0
Financing	12.3	10.8	9.7	10.8	12.0	9.0
Bond issues (net)	12.3	11.0	11.3	10.5	10.5	8.8
Deficit financing bonds	6.0	5.3	5.0	5.0	3.7	3.2
Construction bonds	6.3	5.7	6.3	5.5	6.9	5.7
Other	...	-0.1	-1.6	0.3	1.5	0.1
			(In percent of GNP)			
Memorandum items:						
Expenditure	16.5	16.0	16.0	15.5	16.4	15.5
Revenue	12.7	12.8	13.1	12.5	13.0	13.1
Deficit	3.8	3.2	2.9	3.1	3.5	2.5
Bond financing	3.8	3.3	3.4	3.0	3.0	2.4
Of which: Deficit financing bonds	1.9	1.6	1.5	1.4	1.1	0.9
Deficit plus share sale proceeds	3.8	3.2	2.9	3.2	3.7	2.9
FILP expenditure 3/	6.4	6.6	...	6.8	7.2	6.9
Public works expenditure	2.1	1.9	2.1	1.7	2.4	2.3

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

1/ This presentation differs from that of the authorities; certain revenue and expenditure items in the official presentation are reclassified as financing items.

2/ Transfers of proceeds from sales of shares of Nippon Telegraph and Telephone and Japan Airlines.

3/ Excluding portfolio investment.

consolidation, while revenue will rise with the strong growth of income--the abolition of exemptions provided under the small saver schemes will generate only a small amount of revenue. With the expected improvement in the current balance of the Government, the issuance of deficit financing bonds would decline further to below 1 percent of GNP. The general account deficit would fall from 3 1/2 percent of GNP to 2 1/2 percent, resuming the earlier declining trend.

It is difficult to project the overall position of the general government in 1988/89 because the budgetary process of local governments is yet to be completed. It is evident, however, that the growth of local government revenues will slow because of the reduction in the local income tax that was approved as part of the tax bill in September 1987. Furthermore, there are indications that local governments plan a modest increase in public works spending. Staff projections, which are subject to a wide margin of error, suggest that the overall deficit of the general government would decline slightly.

The authorities are confident that fiscal policy in 1988/89 will, in addition to permitting further progress toward fiscal consolidation, provide adequate support to economic activity. They noted that a vigorous expansion of private demand was keeping the economy at close to full capacity. At the same time, general public works spending would be maintained at the high level established in 1987/88. A further acceleration of public spending could risk a rise in domestic interest rates and a consequent crowding out of the private sector.

Commenting on their medium-term objectives, the authorities stressed the importance of persevering with fiscal consolidation efforts in order to relieve further the tight budgetary conditions. Sources of concern were the large share of interest payments in total spending (about 20 percent) and the prospect of large social security obligations resulting from the rapid increase in the proportion of the elderly in the population. The authorities observed that, in the absence of the fiscal consolidation achieved in previous years, Japan would not have been in a position to introduce promptly the emergency economic measures of May 1987.

The authorities noted that the stock of social overhead capital and the corresponding provision of public goods in Japan lagged behind that in other industrial countries. Therefore, the portion of GNP devoted to capital expenditure by the general government, excluding public enterprises, was higher in Japan than in other major industrial countries--about 5 percent in recent years. This portion was expected to remain broadly stable over the medium term.

The Japanese authorities observed that the Government was committed to continued reform of the tax system, which still suffers from serious problems, including a lack of horizontal equity and a heavy burden of corporate taxes that encourages corporations to resettle abroad.

Priority would be placed on reducing income, corporate, and inheritance tax rates, but additional revenue would have to be raised elsewhere in order to protect public finances. The existing commodity-specific indirect taxes not only limited the prospects for raising further revenue, but also distorted resource allocation. It was therefore essential to introduce a broad-based indirect tax. The required tax reform measures were likely to be introduced in late 1988.

2. Monetary policy and exchange rates

During 1986 and the first half of 1987, monetary policy attached greater weight to supporting economic activity and stabilizing the exchange rate, as concerns with inflation receded with the sharp appreciation of the yen. The Bank of Japan lowered the official discount rate five times from January 1986 to February 1987, halving it to 2.5 percent, the lowest level among the major industrial countries. Interest rates in the domestic markets declined sharply through the middle of 1987 (Chart 4).

In spite of the steady relaxation of monetary conditions, the yen came under strong upward pressure on several occasions during the period, owing to developments in other major industrial countries and to shifts in portfolio preferences of private investors. On the policy side, the discount rate in the United States was also reduced significantly; in mid-1987 the discount rate differential was, at 3 percent, identical to the differential in early 1986. Pressures in the foreign exchange market also emanated from changes in the perceived prospects for the adjustment of international imbalances. The associated shifts in portfolio preferences away from U.S. dollar-denominated assets led to upward pressure on the yen as well as to a simultaneous widening of the differential between U.S. and Japanese long-term interest rates.

