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(CULL)

JAPANESE BALANCE OF PAYMENTS

1. THE FOLLOWING ARE SEMI-FINAL JAPANESE BALANCE OF PAYMENTS FIGURES FOR MAY 1988 ANNOUNCED BY THE MINISTRY OF FINANCE. CUSTOMS CLEARANCE FIGURES ARE EXPORTS FOB, IMPORTS CIF, AND INCLUDE NON-MONETARY GOLD. USDLR MILLIONS, YEN BILLION. THE FIGURES IN BRACKETS SHOW PERCENTAGE CHANGE OVER THE SAME PERIOD LAST YEAR. VOLUME FIGURES ARE ONLY AVAILABLE FOR GLOBAL EXPORTS AND IMPORTS. FURTHER DETAILS FOLLOW IN MONTHLY ECONOMIC REPORT.

(A)	MAY 1988	US DOLLARS	YEN
2.	TRADE ACCOUNT (CUSTOMS CLEARANCE)	5,167 (-19.5)	644 (-28.3)
	TRADE ACCOUNT (IMF BASIS, NOT SEASONALLY-ADJUSTED)	6,606 (-18.5)	824 (-27.7)
	CURRENT ACCOUNT (IMF, NSA)	5,792 (-18.6)	723 (-27.7)
3.	CUSTOMS CLEARANCE FIGURES FOR TRADE WITH UK.		
		US DOLLARS	YEN
	EXPORTS	938 (25.4)	117 ( 11.7)
	IMPORTS	374 (19.9)	47 ( 6.9)
	EXCL. NON-MONETARY GOLD	317 (22.6)	40 ( 9.3)

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BALANCE	564 (29.2)	70 ( 15.2)
EXCL. NON-MONETARY GOLD	621 (26.8)	77 ( 13.0)

(B) JANUARY - MAY

4. IMF BASIS, NOT-SEASONALLY ADJUSTED.

	US (%) DOLLARS	YEN (%)
TRADE ACCOUNT	36,112 (-10.5)	4,575 (-23.6)
CURRENT ACCOUNT	31,328 (-13.5)	3,969 (-26.1)

5. CUSTOMS CLEARANCE FIGURES (PROVISIONAL):

	US (%) DOLLARS	YEN (%)	VOLUME CHANGE NSA
TOTAL EXPORTS	103,424 (15.5)	L3,117 ( -2.3)	2.1
TOTAL IMPORTS	75,694 (34.8)	9,593 ( 13.9)	20.5
BALANCE	27,730(-17.1)	3,524 (-29.6)	

EXPORTS TO:

US	34,118 ( 5.4)	4,326 (-10.8)
EC	19,328 (25.7)	2,451 ( 6.1)
UK	4,294 (30.3)	544 ( 10.2)
FRANCE	2,075 (29.4)	263 ( 9.4)
W GERMANY	6,455 (19.4)	819 ( 0.6)

IMPORTS FROM:

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US	16,814 (42.5)	2,132 ( 20.3)
EC	9,532 (47.7)	1,208 ( 24.9)
UK	1,719 (54.3)	218 ( 30.8)
EXCL. NON- MONETARY GOLD	1,520 (46.1)	193 ( 23.4)
FRANCE	1,571 (64.4)	199 ( 39.0)
W GERMANY	3,330 (44.3)	422 ( 21.9)

## BALANCE WITH:

US	L7,304 (-16.0)	2,194 (-28.7)
EC	9,796 ( 9.8)	1,243 ( -7.5)
UK	2,575 ( 18.1)	326 ( -0.2)
EXCL. NON- MONETARY GOLD	2,774 ( 23.0)	351 ( 4.1)
FRANCE	504 (-22.3)	64 (-34.3)
W GERMANY	3,125 ( 0.9)	397 (-15.1)

6. COMMENT: THE DOLLAR CURRENT ACCOUNT SURPLUS FELL IN MAY BY COMPARISON WITH THE SAME MONTH OF THE PREVIOUS YEAR, AND HAS NOW FALLEN CONSISTENTLY SINCE MAY 1987 APART FROM A SMALL INCREASE IN DECEMBER. IMPORT GROWTH THIS MONTH WAS PARTICULARLY STRONG IN NON-FERROUS METALS, STEEL, TIMBER AND CRUDE OIL.

7. ACCORDING TO A MINISTRY OF FINANCE BREAKDOWN OF THE 1987 CURRENT ACCOUNT SURPLUS, 87.9% (76.45 BILLION DOLLARS) WAS WITH OECD COUNTRIES, OF WHICH 65.1% (UP 5.4%) WAS WITH THE US, 20.4% (UP 19.4%) WITH THE EC AND 2.3% (1.99 BILLION DOLLARS) WITH THE UK. FIGURES FOR OTHER EC COUNTRIES ARE NOT AVAILABLE.

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JAPAN: ECONOMIC REPORT: JUNE 1988

11/7/88

- Real GNP grew by 2.7% in the March quarter, and by 4.9% during FY 1987 as a whole. During the fiscal year, domestic demand grew by 6.0%, offset by a 1% decline in net external demand. (Paras 1-4).
- Recent economic forecasts are expecting real GNP in FY 1988 to be considerably higher than the government's official 'target' of 3.8%. The Research Institute on National Economy is predicting real GNP growth of 5.2% (with only a limited slowdown in the first half of 1989), whilst the JERC expects real growth of 4.6% (Paras 24-25).
- However, current economic indicators are suggesting that economic activity slowed to a more normal level in the June quarter. In May industrial production fell by 1.7%, and producers' shipments by 1.9%, - although both series continued to show substantial year on year gains. The leading indicators index has slipped to just over 50% in the last three months. (Paras 5-9).
- Consumer prices rose by 0.2%, and wholesale prices fell by 0.5% in May (year on year). However, concern has been expressed that the recent weakening of the yen might lead to an increase in wholesale prices before long. (Paras 13-14)
- The seasonally adjusted trade and current account surpluses fell further, to \$6.8 billion and \$6.0 billion respectively in April. The current account surplus for the first five months of 1988 is \$31.3 billion, 13.5% down on 1987. (Para 15)
- The net outflow of long term capital rose to \$16.2 billion in May, as Japanese investors increased their purchases of foreign bonds. (Para 18)
- The yen weakened against the dollar towards the end of June closing the month at Y132.40. (Para 20).
- Interest rates and bond yields continued to rise, reflecting international trends, and the markets increasingly anticipated a tightening of monetary policy. (Paras 19-23)

GNP DATA (TABLE I)

TABLE I: GROSS NATIONAL EXPENDITURE  
(Real, seasonally-adjusted, base year = CY 1980)  
Percentage change over the preceding period

	FISCAL YEARS			QUARTER ENDING					
	1985/86	1986/87	1987/88	1986	1987			1988	
				DEC	MAR	JUNE	SEPT	DEC	MAR
Consumers' Expenditure	2.8	3.6	4.0	-0.6	2.0	0.7	1.0	0.4	2.6
Private Housing	2.9	10.9	23.9	5.2	1.2	3.0	10.2	12.7	1.0
Private Investment	13.2	4.5	10.1	1.8	2.5	1.8	2.7	4.1	3.6
Private Inventories	7.0	-74.7	87.5	61.7	-83.8	530.1	-21.0	63.6	-10.4
Government Current Expenditure	1.6	6.8	-0.8	14.3	-11.3	1.2	-0.3	0.2	1.1
Government Capital Expenditure	-6.3	6.6	10.8	0.9	0.7	1.7	3.1	6.6	4.0
Government Inventories	79.0	174.0	-94.9	-215.7	-	145.2	-	-	-
External (Net)	20.9	20.9	-35.0	3.2	20.8	-41.0	11.0	-30.1	-5.6
Exports	2.1	-3.6	5.0	-0.6	2.5	-1.8	6.7	-0.9	3.5
Imports	-2.3	5.5	5.0	-1.2	-0.7	6.4	6.2	2.6	4.3
GNE (Percentage change)	4.4	2.6	4.9	0.7	1.5	0.0	2.0	1.8	2.7
GNE (Y Billion)	293,903.6	301,679.7	316,610.9	302,299.0	306,780.1	306,805.8	313,030.0	318,776.3	327,402.3
Memo item: Nominal GNE	6.0	4.2	4.8	0.4	1.1	-0.2	2.7	1.7	2.8
(Y Billion)	321,158.2	334,651.5	350,769.7	335,402.0	339,158.5	338,543.5	347,574.0	353,552.3	363,299.8

1. Real GNP grew by 2.7% seasonally adjusted in the March quarter, a little higher even than preliminary estimates. This was equivalent to an annual rate of 11.3%, and as a result real GNP grew by 4.9% in FY 1987, against 2.6% in FY 1986. This was well above the government's "target" of 3.7%.



2. Consumer spending rose by 2.6% in the first quarter, the fastest quarterly growth since 1978, and by 4.0% overall in FY 1987. The rate of growth of housing construction slowed to 1.0% in the March quarter, although this component of GNP was the most buoyant during the fiscal year, rising by nearly 24%. Housing starts remain at a high level, although they are not expected to form such an important element of growth in the current fiscal year. Other private sector investment grew by 3.6% in the March quarter, and by 10.1% during the year: investment has been particularly strong in the last six months of the year and, buoyed up by high profits and strong consumer spending, it is expected to remain so in FY 1988.

3. In the March quarter, domestic demand grew by 2.8%, offset by a 0.1% decline in the net external sector. In the fiscal year as a whole, domestic demand grew by 6.0%, offset by a 1.0% decline in the net external sector. Exports grew in both the quarter and in year, and the negative external sector growth was only achieved because of the faster growth of imports in each case.

4. Recent forecasts of GNP growth in FY 1988 are considerably higher than the official target of 3.8%. See paragraphs 25 and 26.

INDUSTRIAL AND BUSINESS ACTIVITY (TABLE II)

TABLE II: PRODUCTION AND BUSINESS ACTIVITY  
SEASONALLY ADJUSTED, EXCEPT FIGURES FOR FISCAL YEARS  
PERCENTAGE CHANGE OVER PREVIOUS PERIOD

	FISCAL YEARS			1987					
	1985/6	1986/7	1987/8	DEC	JAN	FEB	MAR	APR	MAY
Industrial Production Mining and Manufacturing) (1985 = 100)	2.5	-0.2	5.8	1.1	0.6	2.0	0.1	0.1	-1.7
Manufacturing operating ratio	-0.6	-4.8	2.5	1.1	-0.2	1.7	0.9	-3.5	n.a
Housing starts total units)	3.6	11.9	23.5	-4.0	-0.4	-1.2	-3.0	-10.7	13.1
Domestic machinery orders (total)	-1.8	4.1	7.7	2.3	-3.7	-2.8	-9.1	32.4	n.a
Retail sales	3.2	1.1	5.0	0.2	-1.6	5.1	-2.2	-1.4	0.8
Leading Indicators Index (1980=100) End of period	50.0	75.0	n.a.	62.9	72.7	50.0	53.8	54.9	n.a

5. Revised data now show that industrial production (mining and manufacturing) was flat in April, on a seasonally adjusted basis, but preliminary data show quite a sharp fall, of 1.7%, in May. However, the year on year index continued to show healthy growth of 11.0%, and MITI officials expressed confidence that output would continue to rise in the coming months: the official MITI forecast is for a 2.5% rise in June and a 0.3% rise in July.

6. By industry, output in May was down by 6.6% in both industrial and transport machinery sectors, broadly flat for electrical machinery, and up by 2.3% for the iron and steel industries. Year on year, however, output of industrial machinery rose by 12.4% whilst electrical machinery was up by as much 21.4%.

7. The leading indicators index, which seeks to forecast economic activity 6 months ahead, has slipped to only a little over the traditional "boom or bust" level for the three months ending in April. Furthermore, the coincident index which stood at 100 in February and at 91 in March, slipped to 60 in April. These indicators suggest that economic activity may be slowing to a more "normal" level, after the exceptionally rapid growth in the first quarter.

8. Producers' shipments fell by 1.9% seasonally adjusted in May - the first such decline for exactly a year: however, the year on year index was 9.2% up over May 1987. May inventories of finished goods were 0.3% higher than in April, and unchanged on a year on year comparison. This is the first time that inventories did not register a year on year decline for nearly 18 months, and the trend since the beginning of the year seems to indicate a slowdown in destocking in manufacturing industry.

9. Housing starts recovered in May, with a 13.1% seasonally adjusted increase after 5 successive monthly declines. New orders for industrial and commercial construction were also buoyant, registering a 16% year on year increase in May, although this was lower than the 42% increase in the previous month.

10. New orders for machinery recovered strongly in April, although the 32% increase over the previous month may have reflected in part a rush of new orders at the beginning of the new financial year. On the other hand, the unadjusted series still showed a 25% increase year on year. Orders from non-manufacturing industry rose by 60.0% (to Y466 billion), whilst orders from manufacturing rose by 13.7% to Y382 billion.

11. New car registrations rose by 17.3% year on year in the June quarter, after a 14.7% increase in the March quarter. Car sales have been especially buoyant in the first half of 1988: the year on year increase in calendar 1987 as a whole was only 4.1%.

LABOUR MARKET (TABLE III)

TABLE III: LABOUR MARKET

ALL FIGURES SEASONALLY ADJUSTED EXCEPT FIGURES FOR FISCAL YEARS

	FISCAL YEARS			1987	1988				
	<u>1985/86</u>	<u>1986/87</u>	<u>1987/88</u>	<u>DEC</u>	<u>JAN</u>	<u>FEB</u>	<u>MAR</u>	<u>APR</u>	<u>MAY</u>
<u>Unemployment</u>									
Number (mns)	1.58	1.71	1.70	1.61	1.66	1.66	1.62	1.57	1.54
% of Workforce	2.65	2.8	2.78	2.68	2.70	2.71	2.64	2.55	2.49
<u>Employment</u>									
(Regular Workers (1985 = 100))	100.4	101.7	102.1	102.2	102.6	102.7	102.9	102.8	102.9
<u>Overtime Hours Worked</u>									
(all industries) (1985 = 100)	99.9	96.2	102.7	105.6	106.5	107.3	108.0	106.1	106.4
<u>Job Opening/ Job Seeking Ratio</u>	0.67	0.62	0.76	0.85	0.86	0.88	0.90	0.94	0.99

12. The seasonally adjusted unemployment rate fell to 2.49% in May, its lowest level for over 3 years. The ratio of job openings to job seekers jumped to 0.99, the highest level for 14 years. The ratio reached its lowest point, of 0.60, in June 1986.

PRICES AND EARNINGS (TABLE IV)

TABLE IV: PRICES AND EARNINGS

	<u>PRICES AND EARNINGS</u>			<u>% CHANGE ON YEAR EARLIER, NOT SEASONALLY ADJUSTED</u>					
	<u>FISCAL YEARS</u>			<u>1988</u>					
	1985/6	1986/7	1987/8	JAN	FEB	MAR	APR	MAY	JUN
Consumer Prices - National	1.9	0.0	0.5	0.9	0.7	0.7	0.3	0.2	n.a
- Tokyo	2.3	0.3	0.9	1.2	1.2	1.2	0.7	0.6	0.4
Wholesale Prices - Total	n.a	-9.3	-2.0	-1.0	-1.0	-1.0	-0.7	-0.5	n.a
- Domestic	n.a	-5.3	-1.7	-0.1	-0.1	-0.2	-0.2	-0.2	n.a
Average earnings, all industries (real) 1985 = 100	1.1	2.6	1.7	0.1	2.8	2.3	3.4	3.8	n.a
Unit labour costs	2.1	2.9	n.a.	-5.6	-7.4	-6.2	-6.1	n.a	n.a
Labour Productivity (1985 = 100) manufacturing	4.4	1.8.	5.9	12.4	13.8	124.8	n.a	n.a	n.a

13. Consumer prices rose by 0.2% year on year in May. Seasonally adjusted, they registered no change for the second successive month. Prices in metropolitan Tokyo appear to be rising more slowly now than hitherto: after rising by 1.2% year on year in the first quarter of 1988, the index rose by only 0.5% during the 3 months to June. The slower overall growth partly reflects declines in the prices of fresh food, together with further falls in utility prices as a result of last year's appreciation of the yen.

14. Wholesale prices fell by 0.5% year on year in May. As in April, domestic wholesale prices remained virtually flat: prices of non-ferrous metals and general machinery rose, but this was offset by falls in the prices of most other raw materials including iron and steel, as supply constraints were eased. Import and export wholesale prices fell by 2.8% and 1.4% year on year respectively, during the month. As reported separately under Financial Developments, the weakening of the yen during June has led to some concern that wholesale prices may begin to rise in the next few months.

TRADE (TABLE V)

TABLE V: TRADE

(ALL FIGURES IMF BASIS, SEASONALLY-ADJUSTED)

	FISCAL YEAR (NSA)			1987	1988				
	1985/86	1986/87	1987/8	DEC	JAN	FEB	MAR	APR	MAY
Exports (\$ mn)	180,664	211,293	233,389	20,029	21,771	20,963	20,801	20,615	20,288
Imports (\$ mn)	119,063	109,645	139,108	12,032	12,688	12,792	12,339	12,880	13,489
Trade Balance (\$ mn)	61,601	101,648	94,281	7,997	9,083	8,171	8,462	7,735	6,799
Current Account Balance (\$ mn)	55,019	94,139	84,540	7,474	8,031	7,599	7,486	6,365	5,985
Indices, NSA, % change over same period of previous year Volume (1985=100)									
- Exports	3.6	-0.5	0.1	3.7	-0.1	4.2	3.2	3.3	-0.6
- Imports	1.1	10.5	12.6	11.8	12.2	31.3	21.8	20.4	17.9
\$ Unit value									
- Exports	n.a	18.3	10.5	14.7	16.4	12.7	14.1	11.6	11.5
- Imports	n.a	-13.6	14.6	20.6	19.9	12.8	11.2	9.1	7.7
Indices, SA Volume (1985 = 100)									
- Export	99.8	99.1	99.6	100.7	103.6	103.8	102.2	101.5	96.5
- Imports	100.4	111.2	124.4	128.8	130.1	141.7	134.2	135.2	134.6

15. The seasonally adjusted trade surplus fell by almost \$1 billion in May, to \$6.8 billion. Exports fell by 1.6% in dollar value terms, whilst imports rose by 4.7%. The trade surplus before seasonal adjustment, of \$6.6 billion, was 18.5% lower than in March 1987. The current account surplus fell less sharply, reflecting a fall in the invisible deficit, to \$6.0 billion in May. The (unadjusted) current account surplus for the first five months of 1988 is \$31.3 billion, 13.5% lower than a year ago.

16. The invisibles deficit fell to \$0.8 billion in May, from \$1.4 billion in April. Net transfer of funds out of Japan fell to \$0.2 billion, from \$0.6 billion in April.

17. Export volume fell by 0.6% year on year in May (the first decline since January) and by almost 5% on a seasonally adjusted basis over April. Import volume rose by 17.9% year on year, but fell slightly after seasonal adjustment.

CAPITAL ACCOUNT (TABLE VI)

LONG TERM CAPITAL (TABLE VI)

OUTWARDS	CALENDAR YEARS						
	1984	1985	1986	1987	Q1	APR	MAY
Direct Investment	6.0	6.5	14.5	19.5	7.2	2.8	2.3
Trade Credit	5.0	3.0	2.0	1.7	1.2	1.1	0.1
Loans	11.9	10.6	9.1	16.1	3.8	0.5	0.1
Securities							
- Stocks	30.8	1.0	7.0	16.8	(0.5)	(0.7)	0.2
- Bonds		58.8	95.1	70.7	12.6	7.5	11.3
Other	3.1	2.2	4.6	8.7	1.6	0.4	-
	<u>56.8</u>	<u>82.1</u>	<u>132.4</u>	<u>133.5</u>	<u>25.9</u>	<u>11.6</u>	<u>14.0</u>
INWARDS							
External Yen Bonds	7.4	12.8	18.4	30.3	5.6	1.4	1.7
Stocks	(3.6)	(0.7)	(15.7)	(42.8)	6.5	0.9	(1.2)
Bonds	3.5	4.5	(2.1)	6.6	(1.1)	(0.7)	(2.0)
Other	(0.1)	(0.7)	(0.1)	2.2	(0.5)	(0.1)	(0.7)
	<u>7.2</u>	<u>17.3</u>	<u>0.5</u>	<u>(3.7)</u>	<u>10.5</u>	<u>1.5</u>	<u>(2.2)</u>
NET OUTFLOW	49.6	64.8	131.9	137.2	15.4	10.1	16.2

18. The net outflow of long term capital rose to \$16.2 billion in May. As Japanese investors' confidence in overseas securities continued to recover, their purchases of foreign bonds rose to \$11.3 billion, although their net purchases of stocks remained modest at \$0.2 billion. At the same time non-residents reduced their holdings of both stocks and bonds in Japan, by \$1.2 billion and \$2.0 billion respectively. Despite this, non-resident investment in Euro-yen bonds continued to be firm, at \$1.7 billion net during the month.

FINANCIAL DEVELOPMENTS (TABLE VII)

TABLE VII: MONETARY INDICATORS

	<u>FISCAL YEAR</u>			<u>1988</u>					
	<u>1985/6</u>	<u>1986/7</u>	<u>1987/8</u>	<u>JAN</u>	<u>FEB</u>	<u>MAR</u>	<u>APR</u>	<u>MAY</u>	<u>JUN</u>
M1 (annual Growth, %)	4.5	8.4	10.2	8.4	9.8	9.1	9.2	10.2	n.a
M2 + CDs - Annual growth, (%)	8.7	8.6	11.2	11.9	12.4	11.8	11.3	11.4	n.a
Discount Rate (%) (end of period) growth %)	3.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
3-month Gensaki Rate (end of period)	4.395	3.983	3.835	3.847	3.816	3.835	3.795	3.823	3.825
Government Bond Yield (No 10, 6.1%)	4.40	3.79	4.430	4.160 (No 105)	4.310 (No. 105)	4.430 (No. 105)	4.445 (No. 105)	4.665 (No. 105)	4.865 (No. 105)
Tokyo Stock Exchange First Section Index - Average Price	1,030	1,448	2,014	1,828.36	1,985.47	2,109.32	2,165.74	2,167.79	2,185.63
Yen/Dollar rate (end of period (closing))	160.10	145.80	124.50	127.18	128.12	124.50	124.82	124.80	132.20
Yen/Sterling T.T. Selling rates (AV)	237.59	234.30	238.93	238.99	231.01	236.88	238.69	237.44	230.87

19. M2 + CD's, the broadly defined measure of the money supply, rose by 11.4% year on year in May, continuing the slightly more moderate rate of growth seen in April. On 9 June the Bank of Japan asked the commercial banks to restrict the growth in their lending in the third quarter to about the same as in the second quarter. It was estimated that this would result in lending growth of only around 4% above the level of a year earlier, and was interpreted by the markets as an indication of a tightening of monetary policy prompting rises in both short and long term interest rates. This was however denied by the Bank of Japan.

20. The yen remained stable in the range Y125-Y126 until around 22 June, when it began to weaken against the dollar. This reflected a combination of factors, including the announcement of encouraging US trade figures on 14 June, a perception in the markets that the communique of the Toronto Summit had indicated that the G7 countries would not discourage a stronger dollar, and moves to increase interest rates in European countries. The yen fell to below Y130 over the weekend of the 25th/26th June and to below Y133 on 29 June before closing the month at Y132.40. Although speculation grew that the Bank of Japan might enter the markets to support the yen, there was no reported intervention during the month.

21. Interest rates continued to move up during the month, with 3-month CD's rising from 4.31% to 4.41%. Throughout the month, and particularly after the yen began to weaken, commentators tried to assess whether the Bank of Japan was about to tighten monetary policy or even to increase the official discount rate. In the middle of the month the Bank of Japan allowed short term bill discount rates to rise by about one-sixteenth percent (to 3.97%), but claimed that this merely reflected the recent rises in open market rates.

22. The bond markets had a bearish month, reflecting worries about inflation and the prospect of higher interest rates both at home and abroad. The yield on the benchmark No 105 bond rose to 4.87% by the end of the month, but broke through the 5% barrier the following day. The July issue of 10-year bonds will carry a coupon of 5.0%, 0.2% up on the coupon for the June issue.

23. Prices on the Tokyo Stock Exchange reached a peak of 28,342 on the Nikkei Index on 17 June, but thereafter the market was affected by the weakness of the yen and the prospect of higher interest rates. By the end of the month prices had slipped back to Y27,769. Sales volume remained at a high level in both April and May, with average daily turnover once again exceeding one billion shares during the latter month.

#### Economic Forecasts

24. Recent forecasts of GNP growth in FY 1988 are considerably higher than the official target of 3.8%, set in January this year. The Research Institute on National Economy, which has traditionally adopted a bullish approach to the economy, has recently revised its original forecast of 4.3% annual growth (made in December last year) up to 5.2%; moreover, in contrast to some commentators who have expressed concern that growth would falter in the latter part of the fiscal year, the Institute is expecting growth of 4.5% in the first half of 1989. A rather more cautious forecast has recently been produced by the Mitsubishi Research Institute which expects 4.6% growth in the current fiscal year, falling to 3.2% real growth in FY 1989.



25. In its latest short-term forecast, the Japan Economic Research Centre is forecasting real GNP growth of 4.6% in FY 1988. Private consumption is expected to grow at 4.5%, even faster than in FY 1987, and private non-residential investment by 16.4% (after 10.1% in FY 1987). But private housing investment is expected to decline by 1.7%, and, as the government's special public works programmes are completed, government fixed capital formation is forecast to grow by only 1.9% (after 10.8% in FY 1987). The JERC expects negative growth overall of 0.9% in the June quarter, mainly as a result of the slowdown in housing and the effect of the leap year in giving the previous quarter an additional working day. However, the remaining three quarters of the fiscal year are expected to show more normal patterns, with real GNP growth of 1.7%, 0.8% and 1.1% respectively.

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PS/PUS	1	
SIR J FRETWELL	1	
MR BAYNE	1	
MR GILLMORE	1	
MR BOYD	1	
MR KERR	1	
MR DARRICK	1	
MR SLATER	1	
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PS/CHANCELLOR OF THE EXCHEQUER  
TREASURY

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AND TO ROUTINE FCO, TREASURY, BANK OF ENGLAND, UKREP BRUSSELS

JAPANESE BALANCE OF PAYMENTS: PROVISIONAL TRADE FIGURES

1. THE FOLLOWING ARE PROVISIONAL JAPANESE BALANCE OF PAYMENTS FIGURES FOR JUNE 1988 ANNOUNCED BY THE MINISTRY OF FINANCE. THEY ARE ONLY INDICATIVE. MORE PRECISE AND MORE COMPREHENSIVE FIGURES WILL FOLLOW IN REPORT OF SEMI-FINAL FIGURES AND MONTHLY ECONOMIC REPORT. FIGURES ARE CUSTOMS CLEARANCE, EXPORTS FOB, IMPORTS CIF, AND INCLUDE NON-MONETARY GOLD. FIGURES ARE NOT SEASONALLY ADJUSTED. CUMULATIVE FIGURES ARE NOT SEASONALLY ADJUSTED. CUMULATIVE FIGURES ARE DERIVED BY ADDING THE PROVISIONAL FIGURE FOR THE CURRENT MONTH TO LAST MONTH'S SEMI-FINAL CUMULATIVE TOTALS. USDLR MILLIONS, YEN BILLIONS. THE FIGURES IN BRACKETS SHOW PERCENTAGE CHANGE OVER THE SAME PERIOD LAST YEAR. VOLUME FIGURES ARE ONLY AVAILABLE FOR GLOBAL EXPORTS AND IMPORTS.

(A) JUNE

2.	US DOLLARS (%)	YEN (%)	CHANGE IN VOLUME (%)
GLOBAL EXPORTS	22008 ( 17.0)	2756 ( 2.7)	( 4.7)
GLOBAL IMPORTS	16078 ( 31.6)	2013 ( 15.6)	(20.0)
BALANCE	5930 (-10.1)	743 (-21.2)	

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3.	US DOLLARS (%)	YEN (%)
EXPORTS TO EC	3957 (29.6)	495 (13.7)
UK	962 (35.3)	120 (18.8)
IMPORTS FROM EC	2144 (39.5)	268 (22.5)
UK	412 (58.2)	52 (39.0)
BALANCE WITH EC	1813 (19.5)	227 ( 4.9)
BALANCE WITH UK	550 (22.1)	68 ( 7.0)

## (B) CUMULATIVE JANUARY - JUNE

4.	US DOLLARS (%)	YEN (%)	CHANGE IN VOLUME (%)
GLOBAL EXPORTS	125432 ( 15.7)	15873 ( -1.5)	( 2.5)
GLOBAL IMPORTS	91772 ( 34.3)	11606 ( 14.2)	(20.4)
BALANCE	33660 (-15.9)	4267 (-28.3)	

5.	US DOLLARS (%)	YEN (%)
EXPORTS TO EC	23285 (26.3)	2946 ( 7.3)
UK	5256 (31.2)	664 (11.7)

## UNCLASSIFIED

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IMPORTS FROM EC	11676 (46.1)	1477 (24.4)
UK	2131 (55.0)	269 (32.3)
BALANCE WITH EC	11609 (11.2)	1469 (-5.7)
BALANCE WITH UK	3125 (18.7)	395 ( 1.0)

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. JAPAN POLITICAL AND ECONOMIC	ECONOMIC ADVISERS
. (BACKGROUND)	NCAD
LIMITED	SEC POL D
FED	PS
ECD(E)	PS/MRS CHALKER
ERD	PS/LORD GLENARTHUR
COMED	PS/MR PATTEN
ESSD	PS/MR EGGAR
MAED	PS/PUS
UND	SIR J FRETWELL
LEGAL ADVISERS	MR BRAITHWAITE
CRD	MR GILLMORE
NEWS	MR BOYD
INFO	MR KERR
PLANNERS	MR CARRICK
HKD	MR SLATER
SEAD	MISS PESTELL
ACDD	MR FEARN
DEFENCE	MR MCLAREN
PUSD	MR GOULDEN

ADDITIONAL 42

JAPAN POLITICAL AND ECONOMIC

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FROM: G SEGAL  
DATE: 28 JULY 1988

1. MR GIEVE *Looks OK on non-collateral  
basis. Please check on that*
2. MR H P EVANS *J*

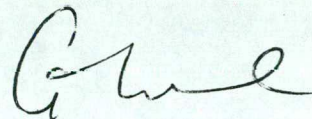
cc PPS/Chancellor 12/2  
Sir P Middleton  
Sir G Littler  
Mr Lankester  
Mr Walsh  
Mr Matthews  
Mr Bush

EUROMONEY: JAPAN AND THE THIRD WORLD

Gary Evans, a reporter for Euromoney magazine, has asked for an opportunity to talk to a Treasury official on the subject of Japan's growing contribution to Third World development. He is particularly interested in HMG's attitude towards an increase in Japan's financial shareholding in the World Bank and the IMF.

