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SM/86/24
Supplement 1

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March 6, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Japan - Staff Report for the 1985 Article IV Consultation

The attached supplement to the staff report for the 1985 Article IV consultation with Japan has been prepared on the basis of additional information. Also attached is an information notice on the real effective exchange rate of the Japanese yen.

Mr. B. Smith (ext. 7301) is available to answer technical or factual questions relating to this paper prior to the Board discussion on Monday, March 10, 1986.

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JAPAN

Staff Report for the 1985 Article IV Consultation-- Supplementary Information and Information Notice

Approved by P.R. Narvekar and John T. Boorman

March 6, 1986

This supplement provides additional information based on developments that have occurred since the staff report for the 1985 Article IV consultation with Japan (SM/86/24) was issued. The principal developments--a further considerable strengthening of the yen and a decline in oil prices--have altered the prospects for growth, prices and the balance of payments. While these changes are of considerable magnitude and have important implications for policies as discussed below, they reinforce the direction of the policy recommendations of the staff appraisal contained in SM/86/24.

Preliminary data show that the appreciation of the yen in real effective terms since the last Executive Board discussion in March 1985 reached 15.2 percent in February 1986. This paper, therefore, also serves as an information notice to bring this development to the attention of the Executive Board.

I. Interest Rate and Exchange Rate Developments

After the September 22 G-5 initiative and the tightening of monetary conditions in Japan at the end of October 1985, the yen appreciated quickly to ¥ 200-205 per US$1, and remained within this narrow range until the last week of January 1986 (Chart 1). In effective (MERM) terms also, the yen was virtually unchanged during this period. Short-term interest rates in Japan were allowed to fall during the second half of December and early January, and short-term interest rate differentials moved in favor of dollar investments by about 1 percentage point. Long-term rates and differentials were broadly unchanged.

Following the 0.5 percentage point reduction in the discount rate at the end of January, short-term interest rates in Japan fell further by more than 1 percentage point and during February remained stable at 6 percent; short-term interest differentials widened in favor of dollar investments by a broadly similar amount. At the end of February, short-term interest rates were about half a percentage point lower than prior to the monetary tightening late last October. Despite these actions to unwind the tightening of monetary conditions induced to encourage a stronger yen, the yen appreciated considerably further beginning in the last week of January, rising by about 12 percent against the dollar to ¥ 180 per US$1 by the end of February. During the same period, the yen strengthened against the pound sterling (6 percent) and the German mark and French franc (3 percent), and by 8 percent in effective (MERM) terms (Chart 2).

There are a number of factors underlying the further strengthening of the yen since late January 1986. The decline in short-term interest differentials favoring dollar investments has not been matched at longer maturities which would be expected to have a greater influence on exchange rates. Long-term interest rates in Japan had, by early December, already fallen back to the low rates ruling prior to the monetary tightening, and have since remained broadly unchanged at about 5 1/2 percent. In contrast, long-term interest rates have declined further in the United States, and long-term interest rate differentials in favor of dollar investments narrowed by about 1 percentage point during February. The recent stability in long-term rates in Japan appears to reflect their already low level in relation to short-term rates, which suggests that the market had earlier discounted the unwinding of the monetary tightening. In addition, the decline in oil prices would have positive implications for the yen, as Japan's economic growth prospects and balance of payments are influenced more than in most countries by changes in oil prices. Moreover, other factors have added to market participants' expectations that the yen will remain strong, relative to the U.S. dollar in particular, in the period ahead.

The appreciation of the yen by 15.2 percent in real effective terms between March 1985 and February 1986 reflects a nominal effective appreciation of 19 percent during this period, partly offset by the effects of a steady reduction in relative normalized unit labor costs in Japan, which amounted to some 3 percent over the 11 months (Chart 3). In real terms, the yen depreciated somewhat during March-August 1985, but has appreciated by some 18 percent during the subsequent six months, largely reflecting a nominal effective appreciation during this period.