Developments in financial markets prompted the Bank of Japan to tighten monetary conditions in the third quarter of 1987. The growth of broad money (M2 plus CDs), which had been in the range of 8-9 percent until early 1987, accelerated to over 10 percent by mid-year. Bank of Japan officials considered such rates of monetary expansion to be high, even though financial liberalization had made it difficult to interpret the movements of broad money. 1/ This perception was reinforced by other developments in the third quarter of the year: exchange market pressures had abated; the indicators of economic performance pointed to a robust recovery; substantial fiscal stimulus was being introduced; and equity and land prices continued to skyrocket. Long-term interest rates

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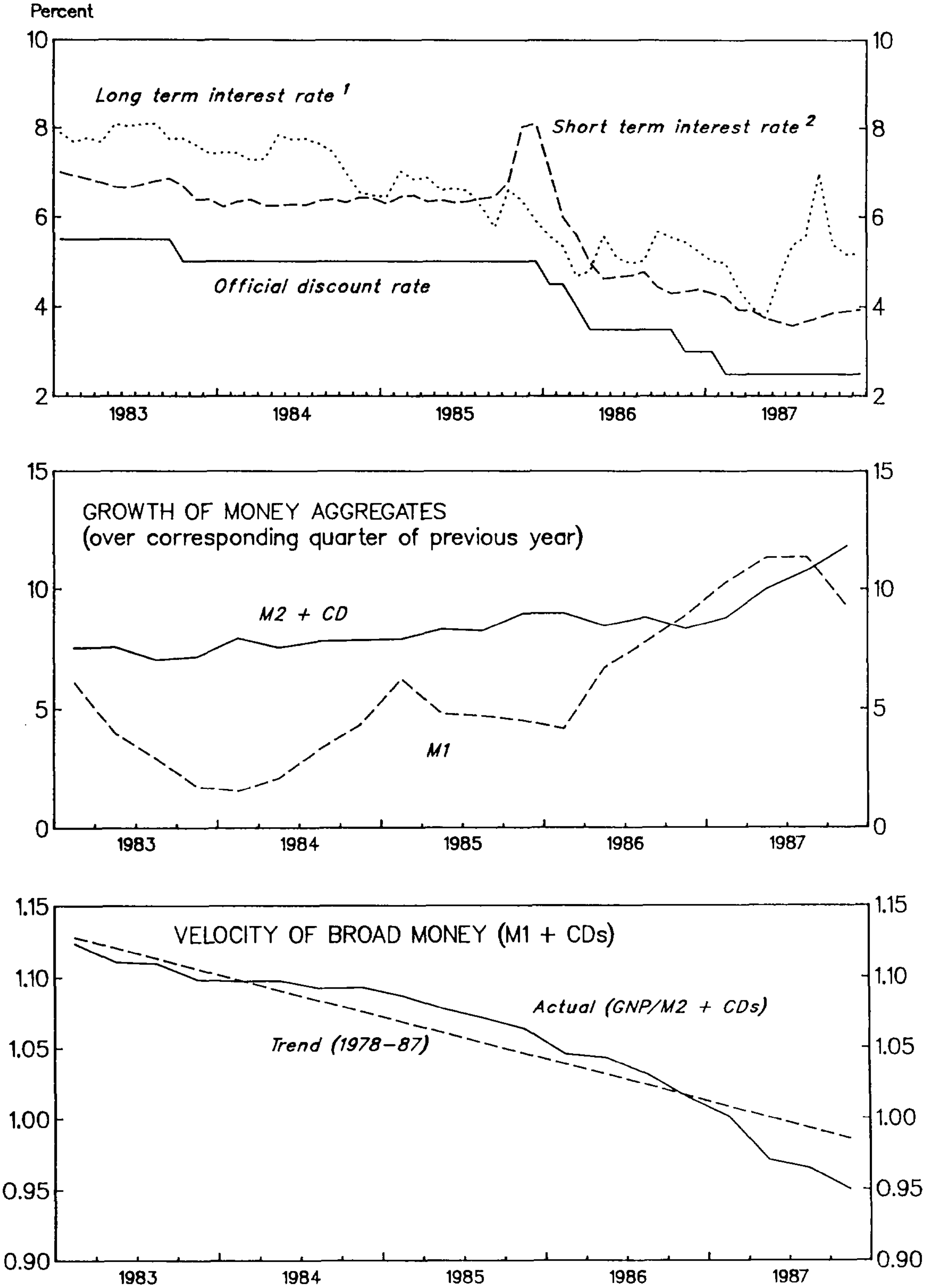
1/ Bank of Japan staff estimates suggest that, because of financial liberalization, the trend decline in income velocity of broad money has shifted by 1 percentage point to 3 percent a year. Accordingly, an underlying growth of about 5 percent in nominal income would warrant a rate of monetary expansion on the order of 8 percent.

CHART 4

JAPAN

INDICATORS OF THE STANCE OF MONETARY POLICY, 1983–87



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

[1] Yield of ten-year government bonds.

[2] Two-month private bill discount rate.

rose rapidly in late August and in September, partly owing to an increase in uncertainty arising from the failure of a domestic corporation--which had been heavily involved in speculative financial transactions--and to higher inflationary expectations. The Bank of Japan decided in late September to allow short-term rates to rise in response to pressures in money markets. Long-term interest rates began to ease in early October, but the Bank maintained its cautious stance. However, following the stock market crash, the Bank of Japan, in coordination with other central banks, adopted an accommodative policy stance. Money market rates declined and the growth of the money supply continued to accelerate, reaching about 12 percent in late 1987.