2. Mr Evans is preparing an article for the September -IMF issue- of Euromoney. He has already spoken to officials in the US Treasury and the Japanese Ministry of Finance as well as people in the IMF, the World Bank, the IADB and the ADB. He is also hoping to fix up an interview with officials in West Germany.

3. If this request is approved, Mr Evans says he is happy to contain the interview to a 5 to 10 minute telephone call. His deadline is August 5th.



G SEGAL

MR SEGAL

FROM: HUW EVANS  
DATE: 29 JULY 1988

cc PPS/Chancellor  
Sir P Middleton  
Sir G Littler  
Mr Lankester  
Mr Walsh  
Mr J Gieve  
Mr Matthews  
Mr Bush

*Prop*  
*Hand*

**EUROMONEY: JAPAN AND THE THIRD WORLD**

1. The only real issue for the Euromoney Magazine is the Japanese quota at the IMF. The Japanese are currently pushing hard for a special increase to take them from fifth to second place. We are at present in second place. The Germans are in third and will be reluctant to move.

2. We shall be considering with the Chancellor in September how to react to the Japanese move, and so will the Germans. So I see no point in talking to Euromoney now and suggest you decline. I would expect the Germans and the French also to be unforthcoming at this stage.

*H.P.E*

H P EVANS

Mr Allan  
12/2

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# MORNING PRESS

INTERNATIONAL MONETARY FUND FRIDAY, Sep 2/88 DA EXTERNAL RELATIONS DEPARTMENT

U.S. AUGUST UNEMPLOYMENT 5.6% AFTER 5.4% IN JULY. News agencies reported from Washington that U.S. August unemployment rose to 5.6% from 5.4% in July although non-farm payroll jobs rose 219,000 after a rise of 200,000 in July.

DOLLAR DROPS ON U.S. JOBLESS DATA. News agencies reported that the U.S. dollar dropped in nervous markets after the announcement of higher-than-expected 5.6% U.S. unemployment in August, to 1.8665 German marks (1.8745), 6.3435 French francs, and 1.5745 Swiss francs. The yen rallied from its lows to 136.85 (136.70). Sterling recovered from early pressure to \$1.6735 (1.6725). Dealers said the Bank of England may have bought pounds for dollars earlier in the day. The Bank of France was also believed intervening as the mark rose to 6.40 francs. Gold was \$429.60. The SDR was \$1.28607 (1.28692).

MIYAZAWA SAYS MARKET WILL SETTLE DOWN; SUMITA SAYS POLICY UNCHANGED. News agencies reported from Tokyo that Japanese Finance Minister Kiichi Miyazawa told a news conference that a stable monetary policy is Japan's best contribution to the world economy. He said recent exchange rate moves are ephemeral, without any long-term trend and dismissed speculation that Japan plans market intervention to support the yen. The market will eventually settle down, he said. The agency reported that Bank of Japan Governor Satoshi Sumita told insurance companies that the Bank will keep its monetary policy unchanged for the time being, but will watch price and exchange rate movements carefully. The Bank will take appropriate action when necessary.

BANK OF JAPAN BIDDING TIME FOR EXCHANGE MARKET INTERVENTION. Kyodo reported from Tokyo that a senior Bank of Japan official said the Bank is weighing the timing of exchange market intervention to prevent a further sharp fall of the yen. He said the Bank cannot say when it will step in, but any market intervention will take account of market psychology as well as timing. He suggested that the Bank could also ask other central banks to intervene on its behalf. The agency also reported that the Finance Ministry will deduct some \$3B from Japan's current annual BOP surplus to include overseas spending by Japanese travellers. An official said the Ministry only wants to increase the accuracy of Japan's BOP statistics and has no other intentions.

SARNEY SEES BRAZIL'S PUBLIC SECTOR DEFICIT ENDED BY 1990. AP-DJ reported from Santos that Brazilian President Jose Sarney said in a speech the public sector deficit will reach 4% of GDP this year, 2% next year and zero in 1990. Sarney said he is resisting, and will continue to resist, strong pressures to maintain government spending levels. The agency said cutting the deficit is important for fulfilling Brazil's agreement with the IMF. But Folha de Sao Paulo reported a 2.75% of GDP deficit in the 1989 federal budget sent to Congress. Strong political pressures have made it difficult for ministers to carry out many proposed reductions in the powerful federal bureaucracy.

Why don't they do it already? Short note from IFZ?

AA

Yes Mr (Morgan Slack W.R.!)

BRAZILIAN CONGRESS VOTES 12% REAL INTEREST RATE CEILING. AP-DJ reported from Rio de Janeiro that Brazil's Congress voted to fix real interest rates at 12% as year in the new Constitution, despite complaints that the measure is unworkable. It did not define real interest rates, and critics said the concept does not exist juridically. The agency said inflation was 496% in the past 12 months, but some banks currently charge more than 1000% annual interest. Planning Minister Joao Batista de Abreu said the decision is unfortunate and hurts the government's monetary policy. AFP reported from Brasilia that Congress approved a Sep 1993 plebiscite to decide whether Brazilians prefer a monarchy or a republic and to choose between a presidential or parliamentary system of government. The text originally went through almost unnoticed in May, when Congress voted to extend President Jose Sarney's mandate to five years.

DE LA MADRID SAID REFORMS ONLY FIRST STEP TO PREPARE FOR FUTURE. AP-DJ reported from Mexico City that departing Mexican President Miguel de la Madrid said in his final state of the nation message that economic changes and political reforms that led to more democratic elections are only starting points in a process that will help Mexico face the future. He told Congress he inherited a country near bankruptcy on Dec 1, 1982, and faced a crisis that shook the very foundations of its social structure. The composition of the new, sharply-divided Congress is evidence of the significant transformations Mexico has undergone, he added. WP, pA23, said opposition Congressmen staged unprecedented demonstrations during the speech, a sign of repudiation of economic policies and the contested July 6 election. WSJ, p10, said President-elect Carlos Salinas de Gortari was not in the audience, the first time in recent history that a President-elect failed to attend the state of nation speech. But his absence did not mute the opposition.

ARGENTINA UNLIKELY TO GET NEW IMF LOAN BEFORE BERLIN MEETINGS. Ldn Fin Times, Sep 1, p4, reported from Buenos Aires that an IBRD mission left after almost three weeks with the promise, according to Argentine officials, of a \$750M loan. An IMF mission is due this week to discuss the country's request for a new \$1.2B standby. Discussions on an IMF loan have been in progress for two months, but it is thought that any loan is unlikely to be authorized before the IMF meeting in Berlin at the end of this month. Argentina also hopes to persuade creditor banks to make fresh loans of up to \$2B.

PERUVIAN CABINET RESIGNS TO MAKE WAY FOR RESHUFFLE. News agencies reported from Lima that Peruvian Government sources said Prime Minister Armando Villanueva Del Campo and his Cabinet resigned to make way for a government reshuffle. President Alan Garcia is expected to replace the Economy, Justice, Commerce and Industry Ministers. This third shakeup in 14 months is the latest attempt to strengthen the team handling the economy, which is racked by inflation, expected to reach as high as 600% this year, and to improve the judicial system. EFE reported that the National Statistics Institute said inflation was 21.7% in August, down from a record 30.9% in July, and 355.9% in the latest 12 months.

EGYPT, IMF TO RESUME TALKS. Ldn Fin Times, p4, reported from Cairo that Egypt and the IMF are scheduled to resume difficult negotiations today on a new economic reform program amid signs of increasing pressures on the Egyptian economy. Worries about rising prices and foreign exchange shortages are certain to cast a shadow over the latest round of talks in a stuttering process that has been going on for most of the year. A senior official said the talks are unlikely to lead quickly to agreement on a new IMF program. Dwindling official and commercial credits to Egypt are adding to pressures to conclude a new IMF accord to ease another round of debt rescheduling. But fears of social unrest from IMF-inspired price increases are a large barrier to an early agreement.

EGYPT HOPES FOR IMF MONEY. Handelsblatt, Aug 29, p9, said in a Cairo report that Egypt is still optimistic of being able to persuade the IMF of the need for more flexibility in its conditions, despite the failure of negotiations thus far, problems with the country's economic and currency reforms, and the reserve of some creditor countries over extending new loans. Prime Minister Atef Sedki feels that Egypt could get by without IMF support, while conceding that the country's credit standing is badly affected by delayed debt payments, and that a new IMF agreement would ease some external pressures. Egypt is drawing confidence from U.S. assurances that it will not leave the country in the lurch and from Soviet offers of help. The paper said the U.S. has been mediating between the IMF and Egypt, and has promised more flexibility in its own aid to the country.



PAKISTAN PLEDGES TO ENFORCE BUDGET CUTS. Ldn Fin Times, p4, reported from Islamabad that Pakistan is seeking to reassure the international financial community that it will implement promised budget deficit cuts as part of a new IMF package. But the death of President Zia ul-Haq and tax concessions already made to business have inevitably raised doubts on whether the big reduction in deficit financing promised in the budget can be achieved.

UNCTAD PROPOSES MAJOR DEBT FORGIVENESS. dpa reported from Geneva that the Unctad urged concerted relief of at least 30% for the 15 most heavily-indebted LDCs, calling this the only realistic way to give them a chance to escape from their indebtedness. A report said economic conditions for a successful debt strategy are lacking. Commodity prices have been depressed since the outbreak of the debt crisis, and deteriorating terms of trade have nullified hopes of lower debt interest burdens. The 15 countries needing priority debt relief are: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, the Philippines, Uruguay, Venezuela, and Yugoslavia. Their debts are \$300B.

CANADIAN 4% GDP GROWTH REINFORCES GROWTH TREND. Ldn Fin Times, Sep 1, p4, reported from Toronto 4% annual real GDP growth in Canada in the second quarter after 3.2% in the first, said the economy has now enjoyed 5 and a half years of uninterrupted growth since the 1982 recession, and added that the current BOP deficit rose sharply in the quarter to 2.3B dollars from 1.76B in the first, despite a 22% rise in the trade surplus. Second quarter growth rose despite higher interest rates, but Canada's export-oriented resource industries, the main engine of recent growth, are starting to feel the pinch of the revitalized Canadian dollar.

BANK OF ITALY SEES GROWING RISK OF EEC PARITY REALIGNMENT. AP-DJ reported from Rome that a Bank of Italy study said persistent EEC current BOP imbalances are increasing pressure for an adjustment of EEC parities. Continued BOP imbalances could lead to competitive devaluations that would have a strongly negative impact on inflation, the study said. It cited the deterioration of the French and Italian current BOP deficits and the rising German BOP surplus as the main reason for concern. Inflation differentials have been reduced and current account imbalances have become the main factor in determining exchange rate expectations, the study said.

ICELAND ADOPTS EMERGENCY WAGE/PRICE FREEZE. Reuters reported from Reykjavik that Iceland froze prices and wages and ordered banks to cut interest rates to 30% from 40% as part of an emergency anti-inflation package initially due to run to the end of this month. The agency said inflation is running at about 25% a year and is a hot political issue. The wage freeze bars payment of a 2.5% indexed rise due this month. All price increases have been forbidden. Labor unions indicated they will support the package.

ARSON DEVICES AT 11 BANKS IN BERLIN LINKED TO IMF MEETING OPPONENTS. Reuters reported from West Berlin that police said incendiary devices were posted at 11 banks in what seemed to be a coordinated attack by people opposed to the IMF/IBRD annual meetings in the city later this month. The unidentified arsonists posted the devices, which did little damage, through bank letter boxes on Wednesday night. The agency noted that banks have already been the target of such attacks this year and that groups critical of IMF policies towards LDCs have threatened to try to hinder the meetings.

PRELIMINARIES FOR SELECTION OF NEW GATT HEAD: DUNKEL READY FOR EXTENDED TERM. Neue Zuercher Zeitung, Aug 27, p18, said in a Geneva report that the selection of a GATT Director General is a delicate matter. The term of incumbent Arthur Dunkel was extended for three years to 1989. A new selection procedure, at Brazil's initiative, would set a four year term, extendable for a maximum of four years, although it seems doubtful at the moment that this procedure can be applied. The paper said it would make little sense to select a replacement without serious reason in 1989, just ahead of the scheduled 1990 end of the current round of GATT trade negotiations. But Dunkel is unlikely to be confirmed for a further four years under the new procedure. Dunkel has taken the initiative after some hesitation. He would be ready to cut short his term to 1988, if necessary, but would also be willing to extend it for two years to 1991.

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AND TO ROUTINE UKDEL OECD, UKREP BRUSSELS, HM TREASURY  
AND TO ROUTINE BANK OF ENGLAND

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JAPAN MONTHLY ECONOMIC REPORT: AUGUST SUMMARY

1. AFTER NINE MONTHS OF EXCEPTIONALLY RAPID GROWTH UP TO MARCH THIS YEAR, THE RATE OF EXPANSION OF ECONOMIC ACTIVITY HAS PROBABLY SLOWED. PRELIMINARY ESTIMATES FOR REAL GNP IN THE SECOND QUARTER SUGGEST ZERO GROWTH, OR EVEN A SLIGHT DECLINE. THIS IS PARTLY BECAUSE OF SEASONAL FACTORS, BUT IT IS ALSO LIKELY TO REFLECT A STRONG NEGATIVE CONTRIBUTION FROM THE GROWTH OF IMPORTS, AND A SLOWDOWN IN HOUSING CONSTRUCTION. YEAR ON YEAR, HOWEVER, GROWTH WILL STILL BE IN THE 4-5% RANGE, AND THE EPA DESCRIBES THE ECONOMY AS BEING 'AT CRUISING SPEED'.

2. AS EXPECTED, NON-RESIDENTIAL PRIVATE INVESTMENT IS TAKING OVER AS THE MOST DYNAMIC ELEMENT IN THE ECONOMY. DOMESTIC MACHINERY ORDERS ROSE BY 23.6% IN THE SECOMD QUARTER (INCLUDING A 19.4% INCREASE FROM MANUFACTURING INDUSTRY). IN CONTRAST, RETAIL SALES HAVE BEEN MARKING TIME (A 0.1% FALL IN THE SECOND QUARTER, FOLLOWED BY THE SAME FALL IN JULY MONTH ON MONTH) ALTHOUGH THE JULY FIGURE WAS STILL 4.5% ABOVE THE LEVEL A YEAR PREVIOUSLY.

3. ALTHOUGH ANXIETY ABOUT THE PROSPECT OF AN UPTURN IN INFLATION HAS MOUNTED, BECAUSE OF THE WEAKENING OF THE YEN AND EVIDENCE OF TIGHTENING IN THE LABOUR MARKET, THE FIGURES DO NOT YET SHOW ANY DETERIORATION. THE CPI ROSE BY 0.5% YEAR ON YEAR IN JULY AND WHOLESALE PRICES FELL BY 0.9, SHOWING NO SIGNIFICANT DIVERGENCE FROM THE PATTERN OF THE LAST SIX MONTHS.

4. THE SEASONALLY ADJUSTED TRADE SURPLUS ROSE TO US DOLLARS 7.2 BILLION IN JULY, UP BY US DOLLARS 1 BILLION FROM JUNE AND THE FIRST INCREASE SINCE JANUARY. EXPORTS ROSE BY 2% IN DOLLAR VALUE TERMS (THE SECOND CONSECUTIVE MONTHLY RISE), AND IMPORTS FELL BY 4.2%. THE INCREASE REINFORCED THE FEARS OF THOSE WHO SUSPECT THAT THE

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RELATIVE STABILITY OF THE YEN SINCE THE END OF LAST YEAR MAY NOW BE ENCOURAGING A RESURGENCE IN EXPORTS. THE CURRENT ACCOUNT SURPLUS FELL TO A NEW LOW OF US DOLLARS 5.0 BILLION IN JULY , BUT THIS WAS AFTER A CONTROVERSIAL DECISION BY THE MOF TO CHANGE THE BASIS OF CALCULATING TOURISM RECEIPTS IN THE INVISIBLES ACCOUNT.

5. MARKET INTEREST RATES EDGED STEADILY UPWARD DURING AUGUST, REFLECTING INTERNATIONAL TRENDS, AND PRESSURE GREW ON THE BANK OF JAPAN TO INCREASE ITS DISCOUNT RATE FROM ITS PRESENT POST-WAR LOW OF 2.5%. THIS HAS BEEN INTENSIFIED SINCE THE END OF THE MONTH BY THE SPECULATIVE DOWNWARD PRESSURE ON THE YEN. ON 2 SEPTEMBER THE FINANCE MINISTER MIYAZAWA FLATLY DENIED THAT THERE WAS ANY NEED TO CHANGE MONETARY POLICY, BUT THIS HAS DONE LITTLE TO DAMPEN EXPECTATIONS THAT A RISE MAY BE INEVITABLE. SOME COMMENTATORS ARE SUGGESTING THAT A RISE IN THE DISCOUNT RATE, AND POSSIBLE INTERVENTION BY THE BANK OF JAPAN, ARE BEING HELD IN RESERVE TO DEFEND THE YEN 140 LEVEL

WHITEHEAD

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MAIN 177

FINANCIAL

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JAPANESE  
DEBT PLANS

*Let's work hard  
for it, via G7  
advance with  
plan of the IMF  
@ X -*

*Mr Allan  
12/2  
BF for  
international issues  
meeting on Monday  
12/9*

FROM BR. IEMB WION

09/07/88 04:14 P. 1

# MORNING PRESS

INTERNATIONAL MONETARY FUND TUESDAY, Sep 6/88 DA EXTERNAL RELATIONS DEPARTMENT

**DOLLAR LOWER.** News agencies reported that the U.S. dollar eased in cautious exchange markets, in continued reaction to Friday's announcement of a rise in U.S. August unemployment to 5.6% from 5.4% in July. Dealers said the news makes further Federal Reserve tightening and higher interest rates less likely. The dollar is now expected to move narrowly until next week's release of U.S. trade figures for July. Exchange rates included: German mark 1.8465 (1.8565), yen 135.45 (136.05), sterling \$1.7010 (1.6860), French franc 6.2830, Canadian dollar 81.07c, lira 1382, Swiss franc 1.5570, guilder 2.0940 and Belgian franc 38.89. Gold was \$428. The SDR was \$1.29689 (1.28607).

**GERMANY DEFIES CRITICS WITH STRONG FIRST HALF GROWTH.** Reuters reported from Bonn that the German Economics Ministry said real GNP rose a robust 3.9% in the first half, supporting official forecasts for the whole year and defying critics of government economic policy. Year-on-year growth in the second quarter was 3.4%. Sources said the figures will bolster Finance Minister Gerhard Stoltenberg in his budget presentation to Parliament today. The Ministry said first half growth was the strongest in any six months since the end of a recession in the early 1980s.

**JAPAN TO URGE SPECIAL FUNDS FOR DEBTORS AT IMF/IBRD MEETINGS.** Kyodo reported from Tokyo that Japanese Finance Ministry sources said Minister Kiichi Miyazawa will urge the IMF to establish special funds to help LDCs reduce their debts, at this month's annual IMF/IBRD meetings in Berlin. Recent interest rate increases by major nations and new policy coordination after June's G7 leaders' annual meeting will be high on the agenda of the Berlin talks. AP-DJ reported that a senior Ministry official told a briefing that Japan is not facing the danger of inflation but is interested in discovering at the Berlin meetings how the U.S. and EEC countries assess inflation possibilities. He declined to say if G7 ministers would meet in Berlin ahead of an IMF Interim Committee meeting.

**CAMDESSUS SAYS PROSPECTIVE LDC GROWTH UNSATISFACTORY.** dpa reported from Washington that IMF Managing Director Michel Camdessus said in an interview that the IMF now expects 1988 growth in industrial countries of 3.5%, up from 3% previously, 7% world trade growth and fairly restrained inflation of around 3%, despite some concerns about rising prices. But prospects for LDCs are less optimistic. Likely growth of 3.5% this year and 4% in 1989 is not sufficient and is also not well distributed. Growth in the poorest and the most indebted LDCs is unsatisfactory. The agency said he showed understanding for the abundant criticism of IMF/IBRD debt strategy, while calling this strategy correct. But all those involved must do more and do it better. LDCs must address their adjustment problems consistently and speedily, while banks and creditor countries must increase their aid. The IMF and IBRD are ready to support stronger programs with larger credits. Camdessus said he understands the fatigue of debtors and creditors, the worry over an uncertain future, and the impatience of those who see the danger of growing poverty in the world. But those who demand more from the IMF are confusing the illness with the remedy. The IMF does not add to the problem. Studies of the effects of its programs on the poorest levels of population show clearly that the very poor in these countries would be considerably worse off without IMF programs. Criticism that the IMF takes a softer line in monitoring major countries is unjustified. The IMF warns openly and frankly of policy shortcomings and risks, and insufficient adjustment efforts. But peer pressure is even more important.

CAMDESSUS SAYS IMF CRITICS OVERESTIMATE INSTITUTION'S POWER. Der Spiegel, Sep 5, ppl10/116, reported from Washington that IMF Managing Director Michel Camdessus said in an interview, that criticism expected in Berlin during the annual IMF/IBRD meetings is important for the institution, in offering the opportunity to explain to the public what the IMF does. Some criticisms of the IMF are justified. He said he would be happy to have a dialogue with German church and labor union critics, adding that their criticism of the IMF often is based on a misunderstanding, in overestimating the institutions's influence and thus expecting too much of it. The IMF was unable to prevent the outbreak of the debt crisis, despite warnings to banks lending to LDCs, but he disputed that it is also powerless in working to solve the crisis, although conceding that progress requires much more time than was originally thought. There is a fundamental economic disorder behind the financial imbalance of the world economy, and this requires time to cure. Noting the frequent charge that IMF adjustment programs burden the poorest people, he said studies of the effect of IMF programs show that nothing hurts the poorest of the poor more than not taking action. Adjustment costs are a difficult problem which the IMF constantly faces and it strives to shield the poorest from their immediate effect. But the IMF has not enough influence to determine how individual countries will allot adjustment costs. The IMF cannot interfere in the domestic affairs of these countries. It may deplore, for example, the untouchability of military and police spending. But it cannot change this, only offer its advice. Debtor country governments must summon the courage to tell their people the truth, even when this has some unpalatable results. Camdessus said he is not prepared to play the role of scapegoat for countries seeking to hide behind the IMF. Countries seeking to use the IMF in this way are not sufficiently determined to undertake essential structural adjustments, and it would be better not to support them. In Berlin, he will attempt to reinforce the understanding that the world must be regarded as a totality and that all those involved -- LDCs, industrial countries, banks and international organizations -- have their contribution to make, if prosperity is to increase, and protectionism and poverty are to be dealt with.

FROM BRITEMB WTON

09/07/88 04:15 P. 2

IMF SEES INDUSTRIAL ECONOMIES BOOMING. AP-DJ reported from Paris that the IMF's World Economic Outlook, to be discussed at a Board meeting tomorrow, says industrial economies are booming this year, and although there is little evidence of overheating at present, policymakers must be ready to act if inflation shows signs of picking up.

YEUTTER SEES LESS DRAMATIC U.S. TRADE IMPROVEMENT IN 1989. Kyodo reported from Tokyo that U.S. Trade Representative Clayton Yeutter said in an interview he expects the U.S. trade deficit to improve less dramatically in 1989 than it has done this year because of a slowdown in export growth and stable imports. But the U.S. can enjoy a further trade improvement next year if existing economic policies are maintained. This year's deficit is conservatively expected to fall by some \$30B to about \$140B.

CHINESE CENTRAL BANK HEAD VOWS TO FIGHT INFLATION. AP-DJ reported from Beijing that China Daily said People's Bank of China Governor Li Guixian said the Bank must cut back on lending and tighten the money supply to halt price rises which have led to panic buying in some cities. Li said the most urgent current issue is to stabilize the money supply and curb the inflationary spiral. The paper reported separately that panic buying seems to have subsided in some cities. Reuters reported that Chinese newspapers said the Bank promised to index personal savings to the rate of inflation, in the latest measure aimed at calming public fear of inflation and at halting panic buying and bank withdrawals.

EGYPT, IMF RENEW CRITICAL TUG-OF-WAR OVER ECONOMIC REFORM. Reuters reported from Cairo that Egypt and the IMF renewed their critical tug of war over how far and fast to reform Egypt's economy, burdened by a \$43B debt. A reform package would clear the way for Egypt to seek further official debt rescheduling from the Paris Club. Egypt is anxious to reform its economy, but worried that hasty measures could provoke social unrest. Many Paris Club payments due since July have not been made, but IMF approval of a new program would allow Egypt to reschedule retroactively.

ARGENTINE INFLATION TOPS 400% A YEAR. dpa reported from Buenos Aires that Argentina's cost of living rose 27.7% in August over July, and exceeded a 400% annual rate. The agency noted that the Government's austerity program aims to cut monthly inflation to below 10% in September. Reuters reported that bankers and economists in Buenos Aires said the month-old anti-inflation plan remains vulnerable to Argentina's volatile politics. The program is already under siege from business and unions, and local economists doubt major economic reforms can be achieved before President Raul Alfonsin steps down after next May's elections. The IMF has reacted positively to the plan, the agency said. AP-DJ reported that an IMF mission started talks yesterday on Argentina's request for a \$1.2B standby.

BRAZIL COMPLETES NEW CONSTITUTION, LIMITS PRESIDENTIAL POWERS. WP, Sep 3, pA21, reported from Rio de Janeiro that the Brazilian Congress ended 19 months of work by passing a socially liberal constitution, curbing the near-imperial powers of the presidency and covering virtually every aspect of daily life. It restores power to the judiciary and Congress, which must approve all future budgets. One article capping real interest rates on domestic loans at 12% was sharply criticized as a futile attempt to discipline the market economy, the paper said. Reuters said the curb on interest rates drew the most attention and the most criticism. Finance Minister Mailson da Nobrega said the limit could make it harder for Brazil to win new loans from foreign creditors. O Globo said the interest rate limit is cheap demagoguery which will make all Brazil suffer. AFP reported that the new Constitution will be promulgated Oct 5. Observers said the new charter finally buries the authoritarian regime inherited from the military government, but leaves intact the major identity crisis of a country facing gigantic social problems, as well as suffocating inflation, and enormous debt. The new constitution often gives the impression of seeking to resolve all Brazil's ills through a series of legislative measures, the agency said. WSJ, p26, said the most fundamental change is the transfer of extensive powers from the executive to Congress, and the abolition of decree laws. All major budgetary and economic decisions, including agreements with the IMF and foreign banks, are subject to the vote of Congress. This shift, combined with a transfer of much taxation from federal to state governments, is likely to cause administrative confusion as Brazil struggles to control inflation and enters the run-up to the first direct presidential elections in almost 30 years in November 1989.

PERU NAMES NEW ECONOMIC TEAM, JUSTICE MINISTER. Reuters reported from Lima that Peruvian President Alan Garcia swore in a new economic team to correct soaring inflation and a new Justice Minister to fight drug smuggling and terrorism. He told new Economy Minister Abel Salinas that inflation, which rose 355.9% in the 12 months to August, must be conquered at all costs. AFP reported that Garcia said the economy's poor showing will be corrected in a substantial and drastic manner. Salinas said a new anti-inflationary plan will be announced in a few days. Observers said the government shuffle will allow abandonment of a gradualist policy in favor of a frontal attack on inflation, with shock measures. AP-DJ said the resignation of former Economy Minister Cesar Roble had been expected after disagreements in the Cabinet on how to reactivate the recession-ridden economy.

EEC MONETARY COMMITTEE MEETS TODAY ON INTEREST RATES, IMF MEETING. AP-DJ reported from Brussels that the EEC monetary committee is scheduled to meet today and is expected to discuss recent EEC interest rate increases and the end-September IMF annual meeting. A monetary source said the meeting was routine.

GOVERNMENT BY-ELECTION WINS IMPROVE JAPANESE TAX REFORM ODDS. WSJ, p27.

KOREAN REPORT URGES MIXED BAG OF ECONOMIC REFORMS. WSJ, p27.

COSTA RICA NAMES NEW ECONOMY, PLANNING MINISTERS. Reuters reported from San Jose.

BURUNDI ARMY RAMPAGE RAISES MORAL DILEMMA FOR IBRD, DONORS. WP, Sep 4, pA39.