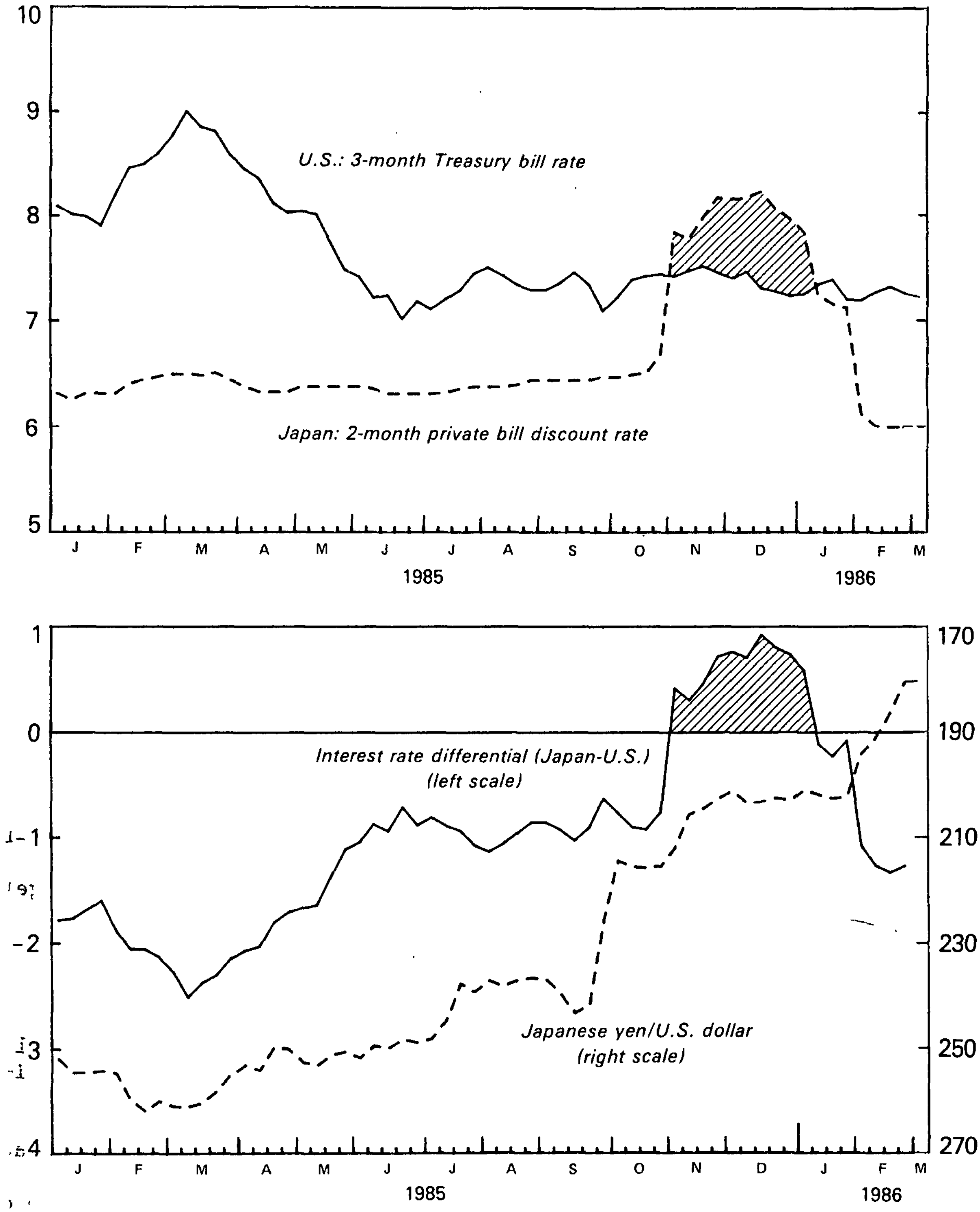
II. Economic Forecasts

The changes that have recently occurred in exchange rates and oil prices have important implications for the projections for growth, prices, and the balance of payments. Table 1 provides revised staff projections for the main macroeconomic variables shown in Table 1 of SM/86/24. The revised projections are based on the assumptions that an exchange rate of ¥ 182 per US$1 and an oil price of $15 per barrel, which approximate current levels, will continue to apply. The stance of fiscal policy is assumed to remain as discussed in SM/86/24, with