Renewed pressure against the U.S. dollar in the last few weeks of 1987 prompted the governments of the major industrial countries to step up intervention in exchange markets and reaffirm their commitments to stable exchange rates. On December 22, the Group of Seven countries agreed to intensify their economic policy coordination efforts, including close cooperation on exchange markets. This agreement was endorsed by the heads of government of Japan and the United States in a joint statement issued on January 13, 1988 (the "Reagan-Takeshita statement"), which indicated that both governments were cooperating closely on exchange markets and had developed arrangements to ensure the adequacy of resources for their cooperative efforts. In addition, the Bank of Japan agreed, "under present stable price conditions, to continue to pursue the current policy stance and to make efforts to accommodate declining short-term interest rates."

During the consultation discussions, the authorities expressed the view that the pursuit of external adjustment should not rely excessively on exchange rate action, and that a period of exchange rate stability was needed. While the economy had adapted well to the large appreciation of the yen since 1985, further appreciation would adversely affect business confidence--and with it, investment and continued adjustment. Exchange rates were greatly influenced by public confidence in the policies of major industrial countries, the strength of international policy coordination, and the prospects for the adjustment of international imbalances. In this context, the authorities attached great importance to the Group of Seven statement of December 22--which had been timed to coincide with the adoption of the deficit-reduction package in the United States--and to the Reagan-Takeshita statement. These statements had gone further than the Louvre Accord by stressing that a further decline of the dollar could be counterproductive. The authorities believed that the manifest resolve of the major industrial countries to intervene in a concerted manner had been effective in stabilizing exchange markets.

The authorities shared the staff's view that appropriate policies in the major industrial countries were a prerequisite for exchange rate stability. In the absence of such policies, efforts to prevent an appreciation of the yen in the face of persistent market forces could eventually risk a rekindling of inflation. The authorities indicated, however, that a conflict between the stability of exchange rates and the stability of prices did not arise in present circumstances. Inflationary expectations had subsided with the more recent appreciation of the yen, the drop in domestic commodity prices, and the stock market decline. Nonetheless, certain indicators needed to be watched closely, including the high rate of monetary expansion, bottlenecks in the construction sector, the rise in capacity utilization, and the marked increase in new job offers. There was also some concern about the inflationary effects of the upcoming spring round of wage negotiations. Bank of Japan officials believed that, although the price situation was favorable at this time, there was no room for complacency. Thus, while exchange rate objectives were given considerable weight under the present conditions, the control of inflation remained the ultimate objective of monetary policy.

3. Structural issues and policies

The formulation of structural policies is the focus of the Government's five-year economic plan, expected to be released in May. The plan will incorporate the proposals on structural issues contained in the pathbreaking study of the Mayekawa Commission issued in 1986, and the more recent and detailed recommendations of the Economic Council submitted in 1987. The interim report on the new plan, which was released in January, has stated the Government's intention of adopting these recommendations.

Structural reforms under consideration call for the buildup of social infrastructure and the elimination of longstanding distortions in production, consumption, and investment in many areas of the Japanese economy. The authorities recognize that radical changes are needed in a number of crucial areas: land use patterns; agricultural protection; and market access. Success in these fields would make possible a much needed increase in the housing stock, a reduction in the cost of living, and--by absorbing domestic savings and opening markets--probably also a mitigation of international tensions. Another priority is to complete the process of financial reform that has been under way for several years.

Even if land were employed in the most efficient manner, the price of land--the scarcest economic factor in Japan--would remain high, resulting in high costs of housing, production, and investment. This basic situation is worsened by land use regulations and policies that have run counter to the requirements of both economic efficiency and social welfare. The tax system discriminates in favor of the agricultural use of land: in prime urban areas, both property and inheritance tax burdens are heavier for residential land than for agricultural land in similar locations. Zoning and building regulations appear to inhibit the efficient use of residential land beyond reasonable requirements of safety and comfort. And large tracts of land are kept in the public domain and not used efficiently for urban development.

Above all, however, a full solution of the land problem would require a substantial liberalization of trade in agricultural products. Protection of agriculture exaggerates the yield of agricultural land, discouraging its use for housing or business purposes. Japan is the largest net food importer in the world and the authorities have been making efforts to liberalize the agriculture sector. Still, parts of the agriculture sector remain heavily protected: a number of agricultural items are subject to quantitative restrictions, and there are large differences between domestic and world prices for certain important agricultural products, such as cereals. The authorities have recently announced their willingness to lift quantitative restrictions on several agricultural items--in response to an action by a GATT tribunal--and to work with other governments in establishing new rules for agricultural trade.

Trade in manufactured goods, by contrast, has been liberalized significantly over time. At present, there are no quantitative restrictions on manufactured goods, and the average tariff rate on manufactured goods is about 2 percent, one of the lowest among the major industrial countries. The Japanese authorities have actively promoted the Uruguay Round of GATT negotiations, and have specified priority areas for further reductions in tariffs. They have also indicated their willingness to join other industrial countries in eliminating tariffs on them, including high technology products, and have supported the inclusion of trade in services and intellectual capital in the negotiations. At the same time, there is a need to improve market access, including a streamlining of the distribution system. The recent report by the Economic Council has proposed several measures to enhance competition in domestic markets: a relaxation of the system of import standards and certification; a review of licensing and other regulations in the retail industry; and deregulation of the rice distribution system.