*py*

FROM: A C S ALLAN  
DATE: 7 September 1988

MR D SAVAGE

cc Sir P Middleton  
Sir T Burns  
Sir G Littler  
Mr Lankester  
Mr H P Evans  
Mr S W Matthews

**JAPANESE BALANCE OF PAYMENTS STATISTICS**

The Chancellor has seen the attached report in the IMF press summary saying that the Japanese Finance ministry will deduct some \$3 billion from Japan's current account surplus to include overseas spending by Japanese travellers. The Chancellor was puzzled by this: why is this not included already? And the change will, presumably, increase the global deficit. He would be grateful for any comments.

*ACSA*

A C S ALLAN

# MORNING PRESS

FRIDAY, Sep 2/88 DA

BANK OF JAPAN BIDDING TIME FOR EXCHANGE MARKET INTERVENTION. Kyodo reported from Tokyo that a senior Bank of Japan official said the Bank is weighing the timing of exchange market intervention to prevent a further sharp fall of the yen. He said the Bank cannot say when it will step in, but any market intervention will take account of market psychology as well as timing. He suggested that the Bank could also ask other central banks to intervene on its behalf. The agency also reported that the Finance Ministry will deduct some \$3B from Japan's current annual BOP surplus to include overseas spending by Japanese travellers. An official said the Ministry only wants to increase the accuracy of Japan's BOP statistics and has no other intentions.



FROM TOKYO TO FCO

TELNO 7 SAVING

UNCLASSIFIED

Addressed to FCO Telegram No 7 Saving of 12 September 1988

Repeated for information to:

Paris, Rome, Bonn Washington, Brussels, Dublin, Stockholm, UKRep  
Brussels, UKMIS Geneva, UKDEL OECD, Ottawa, Bangkok, Canberra, Peking,  
Seoul, Jakarta, Singapore, Manila, Kuala Lumpur, Governor Hong Kong,  
BTC Hong Kong, Osaka.

JAPAN: ECONOMIC REPORT: AUGUST 1988

- GNP data due to be published shortly are expected to show that real GNP may have been flat, or even declined slightly, during the second quarter. However, year on year growth is likely to remain in the 4-5% range, and the economy has been described by the EPA as being 'at cruising speed'. (Paras 1-2)
- The Diet has not yet focussed on the tax reform proposals submitted by the government, because of preoccupation with an alleged share-dealing scandal, but it now seems that substantive discussions may start soon. (Paras 27-28)
- Industrial production fell by 0.2% in the second quarter and by 0.7% in July, but output is still running well above last year's level. (Paras 3-4).
- Similarly, retail sales were sluggish during the second quarter and in July, although on a year on year comparison sales in July were 4.5% above the level seen last year. (Para 11).
- Private sector non-residential investment remains buoyant, with new machinery orders up by 24% during the second quarter. An EPA survey of investment intentions expects this trend to continue. (Paras 9-10).
- The unemployment rate reached a 67-month low of 2.35% (seasonally adjusted) in June. Labour costs are rising more rapidly than in 1987, reflecting in part the tightness in the labour market. (Paras 12-13).
- Consumer prices remain stable, but wholesale prices rose by 0.3% and 0.6% in June and July, reflecting in part the effect of the depreciation of the yen on import and export prices. (Paras 14-15).
- The seasonally adjusted trade surplus rose to \$7.2 billion in July, the first increase since January. Exports increased both by value and by volume. (Paras 16-20).
- The yen traded in the Y132-Y135 range during July and August, but weakened sharply at the end of August in response to rises in European interest rates. (Para 23).

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/ Market

- Market interest rates and bond yields rose during July and August, reflecting international trends, but the authorities resisted market expectations of a rise in the official discount rate. (Paras 24-25).

GNP DATA (Table I)

TABLE I: GROSS NATIONAL EXPENDITURE  
(Real, seasonally-adjusted base year = CY 1980)  
Percentage change over the preceeding period

	FISCAL YEARS			1986		1987			1988	
	1985/86	1986/87	1987/88	DEC	MAR	JUN	SEP	DEC	MAR	
Consumers' Expenditure	2.8	3.6	4.0	-0.6	2.0	0.7	1.0	0.4	2.6	
Private Housing	2.9	10.9	23.9	5.2	1.2	3.0	10.2	12.7	1.0	
Private Investment	13.2	4.5	10.1	1.8	2.5	1.8	2.7	4.1	3.6	
Private Inventories	7.0	-74.7	87.5	61.7	-83.8	530.1	-21.0	63.6	-10.4	
Government Current Expenditure	1.6	6.8	-0.8	14.3	-11.3	1.2	-0.3	0.2	1.1	
Government Capital Expenditure	-6.3	6.6	10.8	0.9	0.7	1.7	3.1	6.6	4.0	
Government Inventories	79.0	174.0	-94.9	-215.7	-	145.2	-	-	-	
External (Net)	20.9	20.9	-35.0	3.2	20.8	-41.0	11.0	-30.1	-5.6	
Exports	2.1	-3.6	5.0	-0.6	2.5	-1.8	6.7	-0.9	3.5	
Imports	-2.3	5.5	5.0	-1.2	-0.7	6.4	6.2	2.6	4.3	
GNE (Percentage Change)	4.4	2.6	4.9	0.7	1.5	0.0	2.0	1.8	2.7	
GNE (Y Billion)	293,903.6	301,679.7	316,610.9	302,299.0	306,780.1	313,805.8	313,030.0	318,776.3	327,402.3	
Memo item: Nominal GNE	6.0	4.2	4.8	0.4	1.1	-0.2	2.7	1.7	2.8	
Y Billion	321,158.2	334,651.5	350,769.7	335,402.0	339,158.5	338,543.5	347,574.0	353,552.3	363,299.8	

1. GNP data for the April/June quarter will be published in mid-September. Preliminary estimates from the EPA suggest that real GNP may have been flat, or even have shown a slight decline, during the second quarter. In part this reflects technical and seasonal factors, such as the inclusion of an extra working day (29 February) in the first quarter figures, and of an extra holiday during the "Golden Week" holiday in early May. The seasonal adjustment employed in the GNP data will not eliminate the distortions caused by these exceptional factors.

2. However, the slowing of growth in the second quarter also reflects real economic trends. After nine months of exceptionally rapid growth in the period to March 1988 some levelling off may be expected. Private housing, which grew by only 1% in the first quarter, may have slowed still further: and it is likely that rapid growth of imports may have led to a substantial negative contribution from the net external sector. In contrast, private non-residential investment will have shown a strong growth (and an EPA survey expects this to continue for the rest of year - see para 10). Consumers' expenditure, which accounts for over 50% of GNP, is likely to show little growth over the previous quarter (which in turn showed the fastest quarterly growth for 10 years): but it is still likely to show a healthy year on year increase. Overall, EPA officials emphasise that the economy is still extremely buoyant and argue that, after the acceleration of the previous nine months, it is now "at cruising speed".

INDUSTRIAL AND BUSINESS ACTIVITY (TABLE II)

TABLE II: PRODUCTION AND BUSINESS ACTIVITY  
Seasonally adjusted, except figures for fiscal years  
Percentage change over previous period

	FISCAL YEARS			1988					
	1985/86	1986/87	1987/88	FEB	MAR	APR	MAY	JUN	JUL
Industrial Production Mining and Manufacturing (1985 = 100)	2.5	-0.2	5.8	2.4	0.5	-0.9	-2.3	3.3	-0.7
Manufacturing Operating Ratio	-0.6	-4.8	2.5	1.7	0.9	-3.5	-0.5	2.6	n.a
Housing starts (Total units)	3.6	11.9	23.5	-1.2	-3.0	-10.7	13.1	1.3	-0.4
Domestic Machinery Order (Total)	-1.8	4.1	7.7	-2.8	-9.1	32.4	-1.0	3.8	n.a
Retail Sales	3.2	1.1	5.0	3.5	-2.2	-1.4	0.7	2.0	-0.1
Leading Indicators Index (1980 = 100) End of Period	50.0	75.0	n.a	57.7	53.8	54.5	41.7	33.3	n.a

3. The seasonally adjusted index of industrial production (mining and manufacturing) proved to be rather volatile during the summer, with a sharp fall of 2.3% in May followed by a 3.3% rise in June and a 0.7% fall in July. The index fell by 0.2% overall during the second quarter (as it did also in the second quarter of 1987), but registered a healthy 10.3% year on year increase. MITI is forecasting a 2.3% increase in August and a 1.3% increase in September (both data seasonally adjusted).

4. By industry, output fell during the second quarter in iron and steel (by 3.0%), metal products (2.9%), textiles (2.8%) and transport machinery (2.2%). Those industries also showed month on month falls in July. The sluggish state of the transport machinery industry is blamed in part on weakening automobile sales to the United States, which fell by 3.7% year on year in June. Output of construction materials fell by 4.3% during the second quarter, reflecting the slow down in private residential construction.
5. A modest rebuilding of producers' inventories may also be contributing to sluggish industrial production. Inventories were unchanged during the second quarter (and down 0.3% year on year), but the index rose by 0.8% in June and 1.0% in July. Shipments fell by 0.5% during July, so that the ratio of inventories to shipments rose by 1.9%.
6. The diffusion indexes all registered declines in May and June. The leading indicator index fell below the traditional "boom or bust" level of 50 in both months, whilst the coincident index fell to only 10 in May before recovering to 55 in June.
7. Manufacturing productive capacity rose by 0.9% year on year in the second quarter. The operating ratio rose by 5.4% year on year in the same period, but fell by 1.9% over the first quarter. This was the first quarterly decline since the same period in 1987, when the ratio fell by 0.8%.
8. The recovery in housing starts seen in May was not sustained, and the number of new units fell by 4.8% (seasonally adjusted) in the second quarter - similar to the rate of decline in the first. Year on year, housing starts rose by 2.6% overall, although housing construction in the public sector fell by 2.0%, offset by a 4.8% increase in the private sector. New orders for industrial and commercial construction remained buoyant, especially from the private sector. Overall, orders rose by 25% year on year in the second quarter with a 31% increase in private sector orders. The Federation of Construction Contractors attributed the increase to strong demand for new sites from semi-conductor manufacturers, and also to redevelopment projects now being undertaken by traditional industries such as steel and textiles.
9. New orders for machinery showed little change in May and June, but the healthy increase in April ensured an overall quarterly growth of 23.6%. Orders from the public sector grew most strongly, at 30.4%, whilst those from non-manufacturing industry rose by 26.9%.
10. Moreover, a recent EPA survey of investment intentions among over 4,000 companies suggests that private capital investment is expected to continue to expand strongly. Overall, capital spending is expected to rise by 19.5% in real terms during this fiscal year, with expenditure by manufacturing industry expected to rise by 26.3% (the faster rate of increase reflects, in part, that sector's relatively lower level of spending in fiscal year 1987).

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11. On a seasonally adjusted basis, retail sales were sluggish during the second quarter and in July, falling by 0.1% in both periods. Year on year, retail sales rose by 3.5% in the quarter (the smallest quarterly increase since the first quarter of 1987) and by 4.5% in July. Sales at department stores and at supermarkets have remained buoyant, rising by 2.2% and by 2.8% respectively during the second quarter.

LABOUR MARKET (TABLE III)

TABLE III: LABOUR MARKET  
All figures seasonally adjusted except figures for fiscal years

	<u>Fiscal Years</u>			<u>1988</u>					
	<u>1985/86</u>	<u>1986/87</u>	<u>1987/88</u>	<u>FEB</u>	<u>MAR</u>	<u>APR</u>	<u>MAY</u>	<u>JUN</u>	<u>JUL</u>
Unemployment Number (mns)	1.58	1.71	1.70	1.66	1.62	1.57	1.54	1.45	1.55
% of Workforce	2.65	2.8	2.78	2.71	2.64	2.55	2.49	2.35	2.51
Employment Regular workers (1985 = 100)	100.4	101.7	102.1	102.7	102.9	102.8	102.9	103.0	103.1
Overtime Hours Worked (All industries) (1985 = 100)	99.9	96.2	102.7	107.3	108.0	106.1	106.4	107.1	108.3
Job Opening/Job Seeking Ratio	0.67	0.62	0.76	0.88	0.90	0.94	0.99	1.05	1.09

12. The seasonally adjusted unemployment rate fell to 2.35% in June, its lowest level since December 1982, before rising back to 2.51% in July. The number of job openings exceeded the number of job seekers in both June and July, giving ratios of 1.05 and 1.09 respectively.

13. The steady tightening of the labour market is leading some commentators to express concern at signs of increases in labour costs. The EPA has noted that the average pay award in the Shunto (spring wage round) this year was 4.4%, up from 3.5% in 1987, and the Federation of Employers' Associations (Nikkeiren) has estimated that summer bonuses rose by 6.3% this year, after only 1.8% in 1987. Indeed, average monthly earnings in July were up 4.1% from a year previously. Unit labour costs continue to decline on a year on year basis (see Table IV) but the seasonally adjusted series showed a 0.5% increase during the second quarter.

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/PRICES

Unclassified

PRICES AND EARNINGS (TABLE IV)

TABLE IV: PRICES AND EARNINGS  
Percentage change on year earlier, not seasonally adjusted

	FISCAL YEARS			1988					
	1985/6	1986/7	1987/8	MAR	APR	MAY	JUN	JUL	AUG
Consumer Prices - National	1.9	0.0	0.5	0.7	0.3	0.2	0.2	0.5	n.a
- Tokyo	2.3	0.3	0.9	1.2	0.7	0.6	0.4	0.8	0.6
Wholesale Prices - Total	n.a	-9.3	-2.0	-1.0	-0.7	-0.5	-0.6	-0.9	n.a
- Domestic	n.a	-5.3	-1.7	-0.2	-0.2	-0.2	-0.2	-0.4	n.a
Average earnings, all industries (real) 1985 = 100	1.1	2.6	1.7	2.3	3.4	3.7	4.3	1.9	n.a
Unit labour costs	2.1	2.9	n.a.	-6.2	-6.1	-3.4	-8.4	n.a	n.a
Labour Productivity (1985 = 100) manufacturing	4.4	1.8	5.9	124.8	114.6	n.a	n.a	n.a	n.a

14. Consumer prices remain very stable. The CPI rose by 0.2% year on year in the second quarter, against a 0.8% rise in the first, and the July year on year increase was 0.5%. Prices in metropolitan Tokyo rose by 0.5% in the second quarter, down from 1.2% in the first.

15. Wholesale prices fell by 0.6% during the second quarter and by 0.9% in July, on a year on year basis. However, the effect of the weakening of the yen could be seen clearly in the monthly seasonally adjusted data for June and July, where increases of 0.3% and 0.6% respectively were recorded. In July the domestic wholesale price index rose by 0.2% seasonally adjusted, mainly because of higher seasonal electric power tariffs (which operate from July to September, to cover the increased use of air conditioning). The export price index rose by 2.4%, and the import price index by 2.1%, with both increases the result mainly of the depreciation of the yen during the previous months.

/TRADE

TRADE (TABLE V)

TABLE V: TRADE  
(ALL FIGURES IMF BASIS, SEASONALLY-ADJUSTED)

	FISCAL YEAR (NSA)			1988					
	1985/86	1986/87	1987/88	FEB	MAR	APR	MAY	JUN	JUL
Exports (\$ mn)	180,664	211,293	233,389	20,963	20,801	20,615	20,288	21,250	21,670
Imports (\$ mn)	119,063	109,645	139,108	12,792	12,339	12,880	13,489	15,070	14,433
Trade Balance (\$ mn)	61,601	101,648	94,281	8,171	8,462	7,735	6,799	6,180	7,237
Current Account Balance (\$ mn)	55.019	94,139	84,540	7,599	7,486	6,365	5,985	5,226	4,953
Indices, NSA, % change over same period of previous year Volume (1985 = 100)									
- Exports	3.6	-0.5	0.1	4.2	3.2	3.3	-0.6	4.8	5.9
- Imports	1.1	10.5	12.6	31.3	21.8	20.4	17.9	20.5	15.6
\$ Unit Value									
- Exports	n.a	18.3	10.5	12.7	14.1	11.6	11.5	11.8	9.9
- Imports	n.a	-13.6	14.6	12.8	11.2	9.1	7.7	9.6	6.7
Indices, SA Volume (1985 = 100)									
- Exports	99.8	99.1	99.6	103.8	102.2	101.5	96.5	101.9	104.0
- Imports	100.4	111.2	124.4	141.7	134.2	135.2	134.6	145.4	140.5

16. The seasonally adjusted trade surplus fell to \$6.2 billion in June, the lowest figure since March 1986, but rose to \$7.2 billion in July: this was the first increase since January this year, and reflected both a 4.2% fall in imports and 2.0% rise in exports (both in dollar value terms). The trade surplus for the first seven months of 1988 was \$53.6 billion, against \$58.4 billion for the same period in 1987.

17. The current account surplus fell to \$5.2 billion in June and to \$5.0 billion in July. However, it is likely that the fall in July was boosted by the inclusion for the first time in tourism receipts of estimated yen cash spent abroad by Japanese travellers. Hitherto such cash (which is recorded rather imprecisely by measuring changes in yen deposit accounts with banks in Japan held by non-residents) had been included in errors and omissions and therefore outside the current account balance altogether.

18. As a result, the invisibles deficit, which rose to \$1.0 billion in June, was boosted to \$2.3 billion in July. Net outflows on the travel account rose to \$1.5 billion against \$1.1 billion in June and \$0.6 billion in July last year. Investment income fell to \$1.4 billion, from \$1.5 billion in June, and registered the lowest monthly figure since January.

19. Export volume rose by 4.8% in June and 5.9% in July year on year, and the seasonally adjusted index also showed monthly increases - of 2.1% in July. Import volumes increased sharply on both series in June, but rose less rapidly in July. The trade data has increased concern among some commentators that the relative stability of the yen in the early part of the year, and its weakening against the dollar since June, may now be prompting a recovery in exports and, despite the high rate of import growth, leading to a renewed widening of the trade surplus.

20. By area, exports are growing most rapidly to the EC (30.7% up year on year in the second quarter) and in particular to the UK (up 33.9% in the same period). Exports to South East Asia grew by 25%, but to the USA by only 2.0%. Imports from the UK grew by 52.0% in the second quarter: from the EC as a whole, by 40.5% and from South East Asia by 34.0%. Imports from the US grew by 37.7%.

CAPITAL ACCOUNT (TABLE VI)

TABLE VI: LONG TERM CAPITAL

	CALENDAR YEARS						
	1984	1985	1986	1987	Q1	Q2	JULY
<b>OUTWARDS</b>							
Direct Investment	6.0	6.5	14.5	19.5	7.2	7.6	2.7
Trade Credit	5.0	3.0	2.0	1.7	1.2	1.5	0.9
Loans	11.9	10.6	9.1	16.1	3.8	2.3	1.5
Securities							
- Stocks	30.8	1.0	7.0	16.8	(0.5)	(0.1)	0.9
- Bonds		58.8	95.1	70.7	12.6	26.2	13.3
- Other	3.1	2.2	4.6	8.7	1.6	0.4	1.4
	<u>56.8</u>	<u>82.1</u>	<u>132.4</u>	<u>133.5</u>	<u>25.9</u>	<u>37.9</u>	<u>20.7</u>
<b>INWARDS</b>							
External Yen Bonds	7.4	12.8	18.4	30.3	5.6	7.5	6.5
Stocks	(3.6)	(0.7)	(15.7)	(42.8)	6.5	(2.7)	(3.2)
Bonds	3.5	4.5	(2.1)	6.6	(1.1)	(2.3)	(1.0)
Other	(0.1)	(0.7)	(0.1)	2.2	(0.5)	(0.9)	-
	<u>7.2</u>	<u>17.3</u>	<u>0.5</u>	<u>(3.7)</u>	<u>10.5</u>	<u>1.6</u>	<u>2.3</u>
NET OUTFLOW	49.6	64.8	131.9	137.2	15.4	36.3	18.4



21. The net outflow of long term capital during the second quarter more than doubled over the first quarter to \$36.3 billion, and reached \$18.4 billion in July - the highest monthly total since last November. Japanese investors' confidence in overseas bonds continued to recover, and reached a new monthly record of \$13.3 billion in July (\$14.0 billion before investment in Euroyen bonds is deducted). After net disinvestment totalling \$0.6 billion in the first 6 months, investment in overseas stocks totalled \$0.9 billion in July. At the same time, net inward investment into Japan was very low, with net selling of both bonds and stocks by non-residents during the four months to July. In contrast, non-residents' interest in Euro-yen bonds continued to be very strong, and the \$6.5 billion of purchases of Euroyen bonds in July constituted another monthly record.

FINANCIAL DEVELOPMENTS (TABLE VII)

TABLE VII: MONETARY INDICATORS

	<u>FISCAL YEARS</u>			<u>1988</u>					
	<u>1985/86</u>	<u>1986/87</u>	<u>1987/88</u>	<u>MAR</u>	<u>APR</u>	<u>MAY</u>	<u>JUN</u>	<u>JUL</u>	<u>AUG</u>
M1 Annual Growth (%)	4.5	8.4	10.2	9.5	9.2	9.9	8.1	7.2	n.a.
M2 + CDs Annual Growth (%)	8.7	8.6	11.2	11.8	11.3	11.4	11.1	11.1	n.a.
Discount Rate (%) (end of period) Growth (%)	3.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
3-month Gensaki Rate (end of period)	4.395	3.983	3.835	3.835	3.795	3.823	3.825	3.855	4.900
Government Bond Yield (No. 10, 6.1%)	4.40	3.79	4.430	4.430 (No 105)	4.445 (No 105)	4.665 (No 105)	4.865 (No 105)	4.925 (No 105)	5.360 (No 105)
Tokyo Stock Exchange First Section Index - Average Price	1,030	1,448	2,014	2,109.32	2,165.74	2,167.79	2,185.63	2,177.78	2,195.02
Yen/Dollar rate (end of period closing)	160.10	145.80	124.50	124.50	124.82	124.80	132.20	132.53	134.97
Yen/Sterling T.T. Selling rates (AV)	237.59	234.30	283.93	236.88	238.69	237.44	230.87	231.06	231.10

22. Money supply growth has eased slightly in recent months, with M2+CD's, the broadly defined measure rising by 11.1% year on year in both June and July. M1, the narrow measure which includes only cash and bank deposits, has been growing more slowly still, with growth of only 7.2% year on year in July. This reflects the growing attractiveness of CDs and other money market instruments over conventional bank deposits.

23. The yen, which had weakened to Y132 during the second half of June, traded in the Y132-Y135 range during July and August, but increases in market interest rates in the US and elsewhere left the currency vulnerable on several occasions. Following the increase in the US discount rate on 9 August, and especially after the coordinated rise of European official rates at the end of the month, the yen weakened sharply, slipping to Y136.45 on 1 September.

24. Interest rates continued to move upwards during July and August, reflecting international trends and market expectations that Japan would be obliged to follow suit. Three month CD's opened at 4.45% at the beginning of July, but moved steadily upwards before closing at 4.90% at the end of August. In the controlled area of the money markets, the Bank of Japan permitted rather smaller rises: the discount rate for bills with maturity of 2 months or longer moved from 3.94% to 4.125% over the 2 month period. Expectations of an increase in the official discount rate continued, and intensified in the first few days of September, but both the Bank of Japan and the Ministry of Finance maintained that in view of continuing price stability there was no justification for such an increase.

25. The bond markets remained nervous throughout July and August as participants followed the upward trend of interest rates. After beginning July at 5.01%, the yield on the benchmark No. 105 10-year bond fell back below the 5% level by early August, but leapt to 5.40% on 10 August following the US discount rate rise. The market recovered its poise but further worries were already intruding by the end of the month when the benchmark yield had climbed back to 5.36%. The September issue of 10-year bonds will carry a coupon a 5.0%, but will be priced to yield around 5.33%.

26. On the Toyko Stock Exchange, the Nikkei Index traded in volatile conditions between 27,000 and a new peak of 28,423 (reached on 5 August). The index suffered its biggest one-day fall this year, of 615, on 10 August, and closed the month at 27,366. Sales volume remained high in July, with an average daily turnover of 1,462 million shares, but it is reported to have fallen back sharply during August.

#### FISCAL POLICY

27. After some delays, the Diet passed the Y1.3 trillion tax cuts for 1988 on 29 July. It had been agreed earlier in the year, that this tax cut should be treated separately from the main tax reform proposals. The ruling Liberal Democratic Party successfully resisted attempts by the opposition parties to write in provisions that the tax cuts should continue in subsequent fiscal years. The cuts in taxation will be retrospective to 1 January 1988.

-10-  
Unclassified

128.

28. However, little progress has been made in the extraordinary Diet session by the LDP with its plans for a wide ranging package of tax reforms. (For details of the proposals, see the May issue of the Monthly Economic Report.) The government has so far refrained from using its large majority to push the proposals through the Diet because of the need to accommodate opposition from some sections of the LDP itself, and also because it is felt that a consensus needs to be obtained with at least some of the opposition parties. That consensus has however been delayed by the emergence in July of a share-dealing scandal, in which it is alleged that a property company, Recruit Cosmos, sold shares to the aides of leading LDP politicians in 1984 at a price which ensured that substantial profits would be made when the shares of the company were listed on the Tokyo Stock Exchange in 1986. Throughout August attempts by the LDP to introduce the subject of tax reform were blocked by opposition demands that before doing so the Recruit case should be investigated and debated. There are however now signs that the opposition parties may be close to an agreement with the LDP to allow the tax reform proposals to go forward, although the specialist committees that will be needed to enable the processing of the tax bills to get underway have still not been set up.

WHITEHEAD

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 MR BAYNE  
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 MR CARRICK  
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 JAPAN POLITICAL AND ECONOMIC

FROM: D SAVAGE  
DATE: 12 SEPTEMBER 1988  
cc: Sir P Middleton  
Sir T Burns  
Sir G Littler  
Mr Lankester  
Mr H P Evans

1. MR MATTHEWS *12/9*
  2. CHANCELLOR
- [Handwritten signature]*

**JAPANESE BALANCE OF PAYMENTS STATISTICS**

You noted a report in the Morning Press, attributed to the Japanese press agency Kyodo, that 'the Finance Ministry will deduct some \$3 billion from Japan's current annual BOP surplus to include overseas spending by Japanese travellers.'

2. The report is somewhat misleading. The Japanese statistics on imports of invisibles already included expenditure by Japanese tourists who had exchanged their yen for foreign currency in Japan or at branches of Japanese banks abroad. However, it did not include expenditure by tourists who changed their money at foreign banks, and it is this expenditure which is now being included in the statistics. Information on this expenditure had been collected from foreign financial institutions for some time, but it had previously been considered too small to take into account.

3. The change appears to be a perfectly genuine attempt to improve the quality of Japan's balance of payments statistics. It is expected to reduce Japan's current account surplus by \$2-3 billion in a full year. This is small in relation to a surplus likely to be in the order of \$80 billion this year. It is also small in relation to the discrepancy in the world balance of payments on current account, which the IMF expects to be around \$68 billion this year.

*DS*

D SAVAGE



FROM: A C S ALLAN  
DATE: 7 September 1988

MR D SAVAGE 3

cc Sir P Middleton  
Sir T Burns  
Sir G Littler  
Mr Lankester  
Mr H P Evans  
Mr S W Matthews

**JAPANESE BALANCE OF PAYMENTS STATISTICS**

The Chancellor has seen the attached report in the IMF press summary saying that the Japanese Finance ministry will deduct some \$3 billion from Japan's current account surplus to include overseas spending by Japanese travellers. The Chancellor was puzzled by this: why is this not included already? And the change will, presumably, increase the global deficit. He would be grateful for any comments.

A handwritten signature in black ink that reads 'ACSA'.

A C S ALLAN

# MORNING PRESS

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FRIDAY, Sep 2/88 DA

BANK OF JAPAN BIDDING TIME FOR EXCHANGE MARKET INTERVENTION. Kyodo reported from Tokyo that a senior Bank of Japan official said the Bank is weighing the timing of exchange market intervention to prevent a further sharp fall of the yen. He said the Bank cannot say when it will step in, but any market intervention will take account of market psychology as well as timing. He suggested that the Bank could also ask other central banks to intervene on its behalf. The agency also reported that the Finance Ministry will deduct some \$3B from Japan's current annual BOP surplus to include overseas spending by Japanese travellers. An official said the Ministry only wants to increase the accuracy of Japan's BOP statistics and has no other intentions.

chex.md/jt/15

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FROM: J M G TAYLOR

DATE: 15 September 1988

MR SAVAGE

cc Sir P Middleton  
Sir T Burns  
Sir G Littler  
Mr Lankester  
Mr H P Evans  
Mr Matthews

**JAPANESE BALANCE OF PAYMENTS STATISTICS**

The Chancellor was grateful for your minute of 12 September.

A handwritten signature in black ink, appearing to be "J M G Taylor".

J M G TAYLOR



*Handwritten signature*

FROM: S M A JAMES  
DATE: 16 September 1988

MR SAVAGE

cc PS/Chancellor  
Sir G Littler  
Mr Evans  
Mrs Lomax  
Mr Mountfield  
Mr P G F Davis  
Mr Ilett  
Mr Matthews  
Mr Bolt  
Miss Preston  
Mr Wiseman  
Mr Cropper  
Mr Tyrie

*Handwritten mark resembling a '2' or 'Z'*

*Handwritten red checkmark*

**ECONOMIC SECRETARY'S DINNER WITH THE JAPANESE AMBASSADOR, TUESDAY  
13 SEPTEMBER**

The Economic Secretary was grateful for your brief of 9 September for this occasion.