CHART 1

JAPAN

NOMINAL SHORT-TERM INTEREST RATES AND THE YEN/DOLLAR EXCHANGE RATE, 1985-86



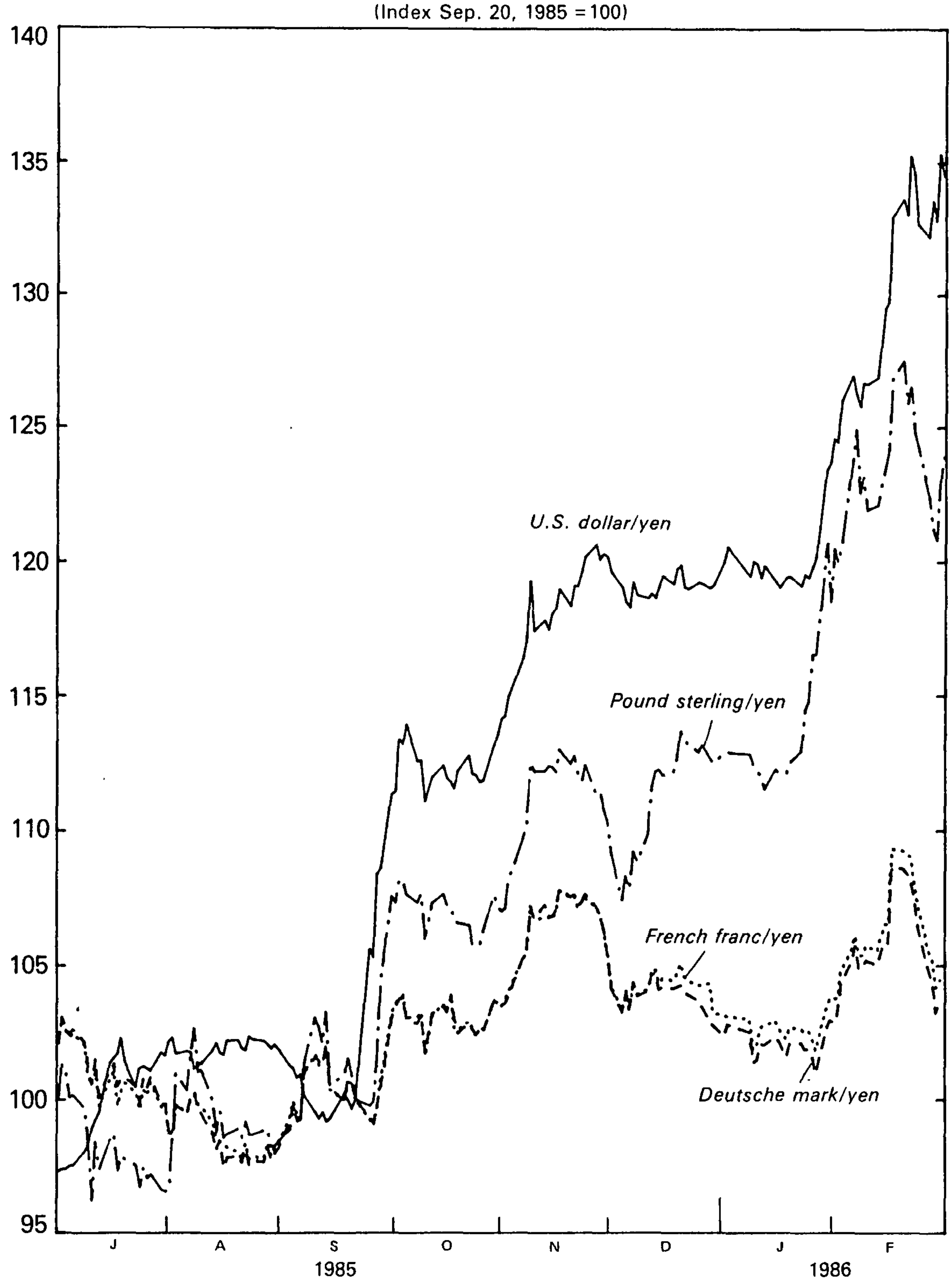
Source: IMF, *International Financial Statistics.*

CHART 2

JAPAN

EXCHANGE RATES, JUL. 1985-FEB. 1986

(Index Sep. 20, 1985 = 100)