Policy actions in the areas just discussed should have a major catalytic effect on the pace of structural adjustment. The elimination of distortions in the use of land will encourage housing and business investment. Together with a reduction in the cost of food and other consumer goods, it would enhance the quality of life. To the extent that structural changes lead to an increase in domestic consumption and investment, external adjustment would accelerate. Furthermore, the expansion of market access, and an increase in its transparency, should help alleviate protectionist sentiment abroad.

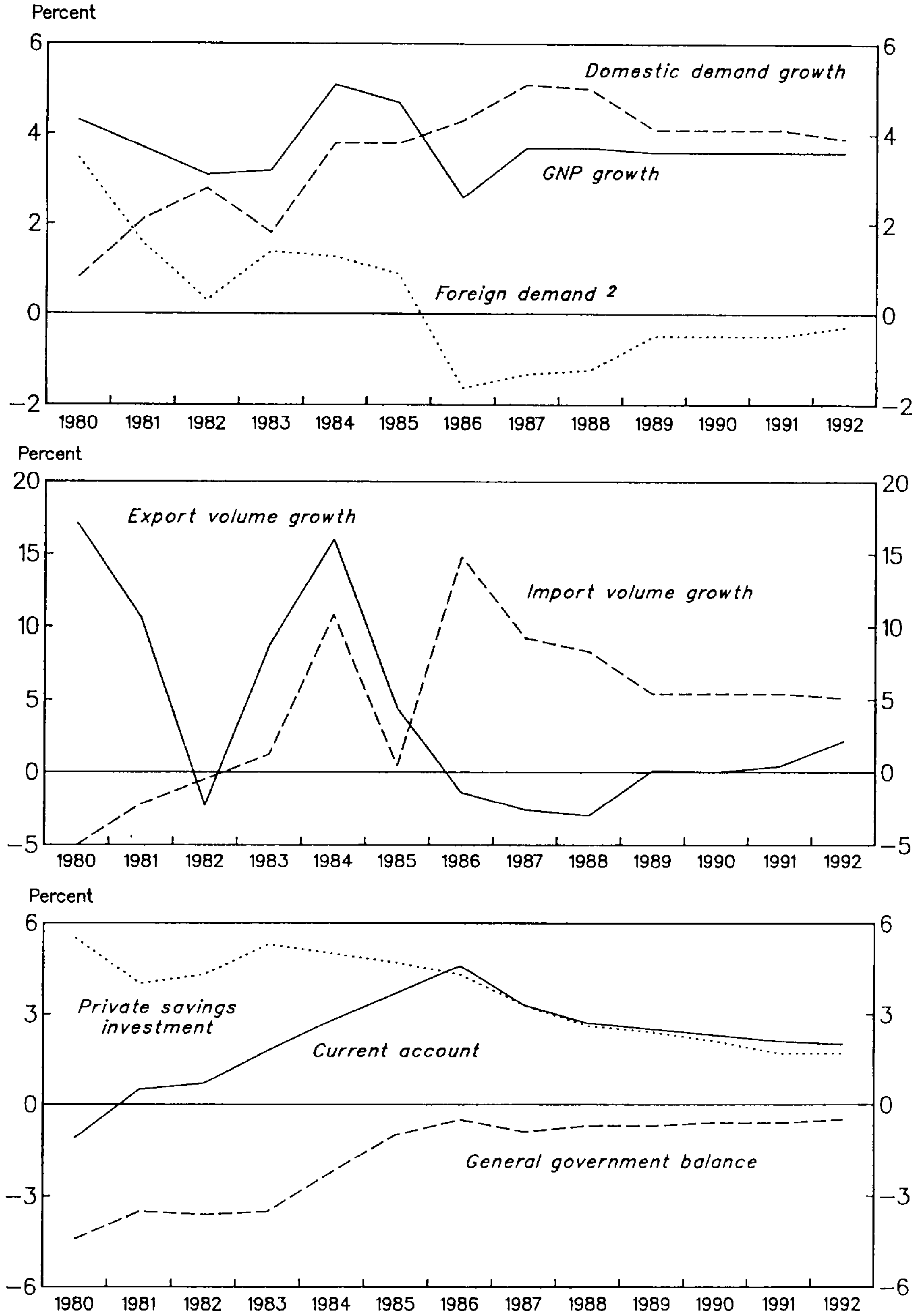
Extensive liberalization and internationalization of the financial sector has been under way since the early 1980s. With the deregulation of interest rates on large deposits in recent years, the share of bank deposits and loans with market-related interest rates has risen rapidly, and the short-term money market has increased fourfold in the past three years to a size equivalent to one third of GNP. Development of the money market should facilitate smoother arbitrage of interest rates, increasing the efficiency of financial intermediation, and enhancing the effectiveness of monetary policy. With the deregulation of interest rates, financial institutions have encountered problems of risk management, generating demands for the opening of financial futures markets--a bill on this issue is expected to be considered by the Diet in 1988. The next step in interest rate deregulation will be the liberalization of small deposits and the reform of the large postal savings system, which enjoys a privileged position vis-a-vis private financial institutions. The important issue of institutional segmentation of financial business also continues to be under study. In other areas, a number of measures have been implemented in the past year: futures transactions on stock packages were introduced in the Osaka Stock Exchange; a commercial paper market was established; tax exemptions under the small saver schemes were abolished; and the Tokyo offshore market opened.