2. The Economic Secretary had a most enjoyable evening and mentioned that the following points were raised.

- i. The Japanese Minister for Finance expected the Chairman of the Japanese Stock Exchange to be retiring shortly. Once he was replaced, and the next time the market was expanded he expected BZW and James Capel to be treated on the same basis as Japanese firms;
- ii. Tax discrimination against Scotch Whisky - Mr Keswick (Jardyne Mattheson) was present at the dinner and (most unhelpfully) said that the reforms would not make any difference at all. The Japanese Minister for Finance disagreed.
- iii. The question of IMF quotas was not raised.

*Handwritten signature*  
S M A JAMES



*par*

FROM: S W MATTHEWS  
DATE: 16 September 1988

PRINCIPAL PRIVATE SECRETARY

cc PS/EST  
Sir P Middleton  
Sir T Burns  
Sir G Littler  
Mr Byatt  
Mr Lankester  
Mr Evans  
Mr Odling-Smee  
Mr Sedgwick  
Mr Spackman  
Mr J Davies  
Mr Riley  
Mr Savage

*AM*

**JAPAN**

We shall be sending you next week some material on Japanese macroeconomic policies and prospects as part of the briefing for the G5/7 meetings, but the Chancellor may also be interested in the attached papers by David Savage on two topical structural issues.

2. The first paper, "Japan : The Economic Effects of an Ageing Population", sets out recent demographic projections for Japan and the other major countries and discusses the implications of these trends for the growth of the labour force, saving behaviour and social security expenditure.

3. Japan has benefitted in recent decades from having a relatively favourable ratio of population of working age to total population and is faced with a dramatic change in this ratio over the next 30 years. The problems of an ageing population are not, however, unique to Japan. Other developed countries are experiencing the same phenomenon and its associated pressures for increased social expenditure, although in differing degrees. The problem may be even more acute in Germany than Japan. It is important to remember, though, that long term demographic projections are subject to a wide margin of error.

4. The second paper sets out the main elements of Japan's tax reform, which follows broadly the same pattern as in the UK (and elsewhere) - a switch from direct to indirect taxes, broadening the base for income tax, and reducing income and corporation tax rates. As you probably know, the Government is having great difficulty in getting its proposals for a broad based sales tax accepted and the Japanese Minister of Finance, Mr Miyazawa, will doubtless give the Chancellor and other G7 colleagues his latest assessment of the prospects in Berlin.

SM.

S W MATTHEWS

**JAPAN : THE ECONOMIC EFFECTS OF AN AGEING POPULATION****DEMOGRAPHIC BACKGROUND****Average Age of the Population**

1. In 1960 Japan had the youngest population of any major industrial country. Since then the population has rapidly aged, as a result of a sharp drop in the birth rate and a remarkable increase in life expectancy (now the longest in the world). In terms of the increase in median age, the rate of ageing has started to slow down. Nonetheless, Japan is expected to experience the greatest population ageing over the next decade, apart from Canada. By 1995 Japan will have the second oldest population, after Germany.

**Table 1 : Median Age of Population (years)**

	<u>1960</u>	<u>1985</u>	<u>1995</u>	
<u>Japan</u>	<u>25.5</u>	<u>35.1</u>	<u>38.5</u>	1995-1985 + 3.4
Canada	26.4	30.5	34.3	+ 3.8
United States	29.4	31.3	34.2	+ 2.9
France	33.0	33.7	36.2	+ 2.5
Germany	34.4	37.8	39.7	+ 1.9
Italy	31.3	35.4	37.1	+ 1.7
United Kingdom	35.4	35.1	36.2	+ 1.1

Source : United Nations

**Age Distribution of the Population**

2. It is not so much changes in the average age of the population that have economic implications as particular features of age distribution - particularly the proportions of the population that are of working and of retirement age.

3. After differing substantially during the 1960s and 1990s, the growth rates of the population of working age were remarkably similar among the major industrial countries during the first half of the 1980s. In most countries, and particularly in Europe, there will be a sharp deceleration in the second half of the decade, reflecting the low birth rates of the early 1970s. However in Japan, where the birth rate did not fall sharply, until the late 1970s, working-age population growth will slow down significantly only in the early 1990s.

4. Beyond the next fifteen years, working-age population projections become increasingly liable to error as they become increasingly dependent on birth rate assumptions. However it is likely that, into the next century, the working-age population will either be growing slowly by historical standards (North America) or actually declining (Europe and Japan).

**Table 2: Growth of Population Aged 15-64 (Annual percentage rates)**

	<u>1960-80</u>	<u>1980-85</u>	<u>1985-90</u>	<u>1990-95</u>	<u>1995-2000</u>
<u>Japan</u>	<u>1.4</u>	<u>0.9</u>	<u>0.9</u>	<u>0.3</u>	<u>- 0.3</u>
Canada	2.2	1.2	0.8	0.9	0.4
United States	1.7	1.0	0.7	0.7	0.5
France	1.0	1.1	0.4	0.1	- 0.1
Germany	0.5	1.0	- 0.2	- 0.5	- 0.7
Italy	0.5	0.9	0.3	- 0.1	- 0.2
United Kingdom	0.2	0.6	0.1	0.0	- 0.1

Source: United Nations

5. The proportion of the population that is aged over 65 is currently lower in Japan than in any other major industrial country (and almost 50 per cent lower than in the UK where the proportion is highest). However the elderly proportion is rising rapidly in Japan, and by the end of the century will be higher than in North America and not much below the average for the major

European countries. Projections this far ahead are fairly firmly based; those looking even further into the future are considerably more uncertain, but it is likely that the elderly proportion in Japan will rise substantially further by the end of the first quarter of the next century.

Table 3: Percentage of Population Aged over 65

	<u>1965</u>	<u>1985</u>	<u>2000</u>	<u>2025</u>
<u>Japan</u>	<u>6.3</u>	<u>10.2</u>	<u>14.9</u>	<u>21*</u>
Canada	7.7	10.4	11.4	19
United States	9.5	11.9	13.0	19
France	12.1	13.0	14.0	16
Germany	12.0	14.8	17.0	24
Italy	9.8	12.9	15.7	19
United Kingdom	12.2	15.1	15.1	19

Source: IMF

\*Japan's Institute of Population Problems projects a greater rise, to 23½ per cent by 2020.

6. Over the past twenty years, the rise in the proportion of old people in the Japanese population has been matched by a fall in the proportion of children: the overall dependency ratio has hardly changed. Projections of dependency ratios are highly uncertain as they are very sensitive to future birth rates; but work by the IMF suggests that there will be only a modest rise in the Japanese ratio over the remainder of the century, a decline in the child proportion of the population continuing to offset the rise in the elderly proportion. At the end of the century, the Japanese ratio will probably still be quite low by international standards. Thereafter the Japanese ratio could rise quite sharply - though projections so far into the future should be treated with considerable reserve.

**Table 4: Dependency Ratios\***

	<u>1965</u>	<u>1985</u>	<u>2000</u>	<u>2025</u>
<u>Japan</u>	<u>47.1</u>	<u>46.6</u>	<u>48.4 (48)</u>	<u>63 (61)</u>
Canada	69.7	46.8	47.0 (48)	61 (61)
United States	66.7	50.6	50.6 (50)	62 (60)
France	60.5	52.0	55.3 (51)	57 (60)
Germany	52.3	42.7	50.4 (48)	61 (62)
United Kingdom	55.2	52.3	53.4 (52)	59 (58)

\* Percentage of population aged under 15 and over 65 of total population. Comparable figures for Italy are not available.

Source: IMF projections (UN projections in brackets).

### ECONOMIC EFFECTS

#### Labour Force

7. Over the past twenty years, the growth rate of the Japanese labour force has been determined very largely by that in the working-age population. Changes in male and female participation rates have been relatively small and have almost cancelled each other out (the male rate falling, with earlier retirement, the female rate rising gradually).

8. The aggregate participation rate (the total labour force, without age limit, divided by the proportion aged 15-64) will probably rise as the population ages, since some of those who reach the age of 65 will go on working. Growth in the labour force is therefore unlikely to slow down as much as that in the working age population.

9. The OECD projects that the deceleration in labour force growth over the next ten years will be no greater in Japan than in North America, Italy or the UK, and much less than in Germany.

**Table 5: Labour Force Projections (Annual growth rates)**

	<u>1979-86</u>	<u>1986-90</u>	<u>1990-95</u>
<u>Japan</u>	<u>1.2</u>	<u>0.9</u>	<u>0.6</u>
Canada	2.0	2.1	1.3
United States	1.6	1.0	1.0
France	0.3	0.7	0.6
Germany	0.6	- 1.1	- 0.9
Italy	0.7	0.6	0.0
United Kingdom	0.6	0.0	0.0

Source: OECD Employment Outlook, September 1987.

### Economic Growth

10. It is gains in productivity, much more than increases in the labour force, that have been responsible for Japan's rapid rate of economic growth. Since 1973, the labour force and employment have grown by less than 1 per cent a year, but output has grown by 4 per cent a year. On the (questionable) assumption that labour's share of national income (two thirds) is a good estimate of the elasticity of output with respect to labour, the effect of the slowdown in labour force growth between 1979-86 and 1990-95 would (other things being equal) be to reduce Japan's annual rate of economic growth by  $\frac{1}{4}$ - $\frac{1}{2}$  per cent.

11. Productivity growth might also be affected by the ageing of the population, but it is not clear which way. A younger labour force is more vigorous and adaptable. An older labour force is more experienced.

### Saving

12. About one third of GNP is saved in Japan - a far higher proportion than in the other major countries (15-25 per cent). Although most of Japan's savings are absorbed by investment, which

is also very high by international standards, high savings have also contributed to Japan's large current account surplus.

13. Saving in Japan is high partly because a high proportion of the population is of working age (when saving is highest) and a low proportion is of retirement age (when saving is low or negative). As the population ages, the savings ratio would therefore be expected to decline. Perhaps the best indication of the size of this effect is from an IMF study, which estimates that the aging of the population could reduce savings by almost 1 per cent of GNP by the end of the decade and by more than 4 per cent by the end of the century.\*

14. To the extent to which this reduction in saving is reflected in lower investment in Japan, it will tend to lower Japan's rate of economic growth.\*\* To the extent to which it is reflected in lower net investment abroad, the growth rate will be little affected and the counterpart will be a reduction in the current account surplus.

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\* 'Japan's High Rate of Private Saving's', background study for the 1985 Article IV consultation with Japan.

\*\*A simple Harrod-Domar growth model can be used to illustrate the impact on the growth rate of the decline in the savings ratio. Given the capital-output ratio,  $K$ , which can be treated as an accelerator, investment in period  $t$  will equal  $k$  times the increases in output,  $Y_t - Y_{t-1}$ .

Investment equals savings, which can be written as  $s$ , the savings ratio, times  $Y_t$

Combining the accelerator and multiplier relationships gives the familiar expression for the growth rate:

$$Y_t = (k-s) Y_{t-1}$$

If (for illustration)  $k$  is given a value of 6, a reduction from 0.30 to 0.26 in  $s$  would reduce the growth rate from 5.3 per cent to 4.5 per cent.



Social Security Expenditure

15. In relation to GNP, Japan's social security expenditure has grown very considerably since the 1960s, but is still among the lowest of the major seven countries.

Table 6: Social Security Transfers as Percentage of GNP

	<u>1960</u>	<u>1975</u>	<u>1980</u>	<u>1986</u>
<u>Japan</u>	<u>3.8</u>	<u>7.7</u>	<u>10.1</u>	<u>11.4</u>
Canada	7.9	10.0	13.0	12.3
United States	5.0	11.1	10.9	11.0
France	13.5	20.4	23.2	26.4*
Germany	12.0	17.6	16.5	15.8
Italy	9.8	15.6	14.1	17.2
United Kingdom	6.8	9.9	11.5	14.1

\* 1985

16. Pensions are the largest and fastest - growing element in social security expenditure in Japan. Since 1975 Government transfers to the elderly through pensions and old-age medical care have increased from only 11 per cent of social security benefits and 1 per cent of GNP to over 25 per cent of benefits and almost 3 per cent of GNP. This rise reflects partly the rising number of elderly and partly increases in the average level of pensions. Pensions were formerly very low by international standards, but are now substantially more generous than in the US. Moreover, at 55, the retirement age is exceptionally low in Japan (though a substantial proportion of the population actually go on working into their sixties).

17. On the demographic trends discussed earlier (and at constant participation rates), the number of pensioners in Japan will increase at a rate of 3 per cent a year, up to the end of this century, slowing to 1½-2 per cent a year over the first quarter of the next century. If the real average level of pensions remained

constant, then real public expenditure on pensions would of course grow at the same rate as the number of pensioners. In fact, on current pension arrangements, the real average level of pensions will tend to rise. The state pension scheme in Japan is very immature, in the sense that newly retired pensioners benefit, relative to their predecessors, from having been in the scheme for a greater part of their working life. Moreover, pensions are linked to past earnings; so that to the extent that real average earnings grow over time, so will real average pensions.

18. Concern in Japan about future pressures on the social security budget has led to the accumulation of huge surpluses by the social security system - equivalent to 2½-3 per cent of GNP in recent years. It is estimated that the funds now accumulated will allow current contribution rates to be maintained until the end of the century.\*

19. Growth in real public expenditure on pensions and other benefits to the elderly will be offset to some extent (in the event of continuing low birth rates) by reduced expenditure on family benefits, education, and other services for the young. However this offset is likely to be very incomplete, as public social expenditure, per head, on the elderly is at least twice that on the young.

20. Recent studies by the OECD and the IMF have attempted to estimate, for each of the major countries, the overall impact of ageing populations on public expenditure. The OECD projections assume no changes in the real average levels of benefits provided: they therefore show the increases in real social expenditure that result purely from demographic pressures.

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\* The assets of the Japanese social security system were over 17 per cent of GNP at end-1986. The other major countries to run substantial surpluses on social security are Canada and the United States. At end-1986 the assets of the Canadian public pension plans were 10 per cent of GNP and by 1990 it is expected those of the US Old Age Security Fund will reach about 4 per cent of GNP.

Table 7 : OECD Projections of Real Social Expenditure

	<u>1980-2000</u>	<u>2000-2020</u>
<u>Japan</u>	<u>1.1</u>	<u>0.6</u>
Canada	1.1	1.3
United Kingdom	0.6	1.4
France	0.4	0.6
Germany	0.2	0.0
Italy	0.1	0.4
United Kingdom	- 0.2	0.4

\* Annual rates of increase

Source : OECD Observer, October/November 1987.

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21. Viewed relative to historical and likely future growth rates in GDP, these increases, implied by demographic factors alone, appear manageable. However, under existing social security programmes real average benefits will be tending to rise. The IMF projections take this into account.

**Table 8 : IMF Projections of Social Expenditure**

	<u>1980</u>	<u>2000</u>	<u>2025</u>
	<u>Percentage of GDP</u>		
<u>Japan</u>	<u>15</u>	<u>21</u>	<u>27</u>
Canada	20	17	21
United States	18	16	19
France	31	32	35
Germany	31	33	39
Italy	25	28	35
United Kingdom	18	16	19

Source: Ageing and Social Expenditure in the Major Industrial Countries, 1980-2025. IMF Occasional Paper, 47.

22. The precise results should be treated with considerable reserve: as the IMF study notes, they are highly sensitive to assumptions about the uprating of benefits, public sector pay, growth rates, etc. They show the burden of social expenditure in Japan rising substantially from an initially relatively low level, but remaining lower than in Germany, France or Italy.

23. Pensions reform is an issue in Japan as elsewhere. The outcome will probably be a reduction in pension benefits and possibly an increase in the exceptionally low retirement age.

24. The potential role of the private sector in providing finance for social expenditure (eg on medicine and education) is very considerable in Japan. Unlike the case in the US and UK, where occupational pensions are important, public pensions are the only basic form of support for most of the elderly in Japan.

## 25. CONCLUSIONS

i. Japan's population is still comparatively young, but is in the course of a transition to an age structure similar to that of the major European countries.

ii. The problems of an ageing population are not peculiar to Japan: they are to a greater or lesser extent being faced by all major countries.

iii. Up to the end of the century (about as far as one can look very reliably ahead), the implications for the potential supply of labour will be less important in Japan than in most other major countries. In any case, in the future, as in the past, the rate of economic growth is likely to depend more on trends in productivity than in labour supply.

iv. Demographic trends will probably tend to reduce Japan's high savings ratio, and hence perhaps its structural current account surplus.

v. An increasing share of the elderly, in the population will put upward pressure on public social expenditure. But it is not obvious that the 'pensions problem' is more acute in Japan than in some other countries, eg Germany.

1. On 28 June, the Japanese Government presented its latest proposals for tax reform. These proposals, which have a good chance of being enacted (if with some modifications), are the culmination of a process of reform which started in 1985.

2. This note summarises the defects of the old tax system; compares some of the main features of the tax system in Japan (before the latest proposed reforms) and the systems in other countries; describes the reforms that have been implemented so far and those contained in the latest set of proposals; and discusses, in broad terms, the likely economic effects of the reforms.

### The Old System

3. In 1985 the Government's Tax System Council identified a number of fundamental problems with the old system:

- i. the high dependence on direct taxes
- ii. the narrow base and steep progressivity of personal income taxes, with very high marginal rates on middle and high incomes
- iii. the tax exemption of most savings (criticised abroad as partly responsible for the high savings rate in Japan and consequently for the current account surplus)
- iv. the preferential treatment of the self-employed, who file their own tax returns and are able to evade or avoid tax, eg by splitting income by paying 'wages' to other members of the household (family income is not consolidated)
- v. the high rate of corporation tax
- vi. the narrow coverage of indirect taxes, with high rates on consumer durables and most other goods and services exempt.

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### International Comparisons

4. Tables 1-5 provide a statistical comparison of some of the main features of the tax systems in Japan and in other countries:

- i. Relative to GDP, the overall level of taxation in Japan is very low by European standards (table 1).
- ii. Indirect taxes are less important than in most other countries, accounting for only 25 per cent of current revenue in 1985 against 38 per cent in the United Kingdom (table 1).
- iii. Average rates of rate on personal incomes are relatively low, particularly for those on low incomes (table 2).
- iv. Marginal rates of income tax are low for those on low incomes, but quite high for those on high incomes (table 3).
- v. This progressivity reflects the relatively high tax threshold and relatively low starting tax rate in Japan but relatively higher tax rates (table 4).
- vi. The rate of corporation tax is relatively high in Japan (table 5).

### Reforms

5. Revenue-neutral reforms were proposed by the Government in December 1986:

- i. cuts in personal and in company income tax
- ii. a simplification and flattening in the rate structure of personal income tax
- iii. the imposition of a flat 20 per cent rate of tax on interest income
- iv. the introduction of a broad-based Sales Tax (similar to VAT).

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**Table 1: Sources of Current Revenue, 1985 Percentages of GDP**

	Direct taxes*	Indirect taxes	Other**	Total current receipts***
Japan	20.5	7.9	2.8	31.2
UK	22.5	15.8	3.5	41.8
Germany	29.2	12.5	3.7	45.4
France	29.3	15.1	4.1	48.5
US	20.4	8.4	2.3	31.1

\* Taxes on personal and company income, and social security contributions.

\*\* Mainly property income and trading surpluses.

\*\*\* General government.

**Table 2: Average Rate of Income Tax\*: Single Person**

	Germany	France	UK	US	Japan
Income (£)					
5,000	29	16	21	15	16
11,000	40	26	30	21	20
20,000	43	32	31	32	25
50,000	50	40	43	40	39
Average earnings	38	22	29	22	19

\* Tax and social security contributions as a percentage of gross income, 1987.

Source: Inland Revenue.



**Table 3: Marginal Rates Tax\*: Single Person**

	Germany	France	UK	US	Japan
<u>Income</u>					
5,000	40	36	34	25	21
11,000	59	32	36	29	27
20,000	53	42	27	49	34
50,000	56	46	60	45	57
Average earnings	55	31	36	29	26

\* Tax and employees' social security contributions as a percentage of gross income, 1987.

Source: Inland Revenue

**Table 4: Starting and Highest Tax Rates: Single Person, 1987**

Threshold (£)	Starting Tax Rate		Highest Tax Rate	
	Rate	Threshold (£)	Rate	
Japan	15	2,740	65	152,710
Germany	22	1,930	56	33,040
France	26	4,070	61	51,250
UK*	27 (25)	2,426	60 (40)	43,626
US*	11 (15)	2,540	45 (33)	34,750

Source: Inland Revenue

\* Current rates in brackets

Table 5: Tax Rate on Profits, 1987\*

Japan	57**
UK	35
Germany	62-66***
France	42
US	43****

\* Marginal tax rate on retained profits (including local or state taxes).

\*\* Central government rate is 42 per cent and local government rate 15 per cent.

\*\*\* Rate varies according to leverage.

\*\*\*\* Rate varies from State to State.

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6. In the face of opposition both in the Diet and in the country at large to the Sales Tax, the proposals were not approved by the Diet during its regular session ending in May 1987.

7. However in mid-September, when it approved the 'Emergency Package' of spending on public works, the Diet passed some parts of the proposed reform:

i. effective from last October, Yen 1½ trillion in 1987-88 of the originally proposed Yen 2.7 trillion of personal income tax cuts

ii. effective from this April, the imposition of the tax on interest income, generating revenue of Yen 1.6 trillion in a full year.

The reform of the indirect tax system and the cut in corporation tax had to be shelved for a time.

8. Revised proposals, covering the unenacted parts of the 1987 tax bill, were agreed by the Cabinet on 28 June. These include:

i. further cuts in income tax. The top rate is to be reduced to 50 per cent.

ii. A cut in corporation tax. The basic rate is to be reduced from 42 to 37½ per cent over the next two years.

iii. A Sales Tax, though at a rate of 3 per cent, against 5 per cent in the original proposal, and with fewer exemptions (to reduce shops' clerical work).

iv. The abolition of eight existing indirect taxes. Details of the indirect tax proposals are given in the Annex to this note.

9. The proposed cuts in income tax and corporation tax (estimated at Yen 4.4 trillion in a full year) are larger than the net increase in indirect taxes (Yen 2 trillion), so that revenue will be reduced overall (by Yen 2.4 trillion or 0.6 per cent of

GNP). Moreover, the income tax cuts are to take effect this year, while the introduction of the Sales Tax is to be delayed until next April.

10. It seems probable that the tax bill will be enacted this time, though possibly not without modifications or delays.

### Effects

11. There will be some short-term stimulus to demand while the indirect tax increase will raise prices. These effects are unlikely to be very large however: the Economic Planning Agency puts the effect on real GNP at 0.2 per cent and the effect on the GNP deflator (at market prices) at 0.3 per cent.

12. With the economy booming, tax receipts are buoyant, and it seems likely that the tax proposals could be implemented without any increase in the budget deficit.

13. The broadening in the indirect and to a lesser extent in direct tax base and the shift from direct to indirect taxation are expected to reduce tax evasion - particularly a problem among self-employed shopkeepers and farmers.

14. The reduction in the high marginal rates of income tax should reduce disincentives to work (though there is little evidence that such incentives are powerful in Japan).

15. The reduction in the high marginal rate of corporation tax will reduce the cost of capital and should encourage investment (though the investment rate in Japan is already very high by international standards).

16. The shift from direct to indirect taxation will tend to increase saving (by an amount which depends on the interest-elasticity of saving), as may the cut in inheritance tax.

17. The effect of the taxation of interest income on the level of saving is theoretically ambiguous (depending on the balance of income and substitution effects), but seems unlikely to be very

large, one way or the other. At the present low level of interest rates, the effect of taxation on the rate of return on small savings (eg postal accounts) is equivalent only to a  $\frac{1}{4}$  per cent increase in interest rates.

18. However the composition of saving is being affected, with less saving going into small-denomination bank deposits and postal accounts and more into stocks and shares, insurance policies, and wholesale bank deposits. There is now considerable pressure from the banks for the deregulation of interest rates on small deposits, which have become increasingly uncompetitive. Thus tax reform may accelerate financial market reform.

19. Because of interest relief, Japanese interest rates may have tended in the past to be higher relative to those of countries without such relief, encouraging a capital outflow and weaker exchange rate. Upward adjustment in Japanese gross interest rates, following the abolition of interest relief, would contribute to a stronger yen and to balance of payments adjustment over the long term.

20. In general the reform of indirect taxation will not alter the competitiveness of imports vis-a-vis domestic substitutes - though imports of particular highly-taxed luxury goods (eg big cars) for which there are not close domestic substitutes will benefit. Changes in excise duties reduce (but do not eliminate) discrimination against imported spirits.

### Assessment

21. The tax reforms - the broadening in the tax base, the shift from direct to indirect taxation and the reduction in marginal rates of tax - are along qualitatively similar lines to those made in the UK since 1979.

22. They will be good for the Japanese economy and public finances - reducing distortions, disincentives and tax evasion, and spreading the tax burden more equitably and more widely. The need (arising from an ageing population and growing demand for public services) for higher revenues would have put the old system, with its narrow base, under increasing strain.

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23. However there is one area where very serious distortions remain - land use. A chronic shortage of land for urban development is exacerbated by much lower rates on agricultural than on residential property, which provides an incentive to maintain very small farms even in big cities, and by the combination of a large capital gains tax and low rates and inheritance tax, which discourages sales of land. Recent tax measures to curb speculation in real estate may actually worsen the shortage of building land, while fiscal measures to increase the demand for housing may merely drive up land prices further.\*

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\*The most important measure aimed at reducing land price inflation is the abolition (from April 1988) of a capital gains tax allowance whereby replacement purchases of land can be set off against the proceeds from sales. The effect may be to further encourage land holding. To promote housing investment (from the demand side), the availability of subsidised government loans has been increased.

## **ANNEX: INDIRECT TAX PROPOSALS**

### **Sales Tax**

1. The new tax is similar in principle to the European VAT, but there is the administrative difference that firms will only be required to keep records of the tax due in their account books and will not have to submit vouchers or sales slips to the tax authorities. This looser method of collection may give scope for evasion.

2. Firms with annual sales of less than Yen 30 million (£130,000) will be exempt - a very high threshold by European standards.

3. At 3 per cent, the rate of tax is very low by European standards. (A transitional rate of 6 per cent is to be levied on cars for a period of three years.)

4. Exemptions are few. Apart from exports, they include insurance premiums and school and doctors' fees.

### **Other Taxes**

5. The new tax will replace various existing commodity-specific taxes.

6. The most important of these taxes is car tax, which is as high as 23 per cent on luxury models. Rates of 5-30 per cent are levied on consumer durables and jewellery.

7. The ad valorem tax on whiskey and brandy is to be abolished. Excise duties on alcohol and tobacco are to be retained, but the differential between imported whiskey and brandy, and locally-produced 'shochu' spirits is to be narrowed.

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Mr Sedgwick  
Mr Spackman  
Mr J Davies  
Mr Riley  
Mr Savage

JAPAN

The Chancellor was grateful for your minute of 16 September, and the attached papers by Mr Savage.

*JMGT*

J M G TAYLOR





FROM: A C S ALLAN  
DATE: 30 September 1988

MR LANKESTER

cc PS/Economic Secretary  
Sir P Middleton  
Sir T Burns  
Sir G Littler  
Mr H P Evans  
Mr Mountfield  
Mr Gieve  
Mr Matthews  
Mr Walsh  
Mr Tyrie  
Mr Cassell (Washington)

#### JAPAN'S INTERNATIONAL FINANCIAL AMBITIONS

At the Annual Meetings in Berlin, the Chancellor asked for an economic and political analysis of the Japanese debt initiatives and their wider implications.

2. The first question is to find out more about what exactly the Japanese proposals are. I attach a copy of Sumita's speech in Berlin. The proposal for increased untied loans "in parallel with" Fund lending seems unexceptionable as put. But there must be some suspicion about whether the Japanese really are planning to do this unilaterally, or whether they will seek to bring in other countries. And it does raise the wider question: while we do not want to bail out own banks, do we care if other countries bail out theirs - and maybe ours too, indirectly? Or would that simply generate irresistible pressure on us to follow suit? It would be helpful, in this context, to have some figures about the relative exposure of Japanese banks.

3. The re-launched Toronto initiative also leaves some important questions unanswered. Where are the debtor countries going to get the resources to put in the "special reserve accounts" at the IMF?



It does seem as if the "hope" that the debtor country's programme will be supported by "bilateral funds from the industrial countries" may be code for funding the special accounts ~~for~~<sup>from</sup> new Government money. But this is not really consistent with the condition (put in after pressure from the US) that the scheme should not entail "any transfer of risk from the commercial banks to the multilateral financial institutions or creditor country Governments". It would be helpful to probe further into how exactly the Japanese expect the scheme to work.

4. More generally, these initiatives - and the parallel request for a special Fund quota increase - seemed to be part of a new flexing of financial muscle on the part of Japan. What are the Japanese ambitions? Do they see themselves replacing the US as the major international financial force? In recent years, the US has been able to maintain its world-wide influence while being fairly mean about the resources it offers (helped by the Soviet Union having decided some time ago that it was too expensive to compete). How will the US react to the Japanese increasing their sphere of influence? Will they be grateful for a reduction in the burden on them, or feel they need to compete?

5. The Chancellor would be grateful for a paper discussing these issues - and any other related points which you think relevant.

A handwritten signature in black ink, appearing to read "ACSA" with a long horizontal flourish underneath.

A C S ALLAN

# BOARDS OF GOVERNORS • 1988 ANNUAL MEETINGS • BERLIN (WEST)

## INTERNATIONAL MONETARY FUND THE WORLD BANK GROUP

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT  
INTERNATIONAL FINANCE CORPORATION  
INTERNATIONAL DEVELOPMENT ASSOCIATION  
INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES  
MULTILATERAL INVESTMENT GUARANTEE AGENCY

Press Release No. 12

September 27, 1988

HOLD FOR RELEASE  
UNTIL DELIVERY

Statement by the Hon. SATOSHI SUMITA,  
Governor, the Bank of Japan, and  
Alternate Governor of the Fund and the Bank for JAPAN,  
at the Joint Annual Discussion

There are a number of important issues before us, and I am grateful for this opportunity to state my views as Alternate Governor for Japan. Before that, however, I would like to express my very sincere admiration and appreciation to the Government of the Federal Republic of Germany for the impeccable arrangements that they have made for our meetings.