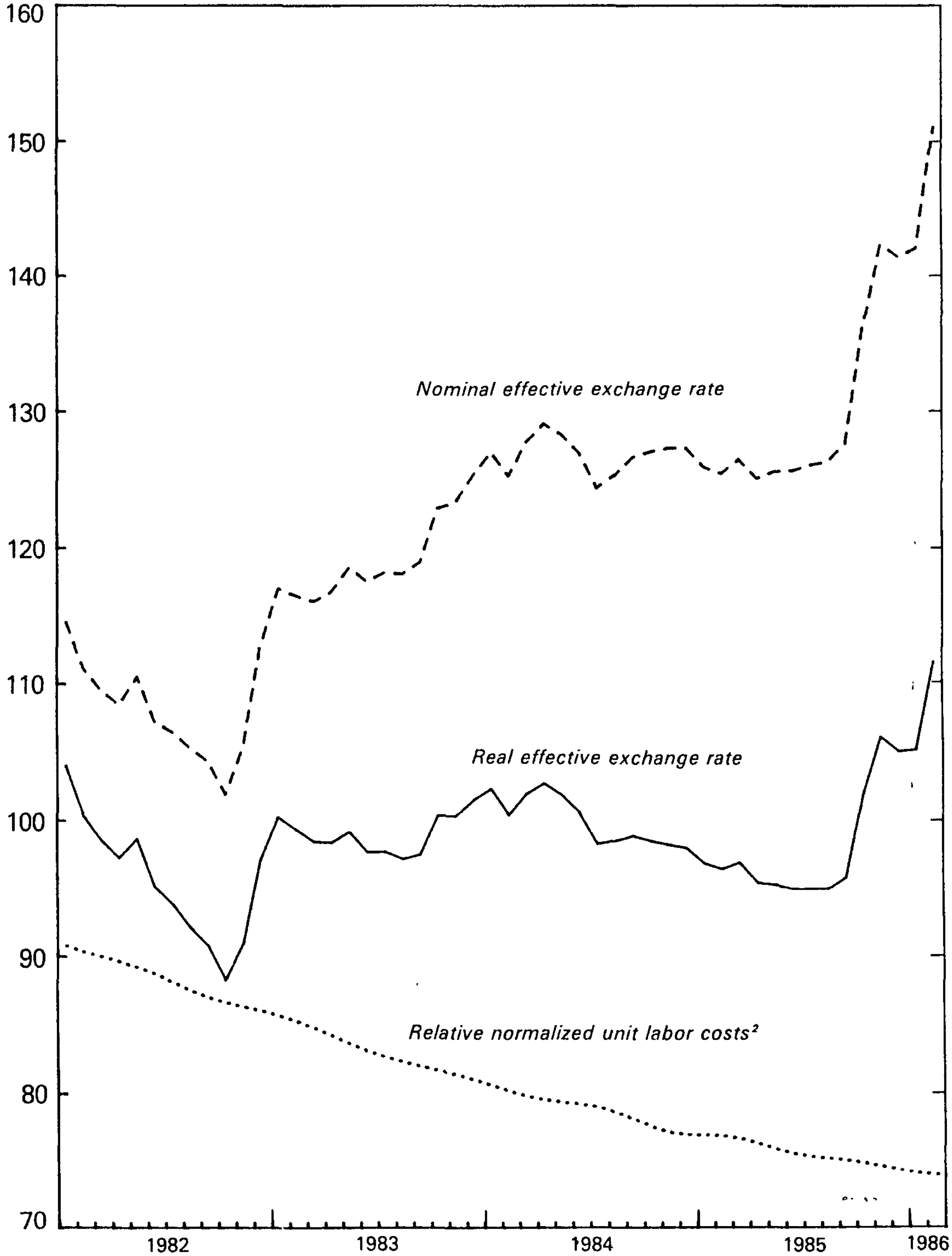
Source: IMF, *International Financial Statistics.*

CHART 3

JAPAN

NOMINAL AND REAL EFFECTIVE EXCHANGE RATES, 1982-86[1]

(1980 = 100)



Source: IMF, *International Financial Statistics*

[1]Increase indicates appreciation

[2]Ratio of normalized unit labor costs in Japan to weighted average of partner countries.

Table 1. Japan: GNP, Price, and Balance of Payments Projections, 1985/86-1986/87

	1985/86			1986/87		
	Official Proj. (December 1985)	Staff Projection Original (Staff Report)	Staff Projection Revised	Official Proj. (December 1985)	Staff Projection Original (Staff Report)	Staff Projection Revised
Aggregate demand (in real terms, percentage change)						
GNP	4.2	3.9	3.9	4.0	2.8	2.1
Total domestic demand	3.5	3.3	3.3	4.3	3.4	3.7
Of which:						
Consumption	3.0	2.8	2.8	3.6	3.3	3.8
Housing	3.1	3.3	3.3	4.6	3.5	3.6
Plant and equipment	11.5 1/	11.2 1/	11.2 1/	7.5	4.6	4.0
Government expenditure 2/	-1.5 3/	-1.5 3/	-1.5 3/	2.0	2.0	2.5
Inventory 4/ 5/	...	-0.2	-0.2	...	0.1	0.1
Foreign balance 4/	0.8	0.7	0.7	-0.2	-0.5	-1.5
Prices						
Consumer prices	2.1	2.0	2.0	1.9	1.3	0.3
Wholesale prices	-2.4	-2.5	-2.7	-1.8	-2.7	-7.6
GNP deflator	1.5	1.6	1.6	1.1	1.1	1.0
Balance of payments (US$ bn.)						
Exports	178	181	182	184	190	191
Imports (f.o.b.)	-120	-119	-117	-128	-126	-116
Of which: oil	...	-42	-39	...	-39 6/	-24 7/
Trade balance	58	62	65	56	64	75
Services and transfers	-7	-7	-6	-5	-5	-4
Current account	51	55	59	51	59	71
(Percent of GNP)	(3.6)	(3.9)	(4.1)	(3.1)	(3.5)	(3.9)