4. Medium-term outlook

Medium-term developments in Japan will be greatly influenced by the extent of sectoral adjustment and pace of structural reforms. The ongoing restructuring of the economy is likely to require greater investment and changes in consumption patterns. Structural changes, however, do not lend themselves to quantification, and it is difficult to predict the international economic environment that Japan is likely to face in the coming years. While recognizing these difficulties, the staff has developed an illustrative medium-term scenario that incorporates supply and trade relationships, the fiscal policy stance, and the investment and saving behavior of the private sector (Table 4 and Chart 5).

The medium-term scenario is predicated on a number of assumptions relating to external and domestic developments. World output is assumed to grow by about 3 percent a year, and world trade by about 4 percent. The Japanese Government is assumed to continue with its fiscal consolidation efforts, but to support output growth through a strong public investment program. In response to the structural reforms described in the previous section, the private investment rate would rise gradually. At the same time, the private saving rate would decline slightly because of both demographic factors and the reforms. The scenario suggests that, with a gradual implementation of structural policies, Japan can continue to grow at a rate of about 3 1/2 percent with price stability. Such a growth path would be consistent with a more or less constant real exchange rate and a steady reduction in the external current account surplus to about 2 percent of GNP by 1992. The reduction in the surplus is associated with a continued decline in the share of exports in GNP; the share of imports would remain broadly unchanged.

CHART 5
JAPAN
MEDIUM-TERM SCENARIO, 1980-92[1]



Sources: Data provided by the Japanese authorities; and staff estimates.
[1] National accounts basis; fiscal years.
[2] Contributions to GNP growth.

Table 4. Japan: Ilustrative Medium-Term Scenario, 1986/87-1992/93 1/

	1986/87	1987/88	1988/89	1989/90	1990/91	1991/92	1992/93
			(In percent of GNP)				
Investment 2/	27.9	28.7	29.0	29.1	29.4	30.1	30.5
Private	23.0	23.5	24.0	24.0	24.2	24.8	25.0
Government	4.8	5.2	5.0	5.1	5.2	5.3	5.5
National savings 2/	32.5	32.0	31.7	31.6	31.7	32.1	32.5
Private	27.3	26.8	26.6	26.4	26.3	26.6	26.7
Government	5.2	5.1	5.1	5.2	5.4	5.6	5.8
Current account	4.6	3.3	2.7	2.5	2.3	2.1	2.0
Of which:							
Merchandise exports	10.1	9.3	8.7	8.4	8.2	8.0	7.9
Merchandise imports	5.3	5.6	5.6	5.6	5.6	5.7	5.7
General government balance 3/	-0.5	-0.9	-0.7	-0.7	-0.6	-0.6	-0.6
			(Percentage change)				
Real GNP	2.6	3.7	3.7	3.6	3.6	3.6	3.6
GNP deflator	1.5	0.3	1.6	1.6	1.5	1.5	1.5
Real domestic demand	4.3	5.1	5.0	4.1	4.1	4.1	3.9
Export volume	-1.4	-2.6	-3.0	0.1	--	0.4	2.1
Import volume	14.8	9.2	8.3	5.4	5.4	5.4	5.1
Unemployment rate (in percent)	2.8	2.8	2.8	3.0	3.0	3.0	2.9

Source: Staff estimates.

1/ Investment, saving, and current account data are on a national accounts basis.
2/ Refers to gross investment and saving, including an allowance for capital consumption.
3/ Land acquisition and capital transfers are recorded as capital expenditure and, therefore, this line is not equal to government saving less investment.

A major question arising from this scenario is whether such developments would be accompanied by a reduction in international tensions. To a large extent, protectionist sentiment is the result of sectoral strains that may not disappear regardless of the macroeconomic environment. Nevertheless, a gradual reduction in Japan's current account surplus would help ease protectionist pressures. There is also the issue of whether a reduction in Japan's surplus of the order envisaged in this scenario would help mitigate pressures in financial markets. Consideration of this issue must take into account developments in other major industrial countries. In the event that the investment-saving gap in these countries remains large, a reduction in Japan's current account surplus would only intensify upward pressure on world interest rates. On the other hand, a reduction in the aggregate current account deficit of the other industrial countries would lower interest rates and provide an opportunity for Japan's surplus to be diverted to the developing countries. Such a rechanneling of Japanese capital outflows, which primarily comprises private funds, would proceed largely through the international capital market. But this process would be facilitated by an increased flow of official financial assistance to the developing countries in support of their adjustment efforts. Furthermore, to the extent that rates of return to investment in developing countries may be higher than those perceived by the market, it may be appropriate for the authorities to take initiatives to encourage the flow of private resources to these countries.