1. Present State of the World Economy and the Economic Issues Before Us.

(i) Present state of the world economy

In looking at the overall state of the world economy today, the first thing we notice is that it is achieving faster and better economic growth than expected. The industrial countries continue to enjoy strong expansion, and the developing countries as a whole are managing sustained though gradual economic growth.

The next feature of note is the progress that is being made in reducing external imbalances among the industrial countries, not only in volume terms but also in nominal value terms. The U.S. trade deficit and Japan's trade surplus in particular have been steadily reduced.

In addition, it is noteworthy that exchange rates, though having changed substantially at times, have been relatively stable of late.

Focusing more narrowly upon Japan, the economy has continued to expand, with the primary impetus from strong domestic demand, while prices have been very stable. Real GNP growth in fiscal 1987 was 4.9 percent--the highest it has been since fiscal 1984. In tandem with this,

the current account surplus is being steadfastly reduced, the surplus for fiscal 1987 being \$10 billion less than that for fiscal 1986--the first reduction since fiscal 1981.

Looking ahead, Japan, is determined to promote and consolidate the shift to domestic demand-led growth in line with the new five-year economic plan adopted this May. The tax reform now being discussed in the Diet is also expected to contribute to the attainment of this objective by creating a distortion-free tax structure and by instituting major tax reductions.

(ii) The economic issues before us

Yet while the outlook for the world economy appears bright, there are still three problems that remain before us.

The first is the continuing need to achieve noninflationary and sustained economic growth and to further reduce international imbalances among nations. This need clearly mandates a continued effort for economic policy coordination and for exchange rate stability.

Second is the need to resist the rising tide of protectionism. Here, I hope that the midterm review of the Uruguay Round will provide additional impetus for the promotion of multilateral free trade negotiations.

And third is the persistent problem of the developing countries' debts. According to IMF figures released recently, these countries' total accumulated debt is expected to be \$1.24 trillion by the end of this year. This is a truly staggering amount, and it is crucial that we make a serious effort to come to terms with this problem, not with idle armchair theories but with practical measures that will have tangible effects.

2. Policy Coordination and Improving the Functioning of the International Monetary System

(i) Policy coordination efforts

Meeting at the Plaza Hotel three years ago, the major industrial countries agreed to coordinate their policies to ensure that the dollar better reflects economic fundamentals. While steady progress has been made in reducing the imbalances among the major industrial countries in the months and years since then, this period has also seen very large and rapid changes in exchange rates. Bolstered by the Louvre Accord 19 months ago, policymakers have realized that they have to coordinate their economic policies and cooperate in exchange markets so as to reduce the external imbalances while promoting exchange stability and to achieve noninflationary economic growth, and all of them are working toward that end.

It was this concerted policy coordination effort by the countries concerned that enabled us to ride out the wave of market uncertainty following last October's Black Monday spasm, and it is this policy coordination that accounts for the progress we are making in achieving sound economic expansion and reducing the external imbalances.

It is important that these efforts for policy coordination be continued if we are to maintain these favorable trends: the surplus countries should sustain the momentum of domestic demand as long as possible, while the deficit countries should strengthen their efforts to reduce their fiscal deficits. At the same time, although the risk of global inflation is not an issue of urgent concern, it is important that we maintain vigilance against its resurgence.

(ii) Improving the functioning of the international monetary system

Many of our countries have deregulated exchange transactions and the international monetary system has undergone sweeping changes since the 1973 shift to floating exchange rates. Having gone through a number of tests and trials, including major exchange rate changes, the floating exchange rate system has gradually evolved and matured. This is thus an opportune time to step back and look at possible ways to improve the functioning of the international monetary system from the medium- to long-term perspective.

However, it should be noted that the introduction of a system establishing ranges, bands, or other binding means restricting the scope for exchange rate fluctuation would necessarily entail full consideration of asset settlement. Given this, I believe that it would be more realistic at this point to consider ways of diversifying reserve currencies to complement the dollar's key role, thereby facilitating the financing of resources for market intervention and dispersing the exchange risk of reserve currencies. Consistent with this, Japan has been steadily removing the barriers that would impede the use of the yen as an international currency.

(iii) The IMF's role

The IMF has an increasingly important role to play in the international monetary system. Not only, for example, does the IMF have a pivotal position in monitoring the sound operation of the exchange rate system, there are also a number of issues requiring the IMF's urgent attention in light of the present international liquidity situation.

The first of these issues is that of studying anew the concept of international liquidity. With the development of financial and capital markets worldwide, and with the enhancement of private sector holdings of foreign exchange, it is unrealistic to define international liquidity simply in terms of the reserve assets held by the monetary authorities. Some new definition needs to be found in better alignment with today's realities.

The second of the issues is posed by the question of whether or not each country actually has the level of liquidity that it needs. I believe that this problem mandates the additional supply of conditional liquidity from the IMF, which will in turn require a strengthening of the IMF's resources. I trust we are agreed that this strengthening should be effected not with borrowings but with a new quota increase. The Committee of the Whole of the IMF is currently studying specific modes for the Ninth General Review of Quotas, and I am hopeful that a substantial quota increase will be agreed upon soon.

In this connection, it should be noted that the quota shares are the basis for members' rights and responsibilities in the IMF, and it would be detrimental to the IMF's smooth functioning to leave these quota shares grossly out of line with economic reality. Japan fully intends to contribute to the international community through the IMF, and we hope that Japan will be allocated a quota share in line with its economic standing. It is with this in mind that I would like to take this opportunity to state that Japan intends to request a special quota increase in the context of the Ninth General Review of Quotas.

And the third of these issues requiring the IMF's attention is the need to study the role of the SDR in connection with international liquidity management. It is imperative that a study be made on improving the SDR's characteristics and making it an easily usable international reserve currency. This must include both analyzing the present situation and problems with regard to the SDR--currently perceived as a contingency safety net--and studying what modalities might be possible to expand the scope of SDR use, including use by the private sector.

### 3. Debt and Development

#### (i) Present situation and basic policy directions

Although the developing countries' debt service ratios have come down slightly, these countries continue to bear a staggering debt load and the situation remains serious. It is imperative that we overcome this situation in order to promote economic growth in the developing countries and to stabilize the international financial system.

It is my firm conviction that the menu approach proposed to cope with the tapering off of the flow of funds to the developing countries from commercial banks is valuable in broadening the range of options and promoting new financing participation.

Efforts to promote case-by-case solutions based upon full and accurate understanding of the situation in each of the developing countries are basic to any attempt to resolve these countries' debt problem. There is no general panacea for the debt problem. For the middle-income countries, it is essential to promote market-oriented

responses premised upon the self-help efforts of those countries with cooperation from the commercial banks, the governments of the industrial countries, and the multilateral financial institutions.

As noted in the Toronto summit's Economic Declaration, we must also recognize the plight of the poorest countries, and each of our countries should work within its legal framework to lighten their debt burden.

Both the IMF and the World Bank have an especially important role to play in dealing with the debt problem in that their financing serves as a critical catalyst for the flow of funds from other sources. I strongly hope that the IMF and the World Bank will continue to strengthen their policy advisory functions and will exercise cooperative leadership in resolving the debt problem.

(ii) Japan's response

Aware of the seriousness of these problems, Japan has made--and will continue to make--every effort to contribute to a solution to the debt and development problem.

We have, for example, instituted a major program designed to recycle at least \$30 billion over a three-year period, and nearly 80 percent of this \$30 billion has already been committed. Japan is active in contributing and subscribing to multilateral organizations as well as in cofinancing, with these organizations, by the Export-Import Bank of Japan, the Overseas Economic Cooperation Fund (OECF), and commercial banks. With specific reference to the importance of direct investment for alleviating the debt problem, it should be noted that the ASEAN-Japan Development Fund (AJDF) was established recently and is moving ahead steadily to implement its investment programs.

Looking to the plight of the poorest countries, Japan announced plans in Toronto to provide grants equivalent to the repayment amount of the principal and interest on yen credits committed to the least developed countries in the decade 1978 to 1987, thereby, in effect, waiving repayment on these credits.

On official development assistance (ODA) overall, Japan announced its Fourth Mid-Term Target this June for the five years from 1988 through 1992. Under this Target, Japan has pledged to raise the half-decade total of its ODA to at least \$50 billion--twice the total for the previous half-decade--and, for example, to respond positively to the need to provide strengthened resources for multilateral organizations, to work to enhance its grant aid to the least developed countries, and to make its yen loans generally untied. I assure you Japan is determined to achieve these goals.

Also in this same vein, I am pleased to announce, on behalf of Minister Miyazawa, that, as part of its contribution to promote growth in the developing countries and to help solve the debt problem, Japan is

prepared to extend additional financing in the form of untied loans in parallel with the Fund's extended or other arrangements. The loans will be extended by the Export-Import Bank of Japan, on a case-by-case basis, mainly to middle-income countries in support of medium-term structural adjustment.

(iii) The IMF's role in resolving the debt problem

With the successes being achieved by the case-by-case approach, I do not believe it would be either realistic or effective to seek a comprehensive, global solution to the debt problem. Reaffirming our support for the existing basic strategy, Japan would like to propose an additional menu item for the middle-income countries' debt strategies, as suggested by Minister Miyazawa in Toronto.

Under the proposed option, the debtor country would have to start by reaching agreement with the IMF on a medium-term program for economic structural adjustment. This is a prerequisite, and it is hoped that this structural adjustment program would be supported by bilateral funds from the industrial countries as well as multilateral funds from the international financial institutions. Once this program is agreed upon, the debtor country and the creditor banks would meet to agree on securitizing some of the debt outstanding and on rescheduling the rest of the debt under appropriate terms and conditions. In both cases, the certainty of repayment would be enhanced by the debtor country's special reserve accounts funded by their own resources and held in trust by the IMF. Of course, it goes without saying that this new scheme would have to be structured so that it meets three conditions: (a) that it is consistent with the case-by-case approach, (b) that it is market-oriented and the creditor banks are free to participate or not as they see fit, and (c) that it does not entail any transfer of risk from the commercial banks to the multilateral financial institutions or creditor country governments.

In addition to this, of course, there is much that the IMF can do within its traditional framework. I am thus encouraged by the fact that an effort is being made to revitalize the extended fund facility (EFF) by, for instance, allowing for one-year extensions of its programs when necessary and accepting some flexibility in its access limits on a case-by-case basis.

Likewise, I am glad to see that the compensatory financing facility (CFF)--created to provide temporary relief for countries that incur export shortfalls as a result of external factors--has been expanded and enhanced into the compensatory and contingency financing facility (CCFF) to deal with a wider range of external contingencies.

By the same token, I am delighted that the enhanced structural adjustment facility (ESAF) has gotten off the ground and lending has begun from this facility. The Export-Import Bank of Japan has supported



the ESAF with an agreement concluded this April to lend SDR 2.2 billion to the IMF, and the Japanese Government has pledged to contribute a grant of SDR 300 million to the ESAF, part of which has already been disbursed.

(iv) The role of the World Bank Group

The World Bank is a major player in international efforts to deal with the debt and development problem. Japan therefore actively supports the efforts to enhance and strengthen the World Bank and its affiliates.

There have recently been rising expectations regarding the World Bank's catalytic role in promoting and ensuring the flow of funds, particularly private funds, in support of the developing countries' efforts for growth-oriented and market-oriented adjustment. Cofinancing by the World Bank and private financial institutions has recently seen a diminishing flow of private funds. Given this, it is therefore all the more important that the World Bank needs to be even more flexible and positive about its catalytic functions--including cofinancing--in line with the specific circumstances of each case.

Among the many forms of private funds flowing to the developing countries, direct investment is especially important because it does not entail new indebtedness and because it is almost invariably accompanied by the transfer of technology and managerial know-how to the host country. It is, therefore, most encouraging that the Multilateral Investment Guarantee Agency (MIGA) has been established to promote such direct investment. I have the greatest expectations not only for its guarantee operations but also for its advisory functions, and I very much hope that more and more countries will become affiliated with MIGA and that MIGA will be able to fulfill the purposes for which it was established.

At the same time, the International Finance Corporation has a very important role to play in promoting debt-equity swaps and other modalities for enhancing the flow of private funds to the developing countries.

In light of the many features that distinguish the debt and development problem in each region and each country, it is important that there be cooperation between the World Bank and the regional development banks. We can all profit from having the World Bank and the regional development banks work together more closely and promote economic development more effectively.

It is indispensable that the World Bank's financial resources be enhanced if the Bank is to meet these expectations and to move meaningfully on the debt and development problem. Japan therefore welcomes the resolution by the Board of Governors on a general capital increase for the World Bank. At the same time, Japan supports the proposal to initiate discussions on IDA's Ninth Replenishment (IDA-9). Special consideration needs to be extended to the poorest countries in

negotiating IDA-9 resource allocations, and I very much hope that Asia-- said to be home to over half of the world's poverty--will be given special consideration along with sub-Saharan Africa.

Japan is determined to actively support the World Bank both in financial terms and in human resource terms. With the objective of recycling resources, over \$5.1 billion has already been committed to cofinancing with the World Bank by the Export-Import Bank of Japan, the OECF, and commercial banks. At the same time, Japan is moving ahead vigorously to provide grant contributions for the Japan Special Fund established within the World Bank last year as well as helping the World Bank raise additional funds from the Tokyo market. We intend to continue this vigorous support.

#### 4. Conclusion

The world economy today presents an irrefutable picture of increasing interdependence. All of us are irrevocably affected by the way any one of us meets the challenges before it. The need for transnational approaches and transnational solutions is clear. And as we move forward to cooperate in solving our shared problems, I am confident that the IMF and the World Bank will provide the nucleus for this international coordination and will play an even more active role than they have so far.

It is widely recognized that Japan should play a more important role in the international community, and the Japanese people fully recognize their responsibilities and wish to rededicate themselves anew to making an even greater effort to contribute from a global perspective.

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PS/CHANCELLOR OF THE EXCHEQUER  
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JAPANESE BALANCE OF PAYMENTS

1. THE FOLLOWING ARE SEMI-FINAL JAPANESE BALANCE OF PAYMENTS FIGURES FOR AUGUST 1988 ANNOUNCED BY THE MINISTRY OF FINANCE. CUSTOMS CLEARANCE FIGURES ARE EXPORTS FOB, IMPORTS CIF, AND INCLUDE NON-MONETARY GOLD. USDLR MILLIONS, YEN BILLION. THE FIGURES IN BRACKETS SHOW PERCENTAGE CHANGE OVER THE SAME PERIOD LAST YEAR. VOLUME FIGURES ARE ONLY AVAILABLE FOR GLOBAL EXPORTS AND IMPORTS. FURTHER DETAILS FOLLOW IN MONTHLY ECONOMIC REPORT.

(A)	AUGUST 1988	US DOLLARS	YEN
2.	TRADE ACCOUNT (CUSTOMS CLEARANCE)	4,935 ( -4.1)	657 (-15.3)
	TRADE ACCOUNT (IMF BASIS, NOT SEASONALLY-ADJUSTED)	6,343 ( 2.6)	848 ( -7.1)
	CURRENT ACCOUNT (IMF, NSA)	4,991 ( -7.5)	667 (-16.2)

3. CUSTOMS CLEARANCE FIGURES FOR TRADE WITH UK.

	US DOLLARS	YEN
EXPORTS	823 (37.0)	109 ( 20.9)
IMPORTS	385 (40.4)	51 ( 23.9)
EXCL. NON-MONETARY GOLD	351 (48.9)	47 ( 31.4)

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BALANCE	438 (34.1)	58 ( 18.5)
EXCL. NON-MONETARY GOLD	472 (29.3)	62 ( 14.1)

(B) JANUARY - AUGUST

4. IMF BASIS, NOT-SEASONALLY ADJUSTED.

	US (%) DOL	YEN (%)
ARS		
TRADE ACCOUNT	58,576 (-7.3)	7,524 (-19.5)
CURRENT ACCOUNT	48,459 (-14.1)	6,219 (-25.5)

5. CUSTOMS CLEARANCE FIGURES :

	US (%) DOLLARS	YEN (%)	VOLUME CHANGE NSA
TOTAL EXPORTS	169,489 (16.2)	21,696 ( -0.1)	3.5
TOTAL IMPORTS	123,748 (32.0)	15,835 ( 13.4)	19.4
BALANCE	45,741(-12.2)	5,861 (-24.4)	

EXPORTS TO:

US	56,414 ( 6.0)	7,222 ( -8.7)
EC	31,004 (27.2)	3,967 ( 9.2)
UK	7,089 (31.1)	907 ( 12.8)
FRANCE	3,285 (28.4)	420 ( 10.3)
W GERMANY	10,420 (24.9)	1,333 ( 7.1)

IMPORTS FROM:

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US	27,744 (38.1)	3,552 ( 18.7)
EC	15,929 (44.1)	2,039 ( 24.1)
UK	2,866 (49.5)	367 ( 28.7)
EXCL. NON- MONETARY GOLD	2,520 (42.5)	323 ( 22.6)
FRANCE	2,807 (62.4)	360 ( 40.0)
W GERMANY	5,346 (39.5)	684 ( 20.0)

## BALANCE WITH:

US	28,670 (-13.4)	3,670 (-25.4)
EC	15,075 ( 13.2)	1,928 ( -3.1)
UK	4,223 ( 21.0)	540 ( 4.0)
EXCL. NON- MONETARY GOLD	4,569 ( 25.6)	584 ( 8.0)
FRANCE	478 (-42.3)	60 (-51.2)
W GERMANY	5,074 ( 12.5)	649 ( -3.8)

6. COMMENT: FOR THE SECOND CONSECUTIVE MONTH THE DOLLAR TRADE BALANCE IS HIGHER THAN IN THE SAME MONTH OF 1987, REFLECTING A HIGH LEVEL OF HIGH TECH EXPORTS. THE CURRENT ACCOUNT BALANCE, HOWEVER, CONTINUES TO FALL, HELPED ALONG BY RECORD SPENDING OVERSEAS BY JAPANESE TOURISTS.

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(CULL)

JAPANESE BALANCE OF PAYMENTS: PROVISIONAL TRADE FIGURES

1. THE FOLLOWING ARE PROVISIONAL JAPANESE BALANCE OF PAYMENTS FIGURES FOR SEPTEMBER 1988 ANNOUNCED BY THE MINISTRY OF FINANCE. THEY ARE ONLY INDICATIVE. MORE PRECISE AND MORE COMPREHENSIVE FIGURES WILL FOLLOW IN REPORT OF SEMI-FINAL FIGURES AND MONTHLY ECONOMIC REPORT. FIGURES ARE CUSTOMS CLEARANCE, EXPORTS FOB, IMPORTS CIF, AND INCLUDE NON-MONETARY GOLD. FIGURES ARE NOT SEASONALLY ADJUSTED. CUMULATIVE FIGURES ARE NOT SEASONALLY ADJUSTED. CUMULATIVE FIGURES ARE DERIVED BY ADDING THE PROVISIONAL FIGURE FOR THE CURRENT MONTH TO LAST MONTH'S SEMI-FINAL CUMULATIVE TOTALS. USDLR MILLIONS, YEN BILLIONS. THE FIGURES IN BRACKETS SHOW PERCENTAGE CHANGE OVER THE SAME PERIOD LAST YEAR. VOLUME FIGURES ARE ONLY AVAILABLE FOR GLOBAL EXPORTS AND IMPORTS.

(A) SEPTEMBER

2.	US DOLLARS (%)	YEN (%)	CHANGE IN VOLUME (%)
GLOBAL EXPORTS	23119 ( 13.6)	3102 ( 6.6)	( 6.9)
GLOBAL IMPORTS	15376 ( 18.9)	2064 ( 11.6)	(12.9)
BALANCE	7743 ( 4.3)	1038 ( -2.0)	

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3.	US DOLLARS (%)	YEN (%)
EXPORTS TO EC	3896 (16.6)	523 ( 9.5)
UK	906 (25.4)	121 (17.7)
IMPORTS FROM EC	1882 (29.9)	253 (21.9)
UK	292 (29.2)	39 (21.3)
BALANCE WITH EC	2014 ( 6.5)	270 ( 0.0)
BALANCE WITH UK	614 (23.7)	82 (15.9)

## (B) CUMULATIVE JANUARY - SEPTEMBER

4.	US DOLLARS (%)	YEN (%)	CHANGE IN VOLUME (%)
GLOBAL EXPORTS	192608 ( 15.8)	24798 ( 0.7)	( 3.9)
GLOBAL IMPORTS	139124 ( 30.4)	17898 ( 13.2)	(18.6)
BALANCE	53484 (-10.2)	6900 (-21.7)	

5.	US DOLLARS (%)	YEN (%)
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EXPORTS TO EC	34900 (25.9)	4489 ( 9.2)
UK	7995 (30.4)	1028 (13.3)
IMPORTS FROM EC	17811 (42.5)	2292 (23.8)
UK	3159 (47.3)	406 (28.0)
BALANCE WITH EC	17089 (12.4)	2197 (-2.7)
BALANCE WITH UK	4836 (21.3)	622 ( 5.5)

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FROM: J M G TAYLOR  
DATE: 28 October 1988

~~SIR G LITTLER~~

cc Mr Lankester

**IMF PRESS SUMMARY: JAPANESE INDICATORS' PROPOSAL**

The Chancellor has seen the enclosed story in the IMF press summary. He has commented that this sounds pretty rum to him. He wonders if you know what the Japanese have in mind.

J M G TAYLOR

Mr Allan  
12/2

FROM BRITISH MISSION

# MORNING PRESS

INTERNATIONAL MONETARY FUND WEDNESDAY, Oct 26/88 DA EXTERNAL RELATIONS DEPARTMENT

**U.S. THIRD QUARTER REAL GNP RISE 2.2% AFTER 3% IN SECOND.** AP-DJ reported from Washington that U.S. real GNP rose at a 2.2% annual rate in the third quarter after 3% in the second, below market expectations of a rise of 3.2%. The Commerce Dept said the impact of drought reduced third quarter GNP by 0.6 points. It also cited a higher trade deficit, slower growth in business fixed investment and declining government spending. The GNP deflator rose 4.4% in the third quarter after 5.5% in the second.

**DOLLAR DROPS ON GNP FIGURES.** News agencies reported that the U.S. dollar fell in hectic exchange markets after the announcement of unexpectedly low 2.2% real U.S. GNP growth in the third quarter. Exchange rates included: German mark 1.7785 (1.7860), yen 126.20 (126.90), sterling \$1.7595 (1.7535), French franc 6.0785, Swiss franc 1.5085, and Canadian dollar 83.43c. Gold was \$408.55.

**JAPAN COULD PROPOSE STRUCTURAL ADJUSTMENT INDICATORS, AT OECD TALKS.** AFP reported from Tokyo that a Japanese Foreign Ministry official said Japan could propose to a November OECD meeting a range of indicators to monitor the progress of structural adjustment among industrial countries. He said Japan is still studying the idea and has taken no decision as yet, adding that there is no consensus among OECD countries on its use. The OECD meeting Nov 13/14 will study a report on improving monitoring of structural adjustment, commissioned by last May's OECD ministerial meeting. He declined to comment on a newspaper list of the proposed indicators, but said they are completely different from the basically financial and monetary indicators of the G7. The stress is different between G7 and OECD surveillance, he added. AP-DJ reported that Ministry of International Trade and Industry officials said the Ministry is considering a set of indicators like labor productivity and savings rates as a means of helping industrial countries promote economic adjustment. Officials said they are still considering which indicators to include and are not yet sure whether to make a formal proposal to the OECD next month.

**LAWSON SAYS BRITISH INTEREST RATES TO REMAIN HIGH.** Ldn Fin Times, p20, reported from London that British Chancellor Nigel Lawson sought in a Parliamentary debate to reassure jittery financial markets on maintaining high interest rates for as long as necessary to control inflation, while firmly resisting sterling depreciation. He said this aim will require that the narrow money supply Mo heads firmly back towards its 1% to 5% target range, from its current 8.1% annual growth rate. The paper said this is a public reassertion of monetary targets after a period when they have been played down compared with the aim of stable exchange rates. Reuters said Lawson was aggressive in defense of his policies, in the face of opposition attacks based on his failure to stay within government inflation and money supply targets.

From: Sir G.Littler  
Date: 31 October 1988

MR J M G TAYLOR

*Noted*

c.c. Sir P.Middleton  
Sir T.Burns  
Mr Lankester

**IMF PRESS SUMMARY: JAPANESE INDICATORS' PROPOSAL**

The OECD's Economic Policy Committee is meeting 14/15 November (Sir P.Middleton and/or Sir T.Burns will attend). On the agenda is a discussion of progress and monitoring of structural reform aimed to lead to a paper contributing to next year's Ministerial as requested at this year's.

2. The idea of 'indicators' in this context has been mentioned by the US (in earlier G7D discussion others tended to be sceptical but I gather it surfaced again in an OECD Working Party). As to the Japs, my only knowledge is that Gyohten has spoken of looking for ways for bringing pressure to bear on domestic resistance to change and in that context has shown interest in developing some form of public or quotable international monitoring. I think we should encourage this - while remaining practical about it.

3. I may have a chance to question Gyohten when I see him in London briefly in a fortnight: or something may emerge at the OECD meeting around the same time.



(Geoffrey Littler)



FROM: J M G TAYLOR  
DATE: 2 November 1988

SIR GEOFFREY LITTLER

cc Sir P Middleton  
Sir T Burns  
Mr Lankester

A large, stylized handwritten signature in black ink, likely belonging to J. M. G. Taylor.

IMF PRESS SUMMARY: JAPANESE INDICATORS' PROPOSAL

The Chancellor has seen and noted your minute of 31 October.

A smaller handwritten signature in black ink, likely belonging to J. M. G. Taylor.

J M G TAYLOR

mp

7

# Europe and Japan break ranks with US on Gatt talks

By William Dullforce in Geneva

THE EUROPEAN Community, Japan and 10 other countries have broken ranks in the Uruguay Round trade talks and are trying to draft an agreement on tropical products independently of the US.

The EC has declared specific products with an annual import value of some Ecu20bn (£13bn) on which it is prepared to abolish or cut tariffs and remove other import restrictions.

Included in the EC list are coffee, tea, cocoa, spices, tropical fruits, tropical woods and rubber. Japan, too, has specified a wide range of products to which it is willing to open its market.

The breakaway group decided the inflexible attitude of the US on tropical products threatened to wreck the trade ministers' mid-term review of the Round at Montreal early next month.

Developing countries account for some 80 per cent of the \$60bn (£33bn) annual world exports of tropical products and ministers agreed, when launching the Uruguay Round in 1986, priority should be given to the fullest liberalisation of this trade.

In the past few weeks however, Third World delegations have become increasingly vociferous in warning the industrial powers they cannot expect co-operation in obtaining agreements at Montreal on agricultural trade, services and

intellectual property, as long as there are no concrete results on matters of special interest to them.

So far, the US has linked concessions on tropical products to progress being made in the reform of agricultural trade.

US negotiators have also been hampered by an inflexible mandate which allows them to make concessions on given products only if other countries offer matching concessions on the same products.

For the past two days negotiators from the EC, Japan and the 10 other countries have been meeting separately in an attempt to break the impasse. The developing countries taking part are Brazil, Colombia, Malaysia and Thailand. The others are Australia, Canada, Finland, Norway, Sweden and Switzerland.

The group has pencilled in a list of the tariffs cuts and other concessions that each is ready to make and has been trying to strike a rough balance. The result will fall well short of full liberalisation, but could provide a substantial intermediate step to be implemented next year.

Ultimately, neither the EC nor Japan will drop its barriers to tropical products if the US does not make a matching contribution. The object of the present exercise is, in the words of an EC official, "to force the US to come clean".

# Expansion set to continue, say top Western officials

By Ian Davidson in Paris

SENIOR economic policy officials of the Western industrialised countries expect the current phase of economic expansion to continue, employment opportunities to increase, and inflation to remain at low levels.

These were three of the main conclusions of two days of discussions in the Economic Policy Committee of the Organisation for Economic Co-operation and Development, according to the summing-up by its chairman, Mr Beryl Sprinkel, chairman of the US Administration's Council of Economic Advisers.

The risk of acceleration in inflation seemed small, he told a news conference yesterday. Nevertheless, he added: "Most delegates thought that in order to deal with inflationary tensions and encourage a sustainable flow of investment, fiscal tightening - particularly expenditure restraints - over the medium term ought to be an indispensable element of government action".

Mr Sprinkel said it was "quite certain" that President-elect George Bush would not seek to deal with the US bud-

get deficit by raising taxes. "We believe," he added, "that the solution is not to have a larger government and a weaker private sector, but to contain government spending."

He described the past six years of economic expansion, with no increase in inflation, as "amazing - unprecedented in modern history".

The continued expansion of the past 12 months, despite last year's stock market crash, he attributed to the right economic policies. The US, in particular, had eased monetary policy, resisted protectionist pressures, and resisted tax increases.

The committee expected that current account imbalances of the US and Japan would continue to narrow, due partly to the strength of domestic demand in Japan.

Mr Sprinkel commented that the recent growth of the West German surplus was due to exports of capital goods and the strength of investment demand in other European countries, which would in time be a factor promoting growth in these countries.