Source: Projections provided by the Japanese authorities and prepared by the staff.

1/ Includes the effect of the privatization of Nippon Telephone and Telegraph (NTT) and the Japan Tobacco Industry. Excluding this effect, real private investment is estimated to rise by about 8 1/2 percent.
2/ Consumption plus investment.
3/ Includes the effect of privatization of Nippon Telephone and Telegraph (NTT) and the Japan Tobacco Industry. Excluding this effect, real government expenditure is estimated to increase by about 1 percent.
4/ Contribution to GNP growth.
5/ Private plus public.
6/ Based on an oil price of $23.5 per barrel.
7/ Based on an oil price of $15.0 per barrel.

broadly unchanged monetary conditions. The earlier forecasts were based on the assumptions that the exchange rate would be constant at ¥ 202 per US$1, and that oil prices would remain at $23.50 per barrel.

With only a short period remaining in 1985/86 (fiscal year ending March), the estimates for GNP growth and its components are unchanged for this year. However, the external current account surplus is now projected to be $4 billion larger at $59 billion, equivalent to 4.1 percent of GNP. The increase mainly reflects reduced oil import values, although export values also increase somewhat because of the "J curve" effect of the recent appreciation of the yen.

More substantial changes apply for 1986/87. The current account surplus is now projected to rise to $71 billion (3.9 percent of GNP), $12 billion higher than previously projected for the year as well as that estimated for 1985/86. Reflecting the substantial appreciation of the yen, export volume is now projected to decline by 4 percent in 1986/87; earlier, export volume was projected to remain unchanged following growth of 3 percent in the current year. However, in value terms, exports would be even slightly higher than previously forecast as dollar unit values will rise because of the yen appreciation. Although import volume growth would be moderately higher at 7 percent because of the stronger yen, the total import bill is now expected to be some $10 billion less, as average dollar import unit values decline by 7 percent on account of lower oil prices. The official balance of payments forecasts, which were based on an exchange rate of ¥ 204 per US$1 and were prepared before the recent decline in oil prices, have not been changed.

The revised staff projections suggest that Japan's terms of trade are likely to improve by almost 20 percent in 1986/87, following a 12 percent improvement in 1985/86. The direct effect on trade prices is estimated to account for more than twice the projected increase in the current account surplus compared with 1985/86. The adjustment in trade volumes as a result of the stronger yen would tend to reduce the surplus by about $14 billion. As the terms of trade gain is not projected to recur, the current account surplus would be expected to decline considerably in 1987/88, returning broadly to the level indicated in SM/86/24 for that year.

The revisions to the export and import volume growth forecasts in the balance of payments imply that the withdrawal of stimulus by the external sector will be substantially larger than projected earlier and by the authorities. Revised estimates for exports and imports of goods and services on a national accounts basis, consistent with the balance of payments projections, indicate that the withdrawal of stimulus by the external sector would increase from 0.5 to 1.5 percent of GNP in 1986/87; the turnaround in the external contribution to growth from 1985/86 would amount to as much as 2.2 percent. The gain in real incomes associated with the oil price decline and the exchange rate appreciation would have a significant positive impact on domestic demand; indeed, the decline in oil prices, taken alone, would be projected to add 0.8 percent to GNP growth in 1986/87. However, this would tend to be partly offset by the negative secondary effects of the yen appreciation on the domestic economy, which the staff believes will be substantial in 1986/87. In particular, nominal wage increases are likely to be scaled back and investment activity curtailed because of the adverse developments affecting industries producing traded goods. Also, the less favorable economic prospects may motivate additional precautionary savings. On balance, the staff now projects domestic demand to increase by 3.7 percent in 1986/87, 0.3 percentage point higher than previously and 0.4 percent faster than in 1985/86. Private consumption expenditure is expected to grow more strongly at 3.8 percent, which would be faster than in any year since 1982. Lower import prices associated with the stronger yen and weaker oil prices are likely to result in a sharp fall in wholesale prices, and consumer price inflation is expected to decline to no more than 0.3 percent, although, as noted above, nominal income growth would also be scaled back because of the impact on domestic economic activity of the decline in exports.