Japan, for its part, has already undertaken major initiatives to support the flow of financial resources to developing countries. The package of economic measures announced in May 1987 included a program that, together with an earlier initiative, provides for the recycling of \$30 billion over three years through various channels. The access of multilateral development banks (MDBs), and in particular the World Bank, to Japanese capital markets would be enlarged by a total of about \$9 billion; capital subscriptions to MDBs would be increased by \$1 billion; and contributions would be made to the replenishments of the Asian Development Fund and the International Development Association for about \$4 billion. The program also called for an increase in cofinancing with MDB by Japan's Overseas Economic Cooperation Fund, the Japan Export-Import Bank (EXIM), and commercial banks, for an aggregate of close to \$9 billion. The EXIM's untied loan program would be increased by about \$3 billion, including private funds. A loan to the International Monetary Fund of about \$3 1/2 billion (SDR 3 billion) was also included in the recycling scheme. By November 1987, implementation of the \$30 billion program reached about 45 percent on a commitment basis. Furthermore, the scheme was enriched at the end of the year through a substantial contribution to the enhancement of the Fund's structural adjustment facility.

IV. Staff Appraisal

Once again, the Japanese economy has risen to the challenge posed by a major new development, this time the sharp appreciation of the yen over a relatively short time. The rapid reallocation of resources in response to market forces reflects, to a large extent, the inherent resilience of the economy. But the policies of the authorities have also made a critical contribution. A flexible adaptation of fiscal policy--that at the same time has not lost sight of its medium-term objective--and an accommodative monetary policy have bolstered the recovery of domestic demand. Output growth has rebounded strongly while prices have remained stable. The adjustment of the current account imbalance is proceeding steadily. Barring a significant worsening of external conditions, these trends should continue in 1988.

In the meanwhile, the global economy is characterized by major vulnerabilities: the possibility of a weakening of growth in the industrial countries, large international payments imbalances, continued trade frictions, and the difficulties faced by heavily indebted developing countries. The severity and widespread impact of the recent turbulence in financial markets underscores the critical importance of sound economic policies in major industrial countries for promoting the financial stability that is crucial for the sustained and balanced growth of the world economy.

Against this background, the desiderata for policy in Japan, from both the domestic and international vantage points, are clear: maintain the domestic economy on its present course of noninflationary growth, ensuring at the same time that domestic demand continues to grow faster than output; provide free access to foreign goods; and facilitate the flow of savings not absorbed domestically in directions that will be most beneficial to the world economy.

In formulating fiscal policy in 1987/88, the authorities have struck an appropriate balance between the short-term need to bolster domestic demand and the medium-term objective of fiscal consolidation. The May package has supported the ongoing recovery of the economy mainly through increased capital expenditure of the public sector, leading to a small increase in the general government deficit. At the same time, continued efforts to curb current spending have reduced central government dissavings, which are the focal point of fiscal consolidation.

It is difficult to assess accurately the overall position of the general government in 1988/89 because the budgetary process of local governments is still underway. Nevertheless, the proposed budget for the central government general account and preliminary staff estimates for local governments' operations suggest that the stance of fiscal policy will remain broadly neutral. Such a fiscal stance appears appropriate at this time, given the underlying strength of the economy. The implementation of fiscal policy, however, should continue to take into account the evolving economic situation.

The staff welcomes the tax reform measures introduced last year. The authorities intend to continue the process of reform by introducing a bill later in the year to further reduce the personal and corporate tax burden and to put in place a broad-based indirect tax. These reforms should make the system more equitable and also revitalize private investment.

The accommodative stance of monetary policy since early 1986 has encouraged the expansion of domestic demand and eased pressures on the exchange rate. Concern about inflation that had emerged during the third quarter of 1987 subsided with the improvement in sectoral demand and supply balances and the sharp decline in equity prices in October. The relaxed stance of monetary policy that was adopted subsequently prevented a liquidity squeeze and helped contain the recessionary effects of the stock market crash. Given the absence of inflationary pressures at this time--and, indeed, apparently also of inflationary expectations--a continuation of the present course of monetary policy seems appropriate so that domestic demand can be sustained and pressures on the yen alleviated. Ultimately, of course, the control of inflation must remain the primary objective of monetary policy.

In light of the substantial appreciation of the yen that has occurred over the past two years and the rapid restructuring of the economy that is already taking place, the staff is sympathetic to the authorities' position that a further appreciation of the yen could be counterproductive: sharp movements in the exchange rate impair business confidence and impede the smooth restructuring of the economy. Nonetheless, as the authorities recognize, exchange rate stability cannot be imposed on the market. In the final analysis, stability of exchange rates cannot be achieved in the absence of favorable economic conditions and policies in the major industrial countries.

In the task of facilitating noninflationary growth, macroeconomic policies can be greatly assisted by the various policies that go under the rubric of structural reforms. The authorities are planning to adopt, in conjunction with the new five-year plan that is to be announced in May, the reform proposals earlier made by the Economic Council. These measures, which are aimed at sustaining noninflationary growth, improving the quality of life, and contributing to more harmonious international relations, should be implemented vigorously. Urban development and housing construction provide considerable scope for generating growth through domestic investment. Substantial distortions arising from the tax system and land use regulations have inhibited urban development and led to an inefficient use of land, particularly for agriculture. Although this involves politically difficult issues, it is to be hoped that rapid progress can be made in implementing corrective measures.