3

Ch.  
MR J M G TAYLOR

From: Sir G.Littler  
Date: 16 November 1988

*Thank you!*  
*Geo.*  
c.c. Sir P.Middleton  
Sir T.Burns  
Mr Lankester

**JAPANESE PROPOSAL FOR 'STRUCTURAL REFORM' INDICATORS**

The Chancellor asked about this (your minute of 28 October and my interim reply of 31 October). I took the opportunity of a chat last night with Gyohden to enquire about it - with a mildly amusing result!

2. He told me that the proposal had been strongly advocated some weeks ago by MITI - anxious as always to find ways of getting in on international economic/financial discussions and seeing an area of 'industrial performance indicators' which would be relevant and validate their claims to participate. They had - without too much difficulty but it took a little time and there was some deliberate leakage to the press by MITI - eventually been defeated by the (for once combined) forces of Ministry of Finance and Economic Planning Agency. He could not promise that there would be no recurrence of the idea, but MOF thought it foolish.



(Geoffrey Littler)

chex.ps/jmt/17

UNCLASSIFIED



FROM: J M G TAYLOR

DATE: 17 November 1988

A handwritten signature in black ink, appearing to be "JMG", written over the date.

SIR G LITTLER

cc Sir P Middleton  
Sir T Burns  
Mr Lankester

JAPANESE PROPOSAL FOR 'STRUCTURAL REFORM' INDICATORS

The Chancellor was grateful for your note of 16 November. He has commented: "Good".

A handwritten signature in black ink, appearing to be "JMG", written above the typed name.

J M G TAYLOR



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## JAPANESE ECONOMIC POLICY

## SUMMARY

1. RESTRUCTURING OF THE JAPANESE ECONOMY SINCE THE PLAZA AGREEMENT HAS PROVEN TO BE THE CATALYST FOR MAJOR CHANGES FROM WHICH JAPAN UNDOUBTEDLY EMERGES A MUCH STRONGER WORLD PLAYER IN EVERY SENSE. BUT NEITHER YEN APPRECIATION NOR THE GOVERNMENT'S SUPPORT FOR EXPANSION OF DOMESTIC DEMAND HAVE SO FAR HAD MUCH EFFECT ON THE TRADE IMBALANCES. THE FUTURE OF US/JAPAN ECONOMIC AND POLITICAL RELATIONS IS A MAJOR TOPIC OF CONCERN IN TOKYO. REDUCTION OF THE US DEFICIT IS SEEN AS A KEY ELEMENT IN FORESTALLING FUTURE PROBLEMS. JAPAN IS BULLISH ABOUT ASIA. THE EC NEEDS A MORE POSITIVE IMAGE AND POLICY TOWARDS JAPAN.

## DETAIL

2. IN ADVANCE OF BAYNE'S DISCUSSIONS HERE NEXT WEEK, IT MAY BE USEFUL TO SUMMARIZE JAPANESE ECONOMIC DEVELOPMENTS AND CURRENT CONCERNS.

## FIVE PERCENT GROWTH RATE

3. THE JAPANESE ECONOMY IS IN A STRONG AUTONOMOUS GROWTH CYCLE BASED ON DOMESTIC DEMAND, OF WHICH THE TWO MAJOR COMPONENTS ARE PRIVATE CONSUMPTION AND CORPORATE CAPITAL INVESTMENT. MOST ECONOMISTS EXPECT THIS TO CONTINUE FOR SOME TIME, AS THERE ARE NO VISIBLE INTERNAL BOTTLENECKS, OIL PRICES LOOK SET TO REMAIN LOW, AND THE ECONOMY HAS REDUCED ITS DEPENDENCY ON EXTERNAL DEMAND. GNP GROWTH OF AROUND 5 PERCENT IN FY 1988 MAY BE REPEATED IN 1989. PRIVATELY, THE ECONOMIC PLANNING AGENCY FORECAST AVERAGE GROWTH IN 1988/92 OF AT LEAST HALF A PERCENT ABOVE THE OFFICIAL 3.75 PERCENT TARGET. THESE BOOM CONDITIONS ARE ATTRIBUTED TO THE TAKE-OFF OF PRIVATE SECTOR ACTIVITY FOLLOWING THE GOVERNMENT'S PUMP PRIMING PACKAGE OF MAY 1987: THE CONSEQUENT RISE IN PERSONAL DISPOSABLE INCOMES AND NEW INVESTMENT:

THE BENEFITS OF YEN APPRECIATION, WHICH HAS ENCOURAGED STRUCTURAL CHANGE AND NEW BUSINESSES, AND ALSO STABILIZED PRICES THROUGH REDUCED IMPORT COSTS: AND THE RAPID APPLICATION OF NEW TECHNOLOGY AND INFORMATION PROCESSING WIDELY IN MANUFACTURING AND SERVICE INDUSTRIES.

#### FISCAL POLICY

4. SINCE THE PRIVATE SECTOR HAS TAKEN OVER AS THE ENGINE OF GROWTH, GOVERNMENT POLICY HAS ASSUMED A PRIMARILY STABILISING ROLE. THE GOAL OF ELIMINATING DEFICIT SPENDING BY L990 HAS BEEN BROUGHT NEARER BY THE NATURAL INCREASE IN TAX REVENUES, DESPITE THE PROSPECT OF A NET REDUCTION IN TAXES OF Y2.4 TRILLION IN THE TAX REFORMS CURRENTLY GOING THROUGH THE DIET. JAPAN'S INTERNATIONAL COMMITMENT TO MAINTAIN HIGH LEVELS OF DOMESTIC DEMAND IS ALSO BEING NATURALLY ACHIEVED. THE GOVERNMENT'S FISCAL STIMULUS THROUGH PUBLIC WORKS SPENDING IN THE 1987 PACKAGE, MODESTLY REPEATED THIS YEAR, HAS BEEN REPLACED BY PRIVATE SECTOR FIXED CAPITAL INVESTMENT. THUS EXTRA STIMULUS IN FY 89 IS PROBABLY UNNECESSARY, AND THE GOVERNMENT PLANS AN ESSENTIALLY NEUTRAL BUDGET, EXCEPT FOR ODA AND DEFENCE SPENDING. THE CONCERN OF THE GOVERNMENT AND BANK OF JAPAN IS, IF ANYTHING, TO COOL THE PACE OF GROWTH IN ORDER TO ENSURE ITS LONGER CONTINUATION. SOME ECONOMISTS ARE CONCERNED AT POTENTIAL RISKS OF OVERHEATING, WITH INFLATION CURRENTLY AT LESS THAN 1 PERCENT AND REAL INCOMES RISING AT NEARLY 4 PERCENT PER ANNUM, AND PROBABLY AS MUCH IN FY 89. PRODUCTIVITY GROWTH IN L988 OF AROUND 7 PERCENT HAS KEPT UNIT LABOUR COSTS FALLING, BUT MAY BE RATHER LESS IN L989. EVEN A MODEST RISE IN INFLATION MIGHT PROMPT THE BANK OF JAPAN TO REVERSE ITS CURRENT EASY MONETARY POLICY AND RAISE INTEREST RATES. ON THE EXCHANGE RATE, FEW PEOPLE IN INDUSTRY OR GOVERNMENT ARE SERIOUSLY CONCERNED AT THE PROSPECT OF FURTHER YEN APPRECIATION, PROVIDED THAT ITS UPWARD PATH IS GRADUAL AND ORDERLY. THE BANK OF JAPAN'S INTERVENTION IN THE FOREIGN EXCHANGE MARKETS IN THE LAST FEW WEEKS HAS BEEN TO SMOOTH THE MARKETS RATHER THAN PEG THE RATE. AVOIDANCE OF A FREE FALL BY THE DOLLAR IS IMPORTANT TO MAINTAIN THE SMOOTH FLOW OF JAPANESE CAPITAL INTO US INVESTMENTS.

#### INDUSTRY SHIFTING GEAR

5. INDUSTRY IS TAKING ADVANTAGE OF HIGHER PROFITS AND CASH FLOW TO INVEST AND DIVERSIFY IN ORDER TO SECURE ITS FUTURE COMPETITIVENESS. NEW CAPITAL INVESTMENT, RUNNING AT AN AVERAGE 17.5 PERCENT, BUT IN SOME MANUFACTURING SECTORS AT 50 PERCENT ABOVE LAST YEAR'S LEVELS, IS CONCENTRATED ON THE DOMESTIC MARKET, WHICH IS SEEN AS THE SOURCE OF MOST CONSTANT GROWTH IN THE FUTURE. IN LEISURE, CONSTRUCTION AND INFORMATION TECHNOLOGY IT IS PARTICULARLY HIGH: THE SEMICONDUCTOR

INDUSTRY ALONE PLANS TO INVEST Y 5000 BILLION (STERLING #2.3 BILLION) IN THIS CALENDAR YEAR. HIGHER INVESTMENT IN RANDD AND IN COST-CUTTING AUTOMATION, THE SHIFT TO HIGHER VALUE ADDED PRODUCTS AND THE DEVELOPMENT BY ESTABLISHED INDUSTRIES SUCH AS STEEL AND SHIPBUILDING OF NEW BUSINESSES IN SOFTWARE, NEW MATERIALS, HOUSING, ETC IS PRIMARILY DESIGNED TO CREATE NEW DEMAND AND ENABLE COMPANIES TO BRING NEW ITEMS MORE RAPIDLY ONTO A HIGHLY COMPETITIVE DOMESTIC MARKET IN WHICH IMPORTS WILL HAVE A LARGER PLACE. BUT THE SIMULTANEOUS GAIN TO COMPETITIVITY IN EXPORTS IS ALREADY APPARENT IN THE TRADE FIGURES (PARA 8 BELOW) AND COULD BECOME MORE PRONOUNCED IF DOMESTIC DEMAND SHOULD WAVER. SECTORS IN DIFFICULTY ARE BEING GIVEN AN OPPORTUNITY TO RESTRUCTURE WITHOUT PAIN AND ARE ENJOYING AN INDIAN SUMMER. STEEL MAKERS AND SHIPYARDS HAVE BETTER ORDER BOOKS THAN FOR SOME TIME. JAPANESE COMPANIES ARE ALSO DEVELOPING BOLDER INTERNATIONAL STRATEGIES. THE LARGER ONES ENCOURAGED BY US PRESSURE AND 1992 ARE NOW COMMITTED TO MAJOR OVERSEAS PRESENCE AND ARE DEVELOPING MULTINATIONAL IDENTITIES. BECAUSE OF THEIR STRONG INTEGRATION AND CENTRALISED CONTROL THEY WILL BE ABLE TO MOVE SWIFTLY TO EXPLOIT OPPORTUNITIES IN FLUCTUATING MARKETS. WITH THEIR LARGE CASH SURPLUSES FROM BOTH OPERATING PROFITS AND INVESTMENTS, THEY ARE IN A STRONGER POSITION TO BUY. SINCE THE OCTOBER 1987 CRASH THEY HAVE BEEN LOOKING (PARTICULARLY IN THE US) AT REAL ESTATE AND, CAUTIOUSLY, ACQUISTION OF STAKES IN EXISTING COMPANIES. AS AT HOME, THEY WILL PREFER ON THE WHOLE TO INVEST FOR THE LONG TERM IN PEOPLE AND SOLID MANUFACTURING OR OTHER BUSINESS ASSETS.

#### THE STRUCTURAL REFORM LEDGER

6. THE GOVERNMENT IS PLAYING A MODEST PART IN ENCOURAGING STRUCTURAL REFORM AND CAN POINT TO PROGRESS ON MOST OF THE MAEKAWA AGENDA - MUCH OF IT AS A RESULT OF NATURAL ADJUSTMENT TO THE HIGHER YEN. DOMESTIC GROWTH IS HIGH AND DEPENDENCY ON EXTERNAL DEMAND REDUCED: INVESTMENT IN DOMESTIC INFRASTRUCTURE IS PROCEEDING AS FAST AS CAN BE ABSORBED (THOUGH JAPAN IS STILL WELL BEHIND HERE), THE GOVERNMENT HAS MOVED VERY SLOWLY ON SOCIAL CHANGES TO ENCOURAGE CONSUMPTION, SUCH AS REDUCTION IN WORKING HOURS AND INCREASE IN PAID HOLIDAYS: CONSUMPTION HAS RISEN THROUGH REAL WAGE INCREASES, CHEAPER IMPORTS AND MORE FOREIGN TRAVEL, BUT PERSONAL SAVINGS RATES, AT 17 PERCENT OF DISPOSABLE INCOME, ARE FALLING ONLY VERY SLOWLY. THE LEVEL OF MANUFACTURES IN IMPORTS HAS RISEN FROM ONE THIRD TO A HALF (ASSISTED BY LOW OIL PRICES), FOREIGN DIRECT INVESTMENT IN MANUFACTURING ROSE FROM US DOLLARS 3.6 BILLION IN L986 TO US DOLLARS 7.8 BILLION IN 1987. JAPAN'S ODA CONTRIBUTION WILL THIS YEAR BE THE HIGHEST IN THE WORLD IN DOLLAR TERMS, AND, WITH THE TAX REFORM NOW LIKELY TO GO

THROUGH, THE GOVERNMENT'S ABILITY TO FIND THE FISCAL MEANS FOR MORE FLEXIBLE ECONOMIC MANAGEMENT IS THEORETICALLY SECURED. THE GOVERNMENT'S ADMINISTRATIVE REFORM COUNCIL IS ALSO RECOMMENDING GRADUAL STEPS TOWARDS DEREGULATION IN SUCH AREAS AS INTEREST RATES ON SAVINGS DEPOSITS, DISTRIBUTION (MAKING IT EASIER TO SET UP LARGE STORES), PETROLEUM (ENDING REFINING QUOTAS FOR INDIVIDUAL PRODUCTS AND MAKING RETAIL MORE COMPETITIVE), AND EASING REGULATIONS ON PRIVATE COMMUNICATIONS NETWORKS, PRIVATE DISTRIBUTION OF RICE, AND TRUCKING. SUCH MEASURES SHOULD MAKE FOR MORE EFFICIENT MARKETS BUT WILL NOT HAVE ANY RAPID TRADE EFFECTS. IN ADDITION THE GOVERNMENT CAN POINT TO SOLUTIONS OF TRADE ISSUES SUCH AS BEEF, CITRUS AND OTHER AGRICULTURAL QUOTAS WITH THE UNITED STATES, CONSTRUCTION, LIQUOR TAX, CAR IMPORT REGULATIONS ETC. WITH THE CURRENT ACCOUNT SURPLUS COMING DOWN FROM ITS PEAK OF 4.6 PERCENT OF GNP IN 1986 TO A CURRENT 2.5 PERCENT AND A TARGET OF 1.5 TO 2 PERCENT WITHIN FIVE YEARS, THERE IS A STRONG VIEW HERE THAT THE GOVERNMENT HAS DONE EVERYTHING ASKED OF IT.

#### INTERNATIONAL HARMONY?

7. SUPERFICIALLY, THEREFORE, THERE IS A BELIEF THAT JAPAN IS NO LONGER IN THE DOCK AND THAT AT LAST THE TABLES CAN BE TURNED A LITTLE BIT. THIS IS MANIFEST FOR EXAMPLE IN JAPAN'S MORE AGGRESSIVE CHALLENGE TO THE EC IN THE GATT AND ON 1992. PRIVATELY HOWEVER JAPANESE OFFICIALS ARE CONCERNED ABOUT TWO MAJOR UNCERTAINTIES: WHETHER JAPAN'S SURPLUSES WILL CONTINUE TO DIMINISH AND THE FUTURE OF THE US ECONOMY. BOTH PROBLEMS COULD CAUSE PROTECTIONIST REACTIONS AND DAMAGE TO POLITICAL RELATIONS WITH THE US.

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### THE TRADE SURPLUS

8. IT IS NOW PUBLICLY ADMITTED THAT THE REDUCTION IN JAPAN'S TRADE SURPLUS THIS FINANCIAL YEAR MAY BE VERY SMALL - MAYBE FROM US DOLLARS 94 TO 90 BILLION. SINCE SEPTEMBER, THE MONTHLY SURPLUS HAS BEEN HIGHER THAN LAST YEAR. THERE ARE SOME TEMPORARY FACTORS, AND THE FALL OF THE OIL PRICE HAS DEPRESSED IMPORTS. IMPORTS OF MANUFACTURED GOODS FROM EC COUNTRIES THIS YEAR HAVE RISEN AT RATES OF OVER 20 AND FROM THE US AT 18 PERCENT OVER LAST YEAR, BUT THERE ARE SIGNS THAT THE RAPID GROWTH OF IMPORTS OF FINISHED GOODS FROM THE NIES IS LEVELLING OFF. JAPANESE EXPORT VOLUMES WHICH WERE FALLING BRIEFLY IN LATE 1987 ARE NOW RISING AGAIN AT AROUND 6 PERCENT YEAR ON YEAR. THIS REFLECTS UNEXPECTED BUOYANCY DEMAND WORLD WIDE, ESPECIALLY IN THE US AND THE EC (TO WHICH REPORTS WERE UP 1 PERCENT AND 26 PERCENT RESPECTIVELY IN DOLLAR TERMS), THE GREATER, AND IN SOME AREAS, UNCHALLENGED COMPETITIVENESS OF JAPANESE COMPANIES IN HIGH TECH INDUSTRIAL COMPONENTS, OFFICE MACHINERY, AND CONSUMER PRODUCTS ENABLING THEM TO RESUME PROFITABLE PRICING IN THESE AREAS WHILE SHIPMENTS OF CARS HAVE BEEN STAGNANT AND ITEMS SUCH AS VCERS AND TELEVISIONS RAPIDLY DECLINING, AND (INCLUDING IN THE UK CASE) THE ESTABLISHMENT OF JAPANESE SUBSIDIARIES OVERSEAS, WHICH INCREASES SHORT-TERM EXPORTS OF CAPITAL EQUIPMENT AND COMPONENTS. ON THE CURRENT ACCOUNT, THE REDUCTION IN THE SURPLUS WILL BE SOMEWHAT LARGER DUE TO A MUCH ENLARGED DEFICIT ON TOURISM BUT JAPAN FEARS THAT THESE LATEST TRENDS IN THE ABSOLUTE FIGURES COULD EXACERBATE REACTIONS FROM HER MAJOR TRADING PARTNERS AT A SENSITIVE TIME FOR THE US AND EUROPEAN ECONOMIES.

### JAPAN/US

9. THE KEY TO JAPANESE CONCERN IS THE UNITED STATES. WITH THE

EXCEPTION OF RICE IMPORTS, WHERE THE JAPANESE MAY MAKE SOME SMALL CONCESSION OF PRINCIPLE ON ACCESS IN THE CONTEXT OF THE GATT ROUND, SECTORAL TRADE DISCUSSIONS ARE IN A LULL. BUT MUCH LARGER POTENTIAL PROBLEMS, SPILLING OVER INTO THE POLITICAL AND SECURITY AREA ARE FORESEEN BECAUSE OF THE CONTINUING US DEFICITS AND THE SHIFT IN YEN/DOLLAR VALUES AND IN HIGH-TECH TRADE. THE JAPANESE ARE NERVOUS THAT A RECESSION COUPLED WITH A LARGE BILATERAL TRADE DEFICIT COULD TRIGGER A SPATE OF UNFAIR TRADE COMPLAINTS OR FORCE THE ADMINISTRATION TO BRING A SUPER 301 CASE UNDER THE NEW TRADE ACT. THEY ARE ALSO SUBJECT TO CONFLICTING PRESSURES AND MESSAGES ABOUT QUOTE BURDEN SHARING UNQUOTE AND INVESTMENT. CONSEQUENTLY, THEY ARE DESPERATELY HOPING MR BUSH WILL TAKE FIRM ACTION TO CUT THE BUDGET DEFICIT AND REDUCE DOMESTIC DEMAND - THE MAIN REQUISITE, AS THEY SEE IT, FOR CUTTING THE BILATERAL IMBALANCE. THEY BELIEVE THE ALTERNATIVE MAY BE A HARDER LANDING IF THE MARKETS, INCLUDING JAPANESE INVESTORS, LOSE CONFIDENCE IN THE DOLLAR. BUT IT IS DOUBTFUL WHETHER THEY WILL SAY SO TO MR BUSH DIRECTLY. THEY ARE STRONG ENOUGH AND MIGHT PERHAPS BE ENCOURAGED TO DO SO. JAPANESE OFFICIALS SAY THEY WANT TO HELP THE US MAINTAIN ITS STRATEGIC AND ECONOMIC PRE-EMINENCE, BUT THIS REMAINS AN ABSTRACT IDEA. THE CONTINUED FALL OF THE DOLLAR AGAINST THE YEN IS AS UNLIKELY AS BEFORE TO HAVE MUCH BILATERAL TRADE-BALANCING EFFECT, SINCE FEW ITEMS ARE PRICE SENSITIVE AND MAJOR JAPANESE COMPANIES COULD STILL EXPORT PROFITABLY AT LEAST DOWN TO Y100. DEVALUATION MAY ONLY FURTHER FEED US PARANOIA AT BEING OVERTAKEN AND TAKEN OVER. THE CONCEPT OF BURDEN-SHARING ALSO MAY NOT BE A PANACEA AND WILL NEED HANDLING WITH CARE. THERE IS SCOPE FOR MORE JAPANESE AID, ITS REDISTRIBUTION AND IMPROVEMENT IN ITS QUALITY. THE AMERICANS ARE LIKELY TO MAKE THIS A KEY POINT IN THEIR APPROACH TO JAPAN. BUT JAPAN WILL NOT WISH TO APPEAR TO BE APPLYING IT ONLY IN AMERICAN STRATEGIC CAUSES. TO THE EXTENT THAT JAPAN IS ASKED FINANCIALLY TO UNDERPIN INTERNATIONAL PEACE-KEEPING OR DEBT-SOLVING EFFORTS, SHE WILL WANT A LARGER ROLE IN THE INTERNATIONAL INSTITUTIONS. IN THE MILITARY FIELD, JAPAN COULD SOMEWHAT INCREASE ITS SUPPORT FOR US FORCES IN JAPAN AND SPENDING IN SUPPORT OF ITS EXISTING ROLES, BUT THERE ARE NO MAJOR NEW ROLES WHICH JAPAN COULD EASILY OR WISELY BE ENCOURAGED TO ASSUME. JAPAN'S DEFENCE BUDGET OF DLR30 BILLION (DLR41 BN BY NATO DEFINITIONS) HAS BEEN RISING AT 5.6 PER CENT PER ANNUM, AND NEITHER THE JAPANESE PUBLIC NOR OTHER ASIAN COUNTRIES ARE KEEN TO SEE IT GROW FASTER.

10. AS SEEN FROM HERE RECENT DISCUSSION OF A US-JAPAN FREE TRADE AGREEMENT OR OTHER NEW ECONOMIC FRAMEWORK IS ONLY A REFLECTION OF THE FEAR THAT THE FAILURE OF BRUISING TRADE NEGOTIATIONS TO REMOVE THE

IMBALANCES AND US COMPLAINTS IS LEADING THE TWO COUNTRIES TOWARDS FRICTIONS ON A LARGER SCALE, AND A DESIRE TO FIND SOME WAY TO RESOLVE FORESEEABLE DIFFICULTIES OVER TRADE, TECHNOLOGY, DEFENCE COLLABORATION ETC WITHOUT GENERATING POLITICAL STRAIN. BUT TWO SIDES MAKE A VERY DIFFERENT ANALYSIS OF THE COMMON PROBLEM, THE AMERICANS IN TERMS OF MARKET ACCESS AND THE NEED FOR THE LEVEL PLAYING FIELD IN TRADE, THE JAPANESE IN TERMS OF STRUCTURAL PROBLEMS IN THE US ECONOMY - NOTABLY THE EXCESS OF CONSUMPTION OVER SAVINGS, AND SHORT-TERMISM IN US CORPORATIONS. OPTIMISTIC JAPANESE BELIEVE THAT JAPANESE INVESTMENT IN THE US WILL NATURALLY HELP TO CORRECT THESE IMBALANCES. EVEN IF ACCEPTABLE, THIS WOULD TAKE TIME. MEANWHILE AS SEEN FROM HERE, NEW FRAMEWORKS ARE NOT A SUBSTITUTE FOR OTHER ACTIONS ON BOTH SIDES.

### THE PACIFIC DIMENSION

11 . THE US AND JAPAN AGREE HOWEVER ON THE FUTURE IMPORTANCE OF THE PACIFIC RIM, AND A CONSCIOUS JAPANESE POLICY TO PROMOTE THE ECONOMIC INTEGRATION OF THIS AREA IS NOW EMERGING. IN PART IT HAS BEEN ENCOURAGED BY PERCEIVED THREATS OF PROTECTIONISM IN THE US AND EUROPE, BUT IT ALSO REFLECTS A JAPANESE ASSESSMENT BOTH OF THE DYNAMISM OF THESE ECONOMIES AND OF THE NEED OF JAPAN, THE NICS AND SOUTH EAST ASIA TO REDUCE THEIR DEPENDENCE ON THE US AND DO MORE AMONG THEMSELVES. WHILE SOME COUNTRIES HAVE POLITICAL RESERVATIONS ABOUT JAPAN'S LEADERSHIP, THE DESIRE FOR A REGIONAL ECONOMIC INTEGRATION SEEMS TO BE RECIPROCATED AROUND THE RIM, INCLUDING AUSTRALIA, AND INVESTMENT AND TRADE ARE DEVELOPING STEADILY. IN 1987 THERE WAS THREE TIMES AS MUCH JAPANESE MANUFACTURING INVESTMENT IN ASIA AS IN EUROPE, AND ASIA ACCOUNTED FOR 65 PERCENT OF JAPAN'S AID PROGRAMME (CF 8 PERCENT FOR LATIN AMERICA AND 10 PERCENT FOR AFRICA). THERE IS A CLEAR RISK OF AN AREA OF MAJOR GROWTH EMERGING OVER THE NEXT DECADE IN WHICH WE AND MANY EUROPEAN COUNTRIES WILL BE ONLY THINLY REPRESENTED.

### EC-JAPAN RELATIONS

12. DESPITE THE SOLUTION OF MANY PROBLEMS AND THE INCREASING MUTUAL TRADE AND INVESTMENT, THE TONE OF OFFICIAL RELATIONS WITH THE EC REMAINS SOMEWHAT NEGATIVE, AND CURRENTLY DOMINATED BY THE ISSUES OF DISCRIMINATORY EUROPEAN QRS AND 1992. SUSPICIONS REMAIN ON BOTH SIDES AND THE EC COLLECTIVELY STILL NEEDS A MORE POSITIVE AND CONSISTENT POLICY THAT RECOGNISES THE STRATEGIC IMPORTANCE OF JAPAN/EC COOPERATION - PARTICULARLY IN HIGH TECH INDUSTRIAL DEVELOPMENT, WHILE SEEKING SPEEDY AND REALISTIC SETTLEMENT OF TRADE



PROBLEMS. THE JAPANESE FOR THEIR PART STILL SEEK TO DIVIDE MEMBER STATES. THE COMMUNITY DOES NOT THEREFORE CONTRIBUTE AS MUCH AS IT SHOULD TO THE TASK OF STRENGTHENING JAPAN'S MORE CULTURAL AND POLITICAL LINKS WITH THE WESTERN COMMUNITY. WE AND OUR LIKE-MINDED PARTNERS WILL HAVE TO CONTINUE THIS EFFORT IN A NATIONAL FRAMEWORK, TOGETHER WITH OUR EFFORTS TO ENCOURAGE BRITISH BUSINESSES TO TAKE THE OPPORTUNITIES IN THIS MARKET.

13. AGAINST THIS BACKGROUND I SUGGEST OUR OWN LINE TOWARDS THE JAPANESE SHOULD CONTAIN THE FOLLOWING ELEMENTS:

- I) A BULLISH LINE ON 1992 FOR THE OPPORTUNITIES IT WILL BRING FOR ALL PARTICIPANTS IN THE MARKET. WE DO NOT NEED TO BE DEFENSIVE ABOUT AREAS NOT ALREADY COVERED IN THE GATT. IF THE JAPANESE WISH TO AVOID ARGUMENT ABOUT RECIPROCITY OR BALANCE OF BENEFITS, THEY SHOULD ENSURE THEIR MARKETS ARE OPEN AND NEGOTIATE CONSTRUCTIVELY E.G. ON SERVICES IN THE GATT.
- II) REAFFIRMATION THAT WE SEE OUR RELATIONS WITH JAPAN AS A DYNAMIC AND PLAIN SPEAKING PARTNERSHIP, AND OF OUR WISH TO DEVELOP THE COMPONENTS OF INDUSTRIAL AND SCIENTIFIC COLLABORATION AND OF OUR EFFORTS TO ENCOURAGE THAT (OPPORTUNITY JAPAN).
- III) RECOGNITION OF THE STRUCTURAL CHANGES IN THE JAPANESE ECONOMY, AND OF JAPAN'S INCREASED CONTRIBUTION IN AID ETC.
- IV) ENCOURAGEMENT TO JAPAN TO SPEAK CLEARLY TO THE BUSH ADMINISTRATION ABOUT THEIR CONCERN ON THE DEFICITS.
- V) A CAUTIONARY NOTE ABOUT JAPAN'S OWN TRADE SURPLUSES, THE NEED FOR FURTHER ACTION TO PROMOTE IMPORT PENETRATION AND ENSURE THAT THE OPENING OF JAPANESE MARKETS IS GENUINE.

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*PM*

Treasury Chambers, Parliament Street, SW1P 3AG  
01-270 3000

9 December 1988

Russell Dixon Esq  
Assistant Private Secretary to the  
Secretary of State for Foreign and Commonwealth Affairs  
Foreign and Commonwealth Office  
Downing Street  
LONDON  
SW1

*Russell Dixon*

... I should be grateful if you could forward the enclosed letter from the Chancellor of the Exchequer to Kiichi Miyazawa.