The staff report identified private plant and equipment investment as the area of greatest difference between the official projections and those made by the staff. As indicated in SM/86/24, the lower growth in plant and equipment investment projected by the staff was mainly based on the prospect of weaker profits and stagnating exports, and the already considerable duration of the investment upswing. The recent appreciation of the yen and contraction in exports is expected to lead to a further reduction in investment spending. This is projected (at least in the short run) to more than outweigh the positive implications of lower oil prices on investment; the staff does, however, expect a significant increase in investment by public utilities, assuming that a large part of the reduction in oil prices is not passed on in the form of lower utility rates. On balance, the staff now projects a growth in private plant and equipment investment of 4.0 percent in 1986/87, 0.6 percentage point below the previous estimate. Recent investment surveys indicate almost no growth in planned private plant and equipment investment in 1986/87.

Overall, therefore, real GNP now appears unlikely to grow by more than about 2.1 percent in 1986/87, 0.7 percentage point lower than previously projected by the staff. 1/ It must be noted that these revised projections are subject to considerable uncertainty, not only because of the possibility that the underlying assumptions may not be realized, but also because the recent changes in exchange rates and oil prices are of such magnitude as to raise additional uncertainty concerning the speed

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1/ Estimates prepared for the WEO exercise project growth of 3.0 percent for calendar 1986. The higher growth in comparison with the original staff projections for 1986/87 arise because in the WEO oil prices were projected at $20 per barrel (rather than $23.50), while the exchange rate assumptions were essentially the same.

and manner in which they will be transmitted throughout the economy; quantitative relationships that had obtained in the past would not be a necessarily useful guide. Nevertheless, the broad conclusion is that the stronger yen and lower oil prices, should they persist, will result in a large, but temporary, surge in the external surplus, downward pressure on prices, and, in net terms, a marked slowing in economic growth.

The outlook for the economy presented in SM/86/24 already tended in these broad directions, and recent developments have mainly magnified the size of the changes to be expected. Accordingly, the broad thrust of policy suggestions contained in the staff appraisal does not require redirection; rather, the policy needs are thrown into sharper focus, and acquire an added urgency, in these new circumstances. With the yen apparently set firmly at a substantially stronger level, any constraints on the conduct of monetary policy from exchange rate considerations can be put aside at the present time. Indeed, the downward pressure on prices will strengthen the tendency for real interest rates to rise. The staff believes that, in present circumstances, a further easing of monetary conditions would be appropriate and should be put in place soon. On the side of fiscal policy, the staff believes that it is now all the more important that public finances not withdraw demand stimulus from the economy in the coming year. To this end, the staff would underscore the important positive role that additional public works spending (by reintroducing front-loading and allocating additional amounts in the second part of the year to compensate for expenditures brought forward) and an income tax cut, could each play. The prospect of slower growth also imparts a new urgency to the authorities' efforts to develop effective programs to stimulate private sector vitality.

III. Other Developments

The scheme to provide temporary support to small- and medium-sized companies to facilitate adjustment to the appreciation of the yen was enlarged in February by increasing the number of eligible industries from 50 to 120-130, raising the total amount of loans available from ¥ 100 billion ($0.6 billion) to ¥ 300 billion ($1.7 billion), extending the period during which these loans are available up to March 1987, and lowering the interest rate from 6.8 percent to 5.5 percent. Improvements were also made in the credit insurance scheme for depressed industries, following an enlargement of the system in December 1985. Furthermore, it is reported that the Government is to make payments to designated export industries affected by weak exports to cover costs associated with retraining, temporary layoffs, and secondment.

In February, the Government announced that the ceiling on exports of automobiles to the United States will be maintained at 2.3 million units for the period April 1986-March 1987. The staff encourages the authorities to discontinue this arrangement as soon as conditions permit.

Also in February, the first issue of short-term government refinancing bonds was made, with bonds totaling ¥ 517 billion being issued by public auction, with an average yield of 5.6 percent. These bonds, which can only be acquired by corporate and institutional investors and financial institutions, have a minimum denomination of ¥ 100 million and a maturity of six months; they are subject to 16 percent withholding tax, but with full tax credit to be given.