The liberalization and internationalization of financial markets in Japan is proceeding apace. The achievements to date are commendable. A major remaining issue is the reform of the postal savings system which, by reason of its size and the special privileges accorded to it, inhibits the liberalization of interest rates for small-denomination deposits. Continued efforts to deal with this and other outstanding issues in financial reform are appropriate, although the authorities are sensitive, as they should be, to the risks the process involves--especially for the smaller financial institutions.

A set of measures that would be conducive to the easing of international tensions is that related to the opening of markets for imports. Japan's market for manufactures is highly open in terms of tariffs and quantitative restrictions, and the increase that has taken place recently in imports of manufactures is remarkable. Nonetheless, there is a sense in many of Japan's trading partners that, partly owing to the nature of the distribution system, entry into Japan's market is not always easy. While this matter does not lend itself readily to clear assessment, it is to be hoped that the authorities will vigorously continue their efforts to ensure the full openness of Japan's markets. The issue of protection of the agricultural sector has always been clear: from an economic point of view, its dismantling will benefit Japan as well as the rest of the world.

If the various structural reforms are vigorously implemented and are successful in stimulating investment, Japan's output can grow over the medium-term at a rate close to its potential, without generating inflation. At the same time, the increased absorption of domestic savings by higher private and public investment would gradually reduce the current account surplus even as public savings increase with continued fiscal consolidation efforts by the central government.

That Japan's current account surplus should decline has been a theme running through this report, just as it is a concern of the authorities. Nonetheless, the value of a moderate surplus as a provider of saving to the rest of the world must be recognized. As the United States succeeds in reducing its saving-investment imbalance, Japanese savings will need to--and perforce will--flow elsewhere. Japan recognizes its responsibility in respect of official development assistance, which it is to be hoped, will be increased further. For the rest, the outflow of Japanese capital will continue to be channeled through the international capital markets. But, clearly, there will be room for further initiatives on the part of all concerned to ensure that Japanese savings flow where they will have the most impact in helping solve the problems besetting the world economy. A larger flow of resources through the international financial institutions--such as are being generously provided by Japan--would enhance the effectiveness of these institutions in ensuring a proper mix of financing and adjustment in the developing countries. This would be an outcome in which Japan, as the largest creditor nation, has a high stake. Ultimately, such capital flows and the trade flows that they finance will rebound to the benefit of Japan and other developed countries, easing their problem of sustaining growth while reducing payments imbalances between them.

Japan--Basic Data

Area	145,900 square miles
Total population (mid-1987)	122.0 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 (1987)	US$19,500

	1986 Percent Share	1984	1985	1986	1987 1/
		(Percentage change)			
GDP at constant market prices	100.0	5.0	4.7	2.4	...
Agriculture	2.9	2.1	-0.6	-4.2	...
Mining and manufacturing	34.3	11.3	6.9	0.6	...
Services	61.4	3.8	4.0	4.0	...
Other	1.4	-38.4	-5.0	-4.9	...
GNP					
At constant 1980 prices		278.1	291.8	298.8	310.2
At current prices		298.5	317.4	331.3	343.7
		(Percentage change)			
Real GNP	100.0	5.1	4.9	2.4	3.9
Domestic demand	97.2	3.8	4.0	4.0	4.7
Personal consumption	56.1	2.7	2.7	3.2	3.8
Residential investment	5.1	-2.0	2.5	8.4	16.8
Plant and equipment investment	18.6	11.5	12.7	6.1	7.3
Government consumption	9.6	2.8	1.7	6.5	--
Government investment	7.3	-2.8	-6.4	4.0	6.7
Stockbuilding 2/	0.6	0.4	0.4	-0.3	-0.3
Foreign balance 2/	2.8	1.3	1.1	-1.4	-0.9
Nominal GNP	...	6.4	6.3	4.5	3.7
		(Percentage change except where indicated)			
Prices, incomes, and employment					
Wholesale prices		-0.3	-1.1	-9.1	-3.7
Consumer prices		2.3	2.0	0.6	0.1
GNP deflator		1.2	1.3	1.9	-0.1
Hourly compensation 3/		3.5	4.5	3.5	2.1
Real hourly compensation 4/		1.2	2.5	2.9	2.0
Real disposable income 4/5/		2.2	1.9	1.2	...