*Yours truly*

*J M G Taylor*

J M G TAYLOR  
Private Secretary



Treasury Chambers, Parliament Street, SW1P 3AG  
01-270 3000

9 December 1988

Kiichi Miyazawa  
Tokyo  
Japan

*Kiichi*

I was sorry to hear you had resigned your post as Finance Minister. I have enjoyed working with you, and I send you my best wishes for the future.

*Nigel Lawson*

NIGEL LAWSON

Kiichi Miyazawa  
Tokyo  
Japan

**DRAFT LETTER FROM CHANCELLOR TO KIICHI MIYAZAWA**

I was sorry to hear you had resigned your post as Finance Minister. I have enjoyed working with you, and I send you my best wishes for the future.

+ n  
"Prosser Dixon" letter.

**NIGEL LAWSON**

File  
File:

FROM TOKYO TO FCO

TELNO 9 SAVING

UNCLASSIFIED

PS/CHANCELLOR OF THE EXCHEQUER  
TREASURY

Addressed to FCO Telegram No 9 Saving of 12 December 1988

Repeated for information to:

Paris, Rome, Bonn Washington, Brussels, Dublin, Stockholm, UKRep  
Brussels, UKMIS Geneva, UKDEL OECD, Ottawa, Bangkok, Canberra, Peking,  
Seoul, Jakarta, Singapore, Manila, Kuala Lumpur, Governor Hong Kong,  
BTC Hong Kong, Osaka.

JAPAN: ECONOMIC REPORT: NOVEMBER 1988

- Seasonally adjusted real GNP grew by 2.2% in the September quarter, equivalent to 9.3% at an annual rate. Domestic demand contributed growth of 1.8% and the net external sector 0.4%. This was the first positive contribution to GNP from the external sector for a year, and confirmed the evidence from the trade figures of a recovery in exports. (Paras 1-3).
- The EPA is expected to revise its estimate for GNP growth in FY 1988 to around 5%. Most private sector forecasters agree, and furthermore expect the economy to continue to grow at around this rate in FY 1989. Domestic demand is expected to continue to be the main component of growth, with the external sector exerting a negative influence. (Paras 4-5).
- The government's tax reform proposals now have a good chance of becoming law by the end of the year, and of being implemented from 1 April 1989, although with a six month introductory period. (Paras 29-30).
- With the focus of attention on tax reform, the publication of the draft budget for FY 1989 will be delayed for 3 or 4 weeks, until mid-January. Buoyant tax revenues will allow the government to reduce its borrowing and still allow some increases in spending programmes. As last year, it is expected that the increases in spending will be concentrated on ODA and defence. (Paras 31-32).
- Industrial production declined by 0.8% in October, but still showed growth of 6.6% year on year. Housing starts have been falling, but investment in plant and machinery and in industrial and commercial construction remains strong. (Paras 6-19).
- Retail sales recovered from a slowdown in the summer to grow by 1.9% in October. (Para 12).

- Consumer prices rose by 1.1% year on year in October, but by only 0.5% after excluding fresh food, the prices of which have increased sharply as a result of poor weather earlier in the year. Wholesale prices fell by 1.5% in October. (Paras 15-16).
- The seasonally adjusted trade surplus reached \$8.5 billion in October - the highest figure since January. After 4 months of consecutive increases export volumes fell in October, but the fall was more than offset by a drop in import volumes. (Paras 18-22).
- Despite concerted intervention by central banks, the yen rose sharply during November and closed the month at Y121.75, close to its record high. (Para 25).
- Prices on the Tokyo Stock Exchange also moved up sharply during November, and in early December broke through the 30,000 barrier on the Nikkei 225 index.

### GNP DATA (TABLE I)

TABLE I: GROSS NATIONAL EXPENDITURE  
(Real, seasonally-adjusted base year = CY 1980)  
Percentage change over the preceding period

	FISCAL YEARS			1987				1988	
	1985/86	1986/87	1987/88	JUN	SEP	DEC	MAR	JUN	SEP
Consumers' Expenditure	2.8	3.4	4.5	0.9	1.3	0.9	2.2	0.6	1.4
Private Housing	2.8	11.0	25.6	4.7	9.5	11.6	1.9	-8.6	6.1
Private Investment	13.2	4.3	10.0	1.9	2.7	3.7	4.0	4.6	4.4
Private Inventories	8.7	-50.5	24.4	567.3	-8.0	74.1	-13.7	42.0	-11.9
Government Current Expenditure	1.6	6.3	-0.9	1.4	-0.3	0.2	0.9	0.5	0.6
Government Capital Expenditure	-6.3	7.0	10.0	2.3	2.3	5.6	4.0	-2.4	-1.8
Government Inventories	79.0	187.5	-94.7	-115.4	-	-6100.3	-	-71.3	-289.0
External (Net)	20.9	-34.5	-36.0	-37.1	16.8	-36.3	-14.0	-132.0	-
Exports	2.1	-3.6	5.2	-1.6	6.0	-0.4	3.4	-3.8	9.0
Imports	-2.3	5.4	12.6	5.9	4.7	4.6	4.9	5.1	6.3
GNE (Percentage Change)	4.5	2.7	5.2	0.4	2.2	1.7	2.4	-0.8	2.2
GNE (Y Billion)	293,981.8	301,833.8	317,589.4	307,582.7	314,467.6	319,940.4	327,750.6	324,982.8	332,284.6
Memo item: Nominal GNE	6.0	4.1	5.0	0.1	2.8	1.3	2.8	-1.1	3.0
Y Billion	321,290.3	334,569.4	351,187.7	339,136.5	348,793.4	353,376.2	363,220.1	359,160.3	369,774.6

1. Seasonally adjusted real GNP grew by 2.2% in the third quarter of 1988, equivalent to 9.3% at an annual rate. This represented a marked turnaround from the second quarter, when real GNP declined by a revised 0.8%, and a return to the high growth seen in the previous three quarters. The outturn was considerably higher than earlier predictions by the Economic Planning Agency and other organisations, which a few weeks earlier had been expecting growth at an annual rate of 6-8%.

2. The main components of the growth rate were consumer spending, private sector investment and the external sector. Consumer spending grew by 1.4%, after a rise of only 0.6% in the second quarter. As expected, private sector non-residential investment once again grew by over 4% over the previous quarter, confirming reports in recent investment intentions surveys of an investment boom. Spending on private investment was 17.8% above the corresponding period in 1987. More surprisingly, private housing recovered to rise by 6.1% over the previous quarter, against expectations that the housing boom was easing. Imports grew by 6.3%, but this was more than offset by a 9.0% rise in exports, confirming the evidence from the trade figures of a resurgence in exports by both value and volume.

3. Overall, domestic demand contributed 1.8% to the quarter's growth. Private sector demand contributed 2.0%, and the public sector -0.2%, reflecting the slowdown in public works spending. The external sector contributed 0.4% - the first positive contribution for a year. The ratio of the current account surplus to GNP rose slightly, from 2.3% in the second quarter to 2.6% in the third.

4. The third quarter's rate of growth means that even without any further expansion real GNP will grow by 4.1% in FY 1988. In practice growth will continue (despite a slowdown in some sectors as a result of the Emperor's illness) and the EPA is now privately predicting real GNP growth of about 5%, against the government's original estimate of 3.8%. The estimate will be officially revised when the EPA publishes its estimates for FY 1989 at the time of the budget in early January.

5. The government's expectations for FY 1988 are generally matched or exceeded by private sector forecasters. The most recent forecast from the Japan Centre for Economic Research (formerly JERC) estimates real GNP growth this fiscal year at 5.3%, with domestic demand contributing 6.8% and the external sector -1.5%. The Daiwa Securities Research Institute puts real growth this year at 4.9%, with a similar split between domestic and external demand. For FY 1989, the Daiwa Research Institute predicts a modest overall fall, to 4.7% with domestic demand growth at 5.4% and the net external sector at -0.7%. The JCER predicts more modest growth, of 4.2% in FY 1989, with domestic demand at 5.0% and the external sector at -0.8%.



INDUSTRIAL AND BUSINESS ACTIVITY (TABLE II)

TABLE II: PRODUCTION AND BUSINESS ACTIVITY  
 Seasonally adjusted, except figures for fiscal years  
 Percentage change over previous period

	<u>FISCAL YEARS</u>			<u>1988</u>					
	1985/86	1986/87	1987/88	MAY	JUN	JUL	AUG	SEP	OCT
Industrial Production Mining and Manufacturing (1985 = 100)	2.5	-0.2	5.8	-2.3	3.3	-0.9	2.7	0.5	-0.8
Manufacturing Operating Ratio	-0.6	-4.8	2.5	-0.5	2.6	-0.3	1.8	1.2	n.a
Housing starts (Total units)	3.6	11.9	23.5	13.1	1.3	-0.4	7.3	-7.3	-2.8
Domestic Machinery Order (Total)	-1.8	4.1	7.7	-1.0	3.8	-1.4	-0.1	-16.8	n.a
Retail Sales	3.2	1.1	5.0	0.7	2.0	-0.1	-1.9	0.5	1.9
Leading Indicators Index (1980 = 100) End of Period	50.0	75.0	n.a	46.2	30.8	36.4	40.0	50.0	n.a

6. Industrial production fell by 0.8%, seasonally adjusted, in October after a rise of 2.5% in the third quarter. However, production was still up 6.6% over the year. The seasonally adjusted fall in October was quite widely spread across 10 of the main production industries, including transport machinery, precision machinery and metal products. A major reason for the fall was a decline in automobile production as a result of a series of model changes. However, MITI is confident that the basic trend of industrial production is still upward: the Ministry is forecasting a rise of 1.5% in November and of 0.9% in December.

7. The leading indicator in the diffusion index showed an improvement in both August and September, reaching 50.0 in the latter month, after 5 months below this traditional "boom or bust" level. The coincident index registered 75.0, and the lagging index 71.4 in the same month.

8. The manufacturing operating ratio rose by 2.0% seasonally adjusted, and by 6.5% year on year during the September quarter. This followed a decline of 1.9% (seasonally adjusted) during the April quarter. Inventories of finished goods rose by 2.4% in the third quarter - the largest quarterly increase for at least 3 years. However, since producers' shipments also rose, by 2.1%, the ratio of inventories to shipments rose more modestly, by 0.9%.

9. Housing starts fell by 7.3% in September, and by 2.8% in October, on a seasonally adjusted basis. It is reported that demand for private housing has peaked most dramatically in the Toyko area, where high land prices have for the time being choked off demand. New orders for industrial and commercial construction fell by 4% year on year in September, as a result of a 25% drop in orders from the public sector, but recovered to rise by 22% year on year in October.

10. A recent MITI survey of the investment intentions of 1,659 corporations showed that capital spending is expected to rise by an average of 17.5% in FY 1988. This compared with an average of 12.9% when the same survey was conducted in February. Capital spending by manufacturing companies is expected to rise by 28.3%, and that by non-manufacturing companies by 10.6%. Spending on research and development is expected to rise by 31.2% over FY 1987.

11. A Bank of Japan survey published at the end of November of 619 companies capitalized at more than Y1 billion predicts that corporate profits will rise by an average of 12.2% in FY 1988, after a 16.7% rise in 1987. Manufacturers' profits are expected to rise by 21.4%, and non-manufacturers profits to fall by 1.9%.

12. Retail sales recovered from their period of weakness during the summer, and rose by 0.5% and 1.9% seasonally adjusted in September and October respectively. Sales in department stores and supermarkets were especially buoyant, rising by 5.2% and 9.5% year on year in these two months.

### LABOUR MARKET (TABLE III)

TABLE III: LABOUR MARKET

All figures seasonally adjusted except figures for fiscal years

	<u>Fiscal Years</u>			<u>1988</u>					
	1985/86	1986/87	1987/88	MAY	JUN	JUL	AUG	SEP	OCT
Unemployment Number (mns)	1.58	1.71	1.70	1.54	1.45	1.55	1.62	1.53	1.50
% of Workforce	2.65	2.8	2.78	2.49	2.35	2.51	2.62	2.49	2.43
Employment Regular workers (1985 = 100)	100.4	101.7	102.1	102.9	103.0	103.1	103.2	103.3	103.5
Overtime Hours Worked (All industries) (1985 = 100)	99.9	96.2	102.7	106.4	107.1	108.3	109.5	108.6	108.1
Job Opening/Job Seeking Ratio	0.67	0.62	0.76	0.99	1.05	1.09	1.07	1.08	1.09

13. The seasonally adjusted unemployment rate slipped back to 2.49% in September and 2.43% in October. The number of people in employment exceeded 60 million in October, 1.4% higher than a year previously. Employment in manufacturing industry was 3.3% higher than a year ago, and in the construction sector 3.5% higher.

14. The Japanese private sector Trade Union Confederation (Rengo), which has 5.4 million workers, has said that it will demand wage rises of 6-8% in next spring's wage offensive ("shunto"), in view of the strength of the economy. It has also said that it would make "every effort" to win a wage increase larger than the average of 4.4% obtained last year. Meanwhile, end-year bonuses are expected to rise by an average of 6.8% year on year, according to a Nikkei survey. This would be the biggest increase for 8 years.

#### PRICES AND EARNINGS (TABLE IV)

TABLE IV: PRICES AND EARNINGS  
Percentage change on year earlier, not seasonally adjusted

	<u>FISCAL YEARS</u>			<u>1988</u>					
	1985/6	1986/7	1987/8	JUN	JUL	AUG	SEP	OCT	NOV
Consumer Prices - National	1.9	0.0	0.5	0.2	0.5	0.7	0.6	1.1	n.a
- Tokyo	2.3	0.3	0.9	0.4	0.8	0.8	1.0	1.6	1.7
Wholesale Prices - Total	n.a	-9.3	-2.0	-0.6	-0.9	-1.0	-0.9	-1.5	n.a
- Domestic	n.a	-5.3	-1.7	-0.2	-0.4	-0.8	-0.9	-1.1	n.a
Average earnings all industries (real) 1985 = 100	1.1	2.6	1.7	4.3	2.1	5.6	3.7	2.8	n.a
Unit labour costs	2.1	2.9	n.a	-4.6	-2.8	-5.1	n.a	n.a	n.a
Labour Productivity (1985 = 100) manufacturing	4.4	1.8	5.9	117.1	118.6	118.5	n.a	n.a	n.a

15. Consumer prices rose by 1.1% year on year in October - the first increase of more than 1% since May 1986. However, as anticipated, the poor weather conditions in the summer are continuing to push up the prices of vegetables and fruit, and after excluding these items the index rose by only 0.5%. Prices in metropolitan Tokyo in November rose by 1.7%, or by 1.1% if fruit and vegetables are excluded.

16. Wholesale prices fell by 0.9% year on year in September and 1.5% in October. The steeper fall in the latter month reflected a sharp fall of 6.8% in the import wholesale price index, mainly the result of further falls in the prices of crude oil and natural gas. The domestic wholesale price index fell by 1.1%, as a result of increased competition from imports for textiles and electrical products, whilst prices for timber also fell as the pace of housing starts eased.

17. Real wages of workers in all industries rose by 3.5% year on year in the third quarter and by 2.8% in October. Disposal income is rising faster - by 4.9% year on year in the third quarter.

TRADE (TABLE V)

TABLE V: TRADE  
(ALL FIGURES IMF BASIS, SEASONALLY-ADJUSTED)

	FISCAL YEAR (NSA)			1988					
	1985/86	1986/87	1987/88	MAY	JUN	JUL	AUG	SEP	OCT
Exports (\$ mn)	180,664	211,293	233,389	20,348	21,269	21,670	21,850	22,244	22,084
Imports (\$ mn)	119,063	109,645	139,108	13,572	15,085	14,433	14,322	14,398	13,602
Trade Balance (\$ mn)	61,601	101,648	94,281	6,776	6,184	7,237	7,528	7,846	8,482
Current Account Balance (\$ mn)	55,019	94,139	84,540	5,762	4,920	4,953	6,176	6,644	6,830
Indices, NSA, % change over same period of previous year Volume (1985 = 100)									
- Exports	3.6	-0.5	0.1	-0.6	4.8	5.9	7.0	7.1	3.3
- Imports	1.1	10.5	12.6	17.9	20.5	15.6	16.9	13.3	8.5
\$ Unit Value									
- Exports	n.a	18.3	10.5	11.5	11.8	9.9	10.7	6.3	9.7
- Imports	n.a	-13.6	14.6	7.7	9.6	6.7	9.2	5.2	4.8
Indices, SA Volume (1985 = 100)									
- Exports	99.8	99.1	99.6	96.5	101.4	104.0	105.7	107.1	103.9
- Imports	100.4	111.2	124.4	134.6	145.4	138.4	145.0	140.7	131.9

18. The seasonally adjusted trade surplus rose further in September and October, to \$7.8 billion and \$8.5 billion respectively. The latter figure is the highest since January. By dollar value exports rose by 5.6% in the September quarter: although they fell by 0.7% in October, this was more than offset by a 5.5% decline in imports in that month, largely the result of falling oil prices.

19. The current account surplus is also rising, and reached \$6.8 billion in October, despite an invisible deficit of \$1.7 billion. This is \$0.6 billion higher than the comparable figure in October 1987.

20. The invisibles deficit was \$1.2 billion in September and \$1.7 billion in October. The outflow on travel reached a new record of \$4.5 billion in the September quarter, whilst the inflow of interest from overseas investments also reached a new record, of \$5.3 billion.

21. After four consecutive months of increases export volumes fell by 3.0% seasonally adjusted in October. However this was offset by a 6.3% drop - the largest since February 1987 - in import volume.

22. Customs clearance trade statistics show that amongst its major trading partners, Japanese exports grew most rapidly during the September quarter to China (up 33%). Exports to the UK were up 29%, higher than the figure to the EC as a whole (25%). Exports to the USA grew by only 6.6%. During the same period Japanese imports from China grew by 38%: from the UK by 33%, and from the EC by 36%: and from the USA by 29%. By product exports of electrical machinery grew by 56% year on year in the September quarter (up from 44% in FY 1987). Imports of iron, steel and metal products increased by 23%, but passenger cars by only 0.3%. Imports of machinery grew by 27% year on year, and of food by 36%, during the quarter, whilst imports of mineral fuels fell by 5% by value.

#### CAPITAL ACCOUNT (TABLE VI)

TABLE VI: LONG TERM CAPITAL

OUTWARDS	CALENDAR YEARS				HI	AUG	SEP	OCT
	1984	1985	1986	1987				
Direct Investment	6.0	6.5	14.5	19.5	14.8	2.3	3.5	3.7
Trade Credit	5.0	3.0	2.0	1.7	2.7	0.3	0.3	0.5
Loans	11.9	10.6	9.1	16.1	6.1	0.3	2.7	-
Securities								
- Stocks	30.8	1.0	7.0	16.8	(0.6)	0.6	0.2	0.4
- Bonds		58.8	95.1	70.7	38.8	8.7	3.3	7.0
Other	3.1	2.2	4.6	8.7	2.0	0.9	0.3	0.2
	<u>56.8</u>	<u>82.1</u>	<u>132.4</u>	<u>133.5</u>	<u>63.8</u>	<u>13.9</u>	<u>10.4</u>	<u>11.8</u>
INWARDS								
External Yen Bonds	7.4	12.8	18.4	30.3	13.1	4.5	4.3	3.3
Stocks	(3.6)	(0.7)	(15.7)	(42.8)	3.8	(1.2)	(0.5)	(3.2)
Bonds	3.5	4.5	(2.1)	6.6	(3.4)	(2.4)	(4.3)	(6.8)
Other	(0.1)	(0.7)	(0.1)	2.2	(1.4)	0.1	0.2	(0.3)
	<u>7.2</u>	<u>17.3</u>	<u>0.5</u>	<u>(3.7)</u>	<u>12.1</u>	<u>1.1</u>	<u>(0.3)</u>	<u>(0.7)</u>
NET OUTFLOW	49.6	64.8	131.9	137.2	51.7	12.8	10.5	12.5

23. The net outflow of long term capital rose to \$12.5 billion in October, above the monthly average of \$10.6 billion so far in 1988. Japanese investments in foreign bonds recovered to \$7 billion, after only \$3.3 billion in September, and direct investment remained strong. Net inward investment was negative for the second month in succession. Net disinvestment of Japanese bonds by non-residents reached a new monthly record of \$6.8 billion, although this was offset by a net increase in investment in stocks of \$3.2 billion.

### FINANCIAL DEVELOPMENTS (TABLE VII)

TABLE VII: MONETARY INDICATORS

	FISCAL YEARS			1988					
	1985/86	1986/87	1987/88	JUN	JUL	AUG	SEP	OCT	NOV
M1 Annual Growth (%)	4.5	8.4	10.2	8.1	7.5	6.2	5.9	7.1	n.a
M2 + CDs Annual Growth (%)	8.7	8.6	11.2	11.1	11.1	10.9	10.6	11.0	n.a
Discount Rate (%) (end of period) Growth (%)	3.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
3-month Gensaki Rate (end of period)	4.395	3.983	3.835	3.825	3.855	4.065	4.200	4.272	4.183
Government Bond Yield (No. 10, 6.1%)	4.40	3.79	4.430	4.865 (No 105)	4.925 (No 105)	5.360 (No 105)	5.020 (No 105)	4.485 (No 105)	4.555 (No 105)
Tokyo Stock Exchange First Section Index - Average Price	1,030	1,448	2,014	2,185.63	2,177.78	2,195.02	2,124.77	2,123.30	2,217.24
Yen/Dollar rate (end of period closing)	160.10	145.80	124.50	132.20	132.53	134.97	134.30	125.00	121.85
Yen/Sterling T.T. Selling rates (AV)	237.59	234.30	283.93	230.87	231.06	231.10	230.68	227.83	226.83

24. M2+CDs, the broadly defined measure of the money supply, rose by 10.6% year on year in September and by 11.0% in October. The rate of growth has slowed a little since mid-summer, but there is little sign as yet of a significant fall. With nominal GNP rising at 6-7% this fiscal year, there is some concern within the Bank of Japan and elsewhere that the rate of money growth is still too high on a long term view.

25. From a level of Y133.80 on 1 October, the yen strengthened during the month on expectations that the US economy was slowing down and the prospects for rises in US rates were receding. It closed the month at Y125.75, despite modest Bank of Japan intervention, the first for 6 months. Upward pressure on the currency intensified following the US presidential election on 8 November, and despite more active intervention by the Bank of Japan and other central banks the yen strengthened throughout November and closed at Y121.75, after briefly reaching a new high of Y120.20.

26. Interest rates declined during October, as the Bank of Japan generally adopted an accommodatory stance, with 3-month CD's falling from 4.88% to 4.49%. At the beginning of November the Bank of Japan introduced some radical changes into the short term money market, with the intention of narrowing the differential between "controlled" and open market interest rates, and allowing a wider range of market instruments and maturities to be set by market forces. As a result, call money and bill discount rates rose sharply, virtually eliminating the differential between these rates and rates for instruments such as CDs and Euroyen. The Bank of Japan continued its accommodative stance during November, and on 30 November 3-month CDs stood at 4.49%: the comparable bill discount rate was 4.50%, whilst collateralised call money was at 3.89%.

27. The bond markets were generally firm in both October and November, reflecting the yen's appreciation and the easing of Japanese interest rates. The yield on the benchmark 10-year bond fell from 4.98% on 1 October to 4.65% by the end of the month and to 4.55% by the end of November. Prices were also kept up by the expectation that the volume of government bond issues next fiscal year would be sharply reduced, as the government seeks to reach its target of eliminating deficit financing bonds by 1990.

28. Prices on the Tokyo Stock Exchange moved within the 27,000-28,000 range on the Nikkei Index during October, but moved up during November. The index closed the month at 29,579, and subsequently broke through the 30,000 barrier on 7 December.

#### FISCAL POLICY

29. After several months during which the government made little progress in the Diet with its plans for tax reform, mainly because of the successful use of the Recruit Cosmos scandal by the opposition parties to block progress, the LDP successfully pushed its tax reform bills through the House of Representatives on 16 November. In order to do so the government agreed a number of compromises with one of the opposition parties, the most important of which was to make the first six months after the introduction of the sales tax an "introductory period". The essence of the sales tax was however unchanged, and it is currently expected that the implementation of the liquor tax reform will go ahead on schedule.

30. The extraordinary session of the Diet has been extended again, until 28 December, in order to allow the House of Councillors to pass the necessary bills. Most commentators are confident that this can now be achieved, although the Recruit Cosmos scandal is still dominating political developments and overshadowing the tax reform process. A further summary of the tax reform proposals will be given in next month's Economic Report, following their passage through both Houses in the Diet.

31. As a result of the delay in securing the passage of the tax reforms, the timetable for the budget for FY 1989 is also likely to be delayed. The MOF's draft budget is now not likely to be issued until around 17 January instead of during the second half of December, and the final draft, produced after consultation with Ministers, will only be approved around 23 January. The Budget Bills will be submitted to the Diet early in February.

32. Preliminary indications are that the overall budget will be for about Y60 trillion, which would be 5.8% higher than in FY 1988. Tax revenues are expected to be up by Y5 trillion, to around Y50 trillion, allowing for a reduction in debt financing whilst still allowing an increase in the overall size. Some Y2 trillion of the increase in tax revenues will however need to be passed through to local authorities and - on current estimates - the increased revenue available for spending on programmes may be only around Y1 trillion. As last year, it is expected that official development assistance and defence will see the largest spending increases.

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TELNO 1133  
OF 280830Z DECEMBER 88  
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INFO PRIORITY BONN, PARIS, WASHINGTON, OTTAWA, ROME, MODUK,  
INFO PRIORITY UKREP BRUSSELS, PEKING, SEOUL, GOVERNOR HONG KONG,  
INFO PRIORITY OSAKA

MODUK FOR SEC(O)C  
DTI FOR OT2

MY 2 IPT: NEW JAPANESE CABINET

DRAFT MESSAGE FROM MR LAWSON TO THE NEW MINISTER OF FINANCE,  
HE MR TATSUO MURAYAMA

BEGINS

MAY I OFFER WARMEST CONGRATULATIONS UPON YOUR NEW APPOINTMENT.  
BRITAIN AND JAPAN HAVE DEEP AND LONGSTANDING RELATIONS, BOTH  
IN THE AREA OF INTERNATIONAL ECONOMIC COOPERATION AND AS TWO  
OF THE WORLD'S LEADING FINANCIAL CENTRES. I LOOK FORWARD TO  
MEETING YOU, PERHAPS AT THE NEXT MEETING OF THE IMF INTERIM  
COMMITTEE IN APRIL NEXT YEAR.

ENDS

DRAFT MESSAGE FROM LORD YOUNG TO THE NEW MINISTER FOR  
INTERNATIONAL TRADE AND INDUSTRY, HE HIROSHI MITSUZUKA

BEGINS

MAY I OFFER MY WARMEST CONGRATULATIONS UPON YOUR NEW APPOINTMENT.  
BRITAIN AND JAPAN HAVE DEEP AND LONGSTANDING RELATIONS OF  
FRIENDSHIP, AND I HAVE BEEN DELIGHTED TO SEE THIS REFLECTED  
RECENTLY IN RAPIDLY EXPANDING TRADE, INVESTMENT AND COLLABORATION  
IN ECONOMIC COOPERATION. I LOOK FORWARD IMMENSELY TO MY NEXT  
VISIT TO JAPAN IN MAY AND TO DISCUSSING WITH YOU HOW WE CAN  
FURTHER PROMOTE OUR MUTUAL COOPERATION AT BOTH GOVERNMENT AND  
INDUSTRIAL LEVEL.

ENDS

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FIELD

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NEW TAKESHITA CABINET

1. THE COMPOSITION OF THE NEW JAPANESE CABINET ANNOUNCED BY  
PRIME MINISTER TAKESHITA ON 27 DECEMBER IS AS FOLLOWS (PROTOCOL  
ORDER, FACTION IN BRACKETS):

PRIME MINISTER	NOBORU TAKESHITA
MINISTER FOR JUSTICE	TAKASHI HASEGAWA (ABE)
MINISTER FOR FOREIGN AFFAIRS	SOSUKE UNO (NAKASONE)
FINANCE MINISTER	TATSUO MURAYAMA (MIYAZAWA)
MINISTER FOR EDUCATION	TAKEO NISHIOKA (MIYAZAWA)
MINISTER FOR HEALTH AND WELFARE	JUNICHIRO KOIZUMI (ABE)
MINISTER FOR AGRICULTURE, FORESTRY AND FISHERIES	TSUTOMU HATA (TAKESHITA)
MINISTER FOR INTERNATIONAL TRADE AND INDUSTRY	HIROSHI MITSUZUKA (ABE)
MINISTER FOR TRANSPORT	SHINJI SATO (TAKESHITA)
MINISTER FOR POSTS AND TELECOMMUNICATIONS	SEIICHI KATAOKA (NAKASONE)
MINISTER FOR LABOUR	HYOSUKE NIWA (KOMOTO)

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MINISTER FOR CONSTRUCTION	HIKOSABURO OKONOJI (NAKASONE)
MINISTER FOR HOME AFFAIRS	SHIGENOBU SAKANO (TAKESHITA)
CHIEF CABINET SECRETARY	KEIZO OBUCHI (TAKESHITA)
DIRECTOR GENERAL OF MANAGEMENT AND COORDINATION AGENCY	SABURO KANEMARU (ABE)
DIRECTOR GENERAL OF HOKKAIDO DEVELOPMENT AGENCY AND OKINAWA DEVELOPMENT AGENCY	CHIKAO SAKAMOTO (KOMOTO)
DIRECTOR GENERAL OF DEFENCE AGENCY	KICHIRO TAZAWA (MIYAZAWA)
DIRECTOR GENERAL OF ECONOMIC PLANNING AGENCY	KEN HARADA (TAKESHITA)
DIRECTOR GENERAL OF SCIENCE AND TECHNOLOGY AGENCY	MOICHI MIYAZAKI (MIYAZAWA)
DIRECTOR GENERAL OF ENVIRONMENT AGENCY	MASAHISA AOKI (NAKASONE)
DIRECTOR GENERAL OF NATIONAL LAND AGENCY	HIDEO UTSUMI (TAKESHITA)

2. BIOGRAPHICAL NOTES ON THOSE MINISTERS NOT IN THE LPR, AND A LIST OF VICE MINISTERIAL APPOINTMENTS, FOLLOWS BY BAG TO FED.