Basic Data (continued)

	1984	1985	1986	1987 1/
Average propensity to consume (in percent) 5/	78.7	77.5	77.4	...
Unemployment (in percent, period average)	2.7	2.6	2.8	2.8
Manufacturing 1/				
Employment of regular workers	1.4	1.9	0.7	-1.8
Output	11.2	4.5	-0.3	4.0
Productivity	8.3	3.3	-0.1	5.7
Unit labor cost	-4.7	1.3	3.4	-3.2
Inventory/shipments ratio (in percent)	94.8	98.6	101.5	...
Financial aggregates (end of period) 6/				
M2 plus CDs	7.8	8.7	9.2	11.5
Domestic credit	8.9	8.8	9.1	11.0
Public sector	6.6	-0.9	6.8	8.3
Private sector	9.4	10.8	9.5	11.5
Fiscal aggregates (fiscal year beginning April)		(In trillions of yen)		
Central government				
Revenue	38.2	40.7	44.0	45.1
Expenditure	51.5	53.0	53.6	57.1
Deficit (-)	-13.3	-12.3	-9.7	-12.0
Deficit/GNP (-, in percent)	4.4	3.8	2.9	3.5
Fiscal investment and loan program	19.6	20.5	21.6	24.9
General government				
Deficit/GNP (-, in percent)	1.8	0.8	0.5	0.9
		(In billions of U.S. dollars)		
Balance of payments				
Exports	168.3	174.0	205.6	224.4
Imports	-124.0	-118.0	-112.8	-128.0
Trade balance	44.3	56.0	92.8	96.5
Services and transfers	-9.3	-6.8	-7.0	-9.8
Current balance	35.0	49.2	85.8	86.7
Net long-term capital	-49.7	-64.5	-131.5	-137.1
Japanese	-56.8	-81.8	-132.1	-133.4
Foreign	7.1	17.3	0.6	-3.7
Basic balance	-14.6	-15.4	-45.6	-50.4
Net short-term capital	17.0	13.9	59.4	92.7
Bank	17.6	10.8	58.5	71.8
Nonbank	-0.6	3.1	0.9	20.9
Overall balance	2.4	-1.5	13.7	42.3
Export volume	16.0	4.4	-1.3	-1.7
Import volume	10.8	0.4	12.5	7.4

Basic Data (concluded)

	1984	1985	1986	1987 1/
Gross official reserves				
End of period, in billions of U.S. dollars	27.3	27.7	43.3	82.2
Exchange rates (period average)				
Yen per U.S. dollar	237.5	238.5	168.5	144.6
Nominal effective exchange rate (MERM; 1980 = 100)	124.1	127.1	161.0	174.2
Real effective exchange rate (relative normalized unit labor costs; 1980 = 100)	102.3	100.2	121.6	125.2

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.

Japan--Fund Relations

(As of December 31, 1987; 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 Fund 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 2,507.0 million (59.4 percent of quota).
(c) Fund credit: None.
(d) Reserve tranche position: SDR 1,716.3 million.
(e) Current Operational Budget (maximum use of currency):

Purchases: SDR 214.1 million
Repurchases: SDR 76.6 million

(f) Lending to the Fund (amounts):

	Limits	Outstanding	Uncalled
GAB	2,125.0	--	2,125.0
SFF	900.0	279.5	--
Enlarged Access	525.0	196.5	...
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 1,736.3 million (194.7 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.

B. Nonfinancial Relations

VII. Exchange Rate Arrangements

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 December 31, 1987 the exchange rate of the yen, as determined by the Fund under Rule O-2(a), was SDR 0.00573082 per Japanese yen.

VIII. Last Article IV Consultation

The Staff Report for the 1986 Article IV consultation with Japan (SM/87/33) was considered by the Executive Board at EBM/87/40 and EBM/87/41 (March 6, 1987). Japan is on a 12-month consultation cycle.

IX. Technical Assistance

Not applicable.

X. Resident Representative

Not applicable.

Japan--Statistical Issues

1. Outstanding statistical issues

a. Government finance

In the 1987 Government Finance Statistics Yearbook (CFSY), data through 1985 have been published for revenue, expenditure, and the overall balance of the budgetary central government on a cash basis. However, there remain problems with Japan's presentation in the GFSY: there are no data reported on the operations of social security funds or of extrabudgetary accounts and on the functional classification of expenditure and lending minus repayments. Also, no data have been reported on the operations of local governments since 1974. The lack of data on operations of social security funds means that data reported by Japan are not comparable to data reported by other leading industrial countries. Therefore, these data have not been published in International Finance Statistics (IFS). Furthermore, the CFSY does not publish provisional data for Japan.

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 February 1988 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Bank of Japan and the Ministry of Finance, which, with the noted exception of CFS statistics, during the past year have been provided on a timely basis.

Status of IFS Data

		Latest Data in February 1988 IFS
Real Sector	- National Accounts	Q2 1987 1/
	- Prices	September 1987 2/
	- Production	October 1987
	- Employment	August 1987
	- Earnings	Q1 1987
Government Finance	- Deficit/Surplus	n.a.
	- Financing	n.a.
	- Debt	n.a.
Monetary Accounts	- Monetary Authorities	October 1987
	- Deposit Money Banks	October 1987
	- Other Financial Institutions	Q1 1987

Interest Rates	- Discount Rate	November 1987
	- Bank Lending/Deposit Rate	Sept./Oct. 1987
	- Government Bond Yield	July 1987
External Sector	- Merchandise Trade: Value	October 1987
	Prices	August 1987
	- Balance of Payments	September 1987
	- International Reserves	December 1987
	- Exchange Rates	December 1987

1/ Gross national expenditure up to Q3 1987.
2/ Wholesale prices up to October 1987.