3. SEE MY 2 IFTS.

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INFO PRIORITY PEKING, SEOUL, GOVERNOR HONG KONG, OSAKA,  
INFO PRIORITY MODUK

MODUK FOR SEC(O)C  
DTI FOR OT2

MIPT: NEW TAKESHITA CABINET

SUMMARY

1. PRIME MINISTER TAKESHITA'S NEW CABINET IS ANNOUNCED. THERE ARE NO SURPRISES AND RELATIVELY FEW NEW APPOINTMENTS. FOREIGN MINISTER UNO IS RETAINED. TAKESHITA IS BANKING ON EXPERIENCE TO SEE HIM THROUGH A POTENTIALLY AWKWARD TIME UNTIL NEXT JULY'S ELECTIONS TO THE UPPER HOUSE. MESSAGES RECOMMENDED (SEE MIFT).

DETAIL

2. THE MUCH-HERALDED YEAR-END CABINET RESHUFFLE WAS FINALLY ANNOUNCED BY PRIME MINISTER TAKESHITA AT 1730 ON 27 DECEMBER FOLLOWING THE END OF THE EXTRAORDINARY DIET SESSION. TAKESHITA HAS OPTED FOR EXPERIENCE OVER EXPERIMENTATION AND THERE ARE NO SURPRISE APPOINTMENTS IN THE NEW LINE-UP WHICH CONTAINS FEWER NEW FACES (9) THAN ANY CABINET OVER THE LAST 9 YEARS. TAKESHITA HAS EXCLUDED FROM CABINET OFFICE ALL THOSE TAINTED WITH THE RECRUIT SCANDAL.

3. MOST OF THE KEY CABINET POSTS HAVE EITHER BEEN RETAINED BY THE INCUMBENT OR GIVEN TO SEASONED VETERANS. THE AVERAGE AGE OF THE NEW CABINET, AT 65.5, IS HIGH EVEN BY JAPANESE STANDARDS. TAKESHITA AVOIDED ANY INTERPARTY STRIFE BY PAYING CLOSE ATTENTION TO FACTIONAL BALANCE IN HIS NEW TEAM. EACH FACTION RETAINED THE SAME NUMBER OF POSTS: TAKESHITA 6, NAKASONE 4, ABE 4, MIYAZAWA 4 AND KOMOTO 2. ALL THE FACTIONS HAVE PROFESSED THEMSELVES REASONABLY HAPPY WITH THE OUTCOME, GIVEN THE BROADLY BALANCED DISTRIBUTION OF KEY POSTS.

COMMENT

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4. TAKESHITA'S CAUTIOUS APPROACH TO HIS NEW CABINET WAS DICTATED MORE BY CIRCUMSTANCES THAN BY CHOICE. DURING THE LAST SESSION OF THE DIET HIS OWN PUBLIC STANDING AND THAT OF THE LDP HAS PLUMMETED IN THE POLLS. WITH AN ELECTION TO THE UPPER HOUSE IN JULY 1989 TAKESHITA NEEDS A SOLID, RELIABLE TEAM TO HELP REBUILD PUBLIC CONFIDENCE IN HIS ADMINISTRATION AND COPE WITH THE OPPOSITION IN THE DIET.

5. IN PARTICULAR THE RETENTION OF UNO (FOREIGN AFFAIRS) AND TAZAWA (DEFENCE), AND THE APPOINTMENTS OF HATA (AGRICULTURE) MURAYAMA (FINANCE) AND HASEGAWA (JUSTICE) MEAN THAT TAKESHITA WILL HAVE A SAFE AND EXPERIENCED PAIR OF HANDS IN THE KEY MINISTRIES. THE FIRST THREE AREAS ARE LIKELY TO BE SIGNIFICANT OVER THE NEXT SIX MONTHS WITH THE LIKELIHOOD OF RENEWED DEMANDS FOR LIBERALISATION OF AGRICULTURAL PRODUCTS AND FOR GREATER BURDEN SHARING FROM THE NEW AMERICAN ADMINISTRATION. THE FINANCE MINISTRY WILL LEAD ON THE IMPLEMENTATION OF THE STILL UNPOPULAR TAX REFORM AND THE JUSTICE MINISTRY WILL BE A KEY POST IN FIGHTING ANY REARGUARD ACTION OVER RECRUIT. HERE HASEGAWA'S REPUTATION AS A 'CLEAN' POLITICIAN WILL BE USEFUL.

6. TAKESHITA'S NEW LINE UP IS PRIMARILY A DEFENSIVE ONE. IT IS, ESSENTIALLY, A SOLID CARETAKER CABINET TO TIDE HIM OVER UNTIL AFTER NEXT JULY'S UPPER HOUSE ELECTIONS WHEN HE IS LIKELY TO CONDUCT ANOTHER RESHUFFLE. THE MAIN OPPOSITION PARTIES AND MUCH OF THE PRESS HAVE CRITICISED HIM BOTH FOR THE DEFENSIVE NATURE OF THIS RESHUFFLE AND FOR THE LACK OF A CLEAR AGENDA FOR THE NEW CABINET. BUT TAKESHITA PRESUMABLY DEEMS THIS A SMALL PRICE TO PAY FOR PLAYING SAFE.

7. I RECOMMEND THAT THE CHANCELLOR OF THE EXCHEQUER AND THE SECRETARY OF STATE FOR TRADE AND INDUSTRY SEND SHORT MESSAGES OF CONGRATULATIONS. SEE MIFT.

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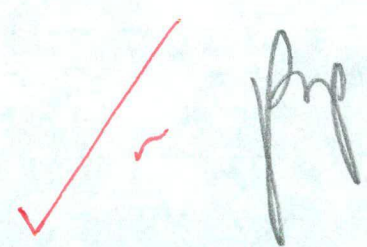
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OF 030815Z JANUARY 89



FOR FED

OUR TELNO 1132 OF 1988: NEW TAKESHITA CABINET

SUMMARY

1. THE NEW JUSTICE MINISTER RESIGNS AFTER REVELATIONS THAT HE HAD RECEIVED POLITICAL CONTRIBUTIONS FROM RECRUIT COSMOS. A BLOW TO TAKESHITA AND A FILLIP TO THE OPPOSITION. THE NEXT DIET SESSION PROMISES TO BE DIFFICULT FOR THE LDP.

DETAIL

2. PRIME MINISTER TAKESHITA'S CABINET STARTED INAUSPICIOUSLY. ON 30 DECEMBER, JUST THREE DAYS AFTER BEING APPOINTED, THE NEW JUSTICE MINISTER, HASEGAWA, RESIGNED AFTER IT WAS REVEALED THAT ONE OF HIS POLITICAL SUPPORT GROUPS HAD RECEIVED DONATIONS OF POUNDS STERLING 25,000 OVER A 12 YEAR PERIOD FROM RECRUIT CO. YET AT A PRESS CONFERENCE IMMEDIATELY FOLLOWING HIS APPOINTMENT HASEGAWA CLEARLY STATED THAT HE HAD NO LINK WITH RECRUIT. ALTHOUGH THESE CONTRIBUTIONS ARE NOT ILLEGAL HASEGAWA RESIGNED BECAUSE HE FELT THAT HIS POSITION AS JUSTICE MINISTER WAS NO LONGER TENABLE AND THAT HE SHOULD TAKE POLITICAL RESPONSIBILITY FOR HAVING MISLED THE PUBLIC. TAKESHITA HAS APPOINTED MASAMI TAKATSUJI, A FORMER DIRECTOR GENERAL OF THE CABINET LEGISLATION BUREAU AND SUPREME COURT JUDGE, AS HIS SUCCESSOR. TAKATSUJI IS ONLY THE THIRD NON-POLITICIAN IN THE POST-WAR PERIOD TO BE MADE A CABINET MINISTER. CHIEF CABINET SECRETARY OBUCHI HAD ALSO APPARENTLY BEEN RECEIVING POLITICAL CONTRIBUTIONS FROM RECRUIT OVER THE LAST FEW YEARS BUT STOPPED ACCEPTING THEM WHEN THE RECRUIT SCANDAL FIRST SURFACED. HIS RATHER MORE ADEPT HANDLING OF THE AFFAIR SEEMS TO HAVE KEPT HIM OUT OF THE FIRING LINE.

3. HASEGAWA IS THE FOURTH CABINET MINISTER TO RESIGN WITHIN A YEAR (AND THE SECOND WITHIN A MONTH). HE WAS CHOSEN BY TAKESHITA TO HELP RESTORE PUBLIC FAITH IN HIS ADMINISTRATION AND, IN PARTICULAR, TO BE RESPONSIBLE FOR THAT CONTINUING CRIMINAL INVESTIGATIONS INTO THE RECRUIT AFFAIR BY THE TOKYO PUBLIC PROSECUTOR'S OFFICE. HIS RESIGNATION IS THEREFORE A MAJOR

POLITICAL EMBARRASSMENT FOR TAKESHITA. IT HAS ALSO DEMONSTRATED THAT THE RECRUIT SCANDAL IS FAR FROM DEAD AND HAS BOOSTED PUBLIC AND DIET INTEREST IN THE AFFAIR. THIS IS GLOOMY NEWS FOR THE LDP.

4. THE JAPAN SOCIALIST PARTY (JSP) AND THE JAPAN COMMUNIST PARTY (JCP) PRESSED FOR HASEGAWA'S RESIGNATION. THEY HAVE ANNOUNCED THAT THEY WILL CONTINUE BOTH TO PURSUE THE RECRUIT AFFAIR AND TO DEMAND AN EARLY RESIGNATION OF THE ENTIRE CABINET. IF SO THE NEXT ORDINARY SESSION OF THE DIET COULD BE DIFFICULT FOR THE LDP. ALREADY THE JSP AND JCP ARE TALKING OF HOLDING THE FY 1989/90 BUDGET DELIBERATIONS HOSTAGE OVER RECRUIT AS THEY DID WITH THE TAX REFORM BILLS. WITH THE UPPER HOUSE ELECTIONS ONLY 6 MONTHS AWAY BOTH PARTIES WILL SEEK TO EXTRACT MAXIMUM POLITICAL MILEAGE.

5. IN PUBLIC TAKESHITA HAS REMAINED CALM: IN A NEW YEAR'S PRESS CONFERENCE HE VOWED TO MAKE 1989 THE YEAR OF POLITICAL REFORM. HE HAD ALREADY ANNOUNCED THAT THE GOVERNMENT WOULD GIVE SERIOUS CONSIDERATION TO BOTH THE QUESTION OF POLITICAL ETHICS AND THE REFORM OF THE MEDIUM-SIZED CONSTITUENCY SYSTEM, WHICH MANY BELIEVE TO BE THE ROOT CAUSE OF JAPANESE MONEY POLITICS. BUT THESE ARE LONG-TERM PROJECTS AND MANY LDP DIETMEN DOUBT THAT EARLY RESULTS WILL BE POSSIBLE. NONETHELESS POLITICAL REFORM IS NOW FIRMLY ON THE AGENDA AND TAKESHITA'S MOVES ARE DESIGNED TO DRAW SOME OF THE HEAT FROM THE ISSUE.

FIELD

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Treasury Chambers, Parliament Street, SW1P 3AG  
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3 January 1989

**His Excellency Mr Tatsuo Murayama  
Minister of Finance  
Japan**

*T. Murayama*

Many congratulations on your appointment as Finance Minister. I look forward to meeting you - perhaps at the April meeting of the IMF Interim Committee - and to working with you in the future.

*Nigel Lawson*  
**NIGEL LAWSON**



MP

Treasury Chambers, Parliament Street, SW1P 3AG  
01-270 3000

4 January 1989

Russell Dixon Esq  
Assistant Private Secretary to the  
Secretary of State for Foreign and  
Commonwealth Affairs  
Foreign and Commonwealth Office  
Downing Street  
London SW1

Dear Russell

... I should be grateful if you could forward the enclosed letter from the Chancellor of the Exchequer to His Excellency Mr Tatsuo Murayama.

Yours Sincerely  
A A DIGHT  
A A DIGHT

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FM TOKYO

TO DESKBY 111100Z FCO

TELNO 035

OF 110900Z JANUARY 89

AND TO IMMEDIATE HM TREASURY, BANK OF ENGLAND

AND TO ROUTINE WASHINGTON, UKREP BRUSSELS, UKDEL OECD

(CULL)

## JAPAN: ECONOMIC FORECAST FOR FY 1989

1. THE GOVERNMENT ESTIMATE FOR ECONOMIC GROWTH IN 1989, AND OUT-TURN IN FY 1988, WHICH WILL BE OFFICIALLY PUBLISHED NEXT WEEK HAS APPEARED WIDELY IN THE NIKKEI AND OTHER MEDIA ALONGSIDE THE DRAFT BUDGET.

2. ACCORDING TO THESE REPORTS, REAL GNP IN FY 1989 WILL BE FORECAST AT 4.0 PERCENT, DOWN FROM 4.9 PERCENT THIS FISCAL YEAR. DOMESTIC DEMAND WILL GROW AT 4.7 PERCENT, OFFSET BY A 0.7 PERCENT DECLINE IN EXTERNAL DEMAND. WHOLESALE PRICES WILL RISE BY 0.9 PERCENT, BUT CONSUMER PRICES BY 2.0 PERCENT (AFTER 0.7 PERCENT IN FY 1988), THE HIGHER INCREASE IN THE CPI BEING ACCOUNTED FOR BY A 'ONE-OFF' 1.2 PERCENT INCREASE AS A RESULT OF THE INTRODUCTION OF THE SALES TAX IN APRIL.

3. THE TRADE SURPLUS IN FY 1988 IS FORECAST AT US DOLLARS 93 BILLION (CF US DOLLARS 94.2 BILLION IN FY 87), FALLING TO US DOLLARS 88 BILLION IN FY 1989. THE CORRESPONDING FIGURES FOR THE CURRENT ACCOUNT SURPLUS ARE US DOLLARS 78 BILLION (84.5 BN) AND US DOLLARS 71 BILLION.

4. THE FIGURES ARE AS FOLLOWS. LAST YEAR'S OUTTURN AND FORECAST FOR FY 1988 ARE INCLUDED FOR COMPARISON.

	OUTTURN FOR FY 87	FORECAST FOR FY 88 (JAN 88)	ESTIMATED OUTTURN FOR FY 88 (JAN 89)	FORECAST FOR FY 89 (JAN 89)
REAL GROWTH RATE (PERCENT)	4.2	3.8	4.9	4.0
CONTRIBUTION OF DOMESTIC DEMAND	5.0	4.8	6.6	4.7

(PERCENT)				
CONTRIBUTION OF EXTERNAL DEMAND (PERCENT)	0.7	-1.0	-1.6	-0.7
NOMINAL GROWTH RATE (PERCENT)	5.0	4.8	5.4	5.2
CURRENT BALANCE (TRILLION YEN)	-	9.6	9.9	8.7
(BILLION DOLLARS)	84.5	72	78	71
TRADE BALANCE (TRILLION YEN)	-	10.8	11.8	10.9
(BILLION DOLLARS)	94.2	81	93	88
WHOLESALE PRICE INDEX (PERCENT)	-2.0	0.3	0.8	0.9
C.P.I. (PERCENT)	0.5	1.3	0.7	2.0

5. COMMENT. THE FIGURES SHOW THAT GROWTH AND DOMESTIC DEMAND IN FY 1988 HAVE BEEN CONSIDERABLY STRONGER THAN OFFICIALLY FORECAST A YEAR AGO. ON THE OTHER HAND, THE ADJUSTMENTS IN THE TRADE BALANCE AND CURRENT ACCOUNT BALANCES HAVE FALLEN FAR SHORT OF THE GOVERNMENT'S TARGET. THE DECLINE IN THE TRADE SURPLUS, AND THE 0.7 PERCENT NEGATIVE GROWTH IN THE EXTERNAL SECTOR IN THE GNP FORECAST FOR 1989 ARE SOMEWHAT INCONSISTENT AT FIRST SIGHT WITH RECENT DATA WHICH HAS SHOWN SUBSTANTIAL YEAR ON YEAR INCREASES IN EXPORT VOLUMES AND EVEN IN YEN VALUE OF EXPORTS SINCE OCTOBER 1988.

6. FURTHER COMMENT WILL FOLLOW.

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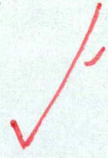
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WMP

JAPAN, GERMANY, US AGREE ON STABLE CURRENCIES NRAG

TOKYO, JAN 11, REUTER - CENTRAL BANKERS FROM JAPAN, WEST GERMANY AND THE U.S. REAFFIRMED THE NEED FOR CURRENCY STABILITY THIS WEEK IN BASEL, BANK OF JAPAN GOVERNOR SATOSHI SUMITA TOLD A PRESS CONFERENCE.

ALL MAJOR NATIONS ARE ALSO CONCERNED ABOUT A REKINDLING OF INFLATION, HE ADDED.

HE SAID THE CURRENCY MARKET IS STILL STABLE AND NOT VOLATILE. THE DOLLAR IS FIRM. HE SAW NO NEED FOR A GROUP OF SEVEN MEETING NOW, BUT SAID A MEETING COULD BE MEANINGFUL IF THE U.S. USED IT TO EXPLAIN ITS POLICY. HE ADDED THAT HE BELIEVES FED WANTS MORE MODERATE U.S. DOMESTIC DEMAND GROWTH.  
11-JAN-0859. MON496 MONC

CONTINUED ON - NRAH

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DEALING - SEE AADA 1002

JAPAN, GERMANY, US AGREE ON STABLE CURRENCIES -PART 2 NRAG

SUMITA SAID HE SHARES A BELIEF IN THE NEED FOR STABLE CURRENCIES WITH FEDERAL RESERVE CHAIRMAN ALAN GREENSPAN AND BUNDESBANK PRESIDENT KARL OTTO POEHL.

BEHIND THE RECENT FIRMNESS OF THE DOLLAR IS CONTINUING BULLISH SENTIMENT SPARKED BY A REBOUND IN OIL PRICES AND REMARKS BY SOVIET LEADER MIKHAIL GORBACHEV LAST MONTH THAT MOSCOW WILL REDUCE ITS CONVENTIONAL ARMED FORCES, HE SAID.

THE POSSIBILITY OF A G-7 MEETING WAS NOT ON THE AGEND OF CENTRAL BANK GOVERNORS WHO MET IN BASLE, SUMITA ADDED. ASKED IF A G-7 MEETING COULD BE HELD IN EARLY FEBRUARY, HE SAID THAT WOULD POSE NO PROBLEM FOR HIM.

11-JAN-0921. MON543 MONC

CONTINUED FROM - NRAG

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CONTINUED ON - NRAI

DEALING - SEE AADA 1002

JAPAN, GERMANY, US AGREE ON STABLE CURRENCIES -PART 3 NRAI

GROWTH IN U.S. DOMESTIC DEMAND SHOULD BE MODERATELY RESTRAINED IN ORDER TO PREVENT A REKINDLING OF INFLATION AND TO RECTIFY ITS TRADE IMBALANCE, SUMITA SAID.

THE U.S. ECONOMY IS STRONG, SUPPORTED BY FIRM EXPORTS, CAPITAL SPENDING AND CONSUMER OUTLAYS, HE SAID.

11-JAN-0925. MON551 MONC

CONTINUED FROM - NRAH

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ENDS

DEALING - SEE AADA 1002

NO COMPETITIVE ROUND OF RATE HIKEs, SUMITA SAYS NRAM  
TOKYO, JAN 11, REUTER - BANK OF JAPAN GOVERNOR SATSOHI  
SUMITA DENIED THAT MAJOR NATIONS HAD EMBARKED ON A COMPETITIVE  
ROUND OF INTEREST RATE HIKEs.

ASKED AT A PRESS CONFERENCE WHETHER HE EXPECTS A CHAIN  
REACTION OF RATE HIKEs AFTER THE LOMBARD RATE INCREASE IN WEST  
GERMANY IN DECEMBER AND RISING SHORT-TERM INTEREST RATES THIS  
MONTH IN THE U.S., HE SAID, "IT IS IMPOSSIBLE. IT WON'T  
HAPPEN."

ASKED ABOUT THE YEN'S STRENGTH AGAINST THE MARK, SUMITA  
SAID THAT IT WAS NATURAL FOR RATES TO MOVE TO SOME EXTENT.  
HOWEVER, MAJOR NATIONS DO NOT WANT TOO MUCH INSTABILITY.

11-JAN-0908. MON515 MOND

CONTINUED ON - NRAM

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DEALING - SEE AADA 1002

NO COMPETITIVE ROUND OF RATE HIKEs, SUMITA SAYS -PART 2 NRAM  
ASKED IF WEST GERMANY FAVOURS A STRONG MARK TO FIGHT  
DOMESTIC INFLATION, SUMITA REITERATED THAT THERE IS NO  
DIFFERENCE OF OPINION AMONG MAJOR NATIONS THAT STABILITY OF  
EXCHANGE RATES IS PARAMOUNT.

11-JAN-0927. MON555 MOND  
CONTINUED FROM - NRAM

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DEALING - SEE AADA 1002

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 TELNO 36  
 OF 110200Z JANUARY 1989  
 AND TO ROUTINE DTI

DTI FOR EJU

OUR TELNOS 1073 AND OTTER 713: VISIT TO UK BY JAPAN CHAMBER OF  
 COMMERCE AND INDUSTRY (JCCI)

1. THE JCCI HAVE NOW REINSTATED THEIR PROPOSED VISIT TO EUROPEAN NATIONS. THE SAME TEAM OF SENIOR INDUSTRIALISTS, TO BE LED BY ROKURO ISHIKAWA (CHAIRMAN, JCCI) PLANS TO ARRIVE IN LONDON ON 7 JUNE AND DEPART FOR TOKYO ON 9 JUNE. THROUGH THE LONDON CHAMBER OF COMMERCE AND INDUSTRY (LCCI) THEY WILL BE REQUESTING CALLS ON THE PRIME MINISTER AND LORD YOUNG ON 8 JUNE. WE HAVE OFFERED THE EMBASSY'S ASSISTANCE, BUT THE JCCI SEEMS INCLINED TO ORGANISE THE PROGRAMME THROUGH THE LCCI. THE TENTATIVE ITINERARY FOR THE VISIT FOLLOWS BY BAG.

2. AS SUGGESTED IN FIRST TUR, THE GROUP INCLUDES SEVERAL INFLUENTIAL INDUSTRIALISTS AND I WOULD RECOMMEND IT BE RECEIVED AT SENIOR MINISTERIAL LEVEL. IT MIGHT ALSO BE VALUABLE AS WELL AS APPROPRIATE FOR HMG TO OFFER SOME FORM OF ENTERTAINMENT.

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ADDITIONAL 44

JAPAN POLITICAL AND ECONOMIC

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PAGE 2  
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When the \$ was strong  
& the US charge <sup>n</sup>

surplus.

I saw ~~at~~ <sup>of</sup> ~~gratify~~ for  
a while from Mr. Wickes  
on whether there is a  
case for using it (it  
only is a Sargent  
Contract) against the Yth  
in current cases.

n



I seem to recall that,  
under an IMF  
Articles, disbursement ~~action~~  
~~can~~ can be taken  
against the currency ~~that~~  
~~is~~ ~~the~~ ~~country~~ of a country  
that was a persistent  
trade surplus (I think it's  
called the Scott currency  
Clause). This has been  
seen before, largely  
because the US forces  
it upon an day  
it was against the \$ -  
that was in the days  
over



FROM: A C S ALLAN

DATE: 13 January 1989

BF  
27/1

MR WICKS

JAPAN

The Chancellor recalls that, under one of the IMF Articles, discriminatory action can be taken against the currency of a country that runs a persistent current account surplus (the 'scarce currency clause'?). This has never been invoked, largely because the US feared it might one day be used against the dollar - that was in the days when the dollar was strong and the US current account in surplus.

2. The Chancellor would be grateful for a note on whether there is any case for using this power (if only as a bargaining counter) against the yen in current circumstances.

ACSA

A C S ALLAN

PS/CHANCELLOR OF THE EXCHEQUER  
TREASURY



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FM TOKYO

TO PRIORITY DTI

TELNO OTTER 039

OF 190800Z JANUARY 89

AND TO ROUTINE FCO, TREASURY; BANK OF ENGLAND, UKREP BRUSSELS

JAPANESE BALANCE OF PAYMENTS: PROVISIONAL TRADE FIGURES

1. THE FOLLOWING ARE PROVISIONAL JAPANESE BALANCE OF PAYMENTS FIGURES FOR DECEMBER 1988 ANNOUNCED BY THE MINISTRY OF FINANCE. THEY ARE ONLY INDICATIVE. MORE PRECISE AND MORE COMPREHENSIVE FIGURES WILL FOLLOW IN REPORT OF SEMI-FINAL FIGURES AND MONTHLY ECONOMIC REPORT. FIGURES ARE CUSTOMS CLEARANCE, EXPORTS FOB, IMPORTS CIF, AND INCLUDE NON-MONETARY GOLD. FIGURES ARE NOT SEASONALLY ADJUSTED. CUMULATIVE FIGURES ARE NOT SEASONALLY ADJUSTED. CUMULATIVE FIGURES ARE DERIVED BY ADDING THE PROVISIONAL FIGURE FOR THE CURRENT MONTH TO LAST MONTH'S SEMI-FINAL CUMULATIVE TOTALS. USDLR MILLIONS, YEN BILLIONS. THE FIGURES IN BRACKETS SHOW PERCENTAGE CHANGE OVER THE SAME PERIOD LAST YEAR. VOLUME FIGURES ARE ONLY AVAILABLE FOR GLOBAL EXPORTS AND IMPORTS.

(A) DECEMBER 1988

2.	US DOLLARS (%)	YEN (%)	CHANGE IN VOLUME (%)
GLOBAL EXPORTS	26080 ( 11.6)	3191 ( 3.3)	( 4.2)
GLOBAL IMPORTS	16434 ( 11.3)	2008 ( 2.6)	(12.6)
BALANCE	9646 ( 12.0)	1182 ( 4.4)	

3.	US DOLLARS (%)	YEN (%)
EXPORTS TO EC	4363 (15.7)	534 ( 7.1)
UK	918 ( 5.6)	112 (-2.3)
IMPORTS FROM EC	2211 (19.7)	270 (10.3)
UK	350 (-1.3)	43 (-9.1)
BALANCE WITH EC	2152 (11.9)	264 ( 4.0)
BALANCE WITH UK	568 (10.4)	69 ( 2.4)

## (B) CUMULATIVE JANUARY - DECEMBER 1988

4.	US DOLLARS (%)	YEN (%)	CHANGE IN VOLUME (%)
GLOBAL EXPORTS	264867 ( 15.6)	33933 ( 1.9)	( 6.1)
GLOBAL IMPORTS	187475 ( 25.4)	24022 ( 10.5)	(16.9)
BALANCE	77392 ( -2.9)	9911 (-14.4)	

5.	US DOLLARS (%)	YEN (%)
EXPORTS TO EC	46867 (24.3)	6002 ( 9.4)

UK	10629 (26.5)	1362 (11.6)
IMPORTS FROM EC	24069 (36.2)	3083 (20.2)
UK	4189 (37.0)	536 (21.0)
BALANCE WITH EC	22798 (13.8)	2919 (-0.1)
BALANCE WITH UK	6440 (20.5)	826 ( 6.2)

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JAPAN POLITICAL AND ECONOMIC

Now

MINISTRY OF FINANCE  
TOKYO

✓  
January 19, 1989

The Right Honourable  
Nigel Lawson, MP  
Chancellor of the Exchequer

Your Excellency:

Thank you very much for your kind message on my appointment as Minister of Finance.

I will try my best to meet the challenge, coming at the very critical moment of international economic cooperation, and would like to ask for your continued support.

Thanking you again,

Sincerely yours,

*Tatsuo Murayama*

Tatsuo Murayama  
Minister of Finance  
Japan



FROM: N L WICKS  
DATE: 25 JANUARY 1989

CHANCELLOR OF THE EXCHEQUER

cc Mr Lankester  
Mr H P Evans  
Mr Peretz  
Mr Walsh

*Thanks. If it is (a) ultra vires →  
→ process →  
→ (b) ultra vires, →  
→ then clear →  
→ no need →  
→ to provide →  
→ further. →*

**JAPAN: THE SCARCE CURRENCY CLAUSE**

Your Principal Private Secretary's minute of 13 January recorded your questions about the Scarce Currency Clause in the IMF Articles and the possibility that we might use it, if only as a bargaining counter, against the Yen.

2. Your recollection of the history is exactly right. I attach an extract from Gardner's standard work on the origins of the IMF. As you will see, it seems that you are on Lord Keynes' side in envisaging the use of the Scarce Currency Clause against a country running a persistent balance of payments surplus, as the USA was then doing. Harry Dexter White took a different view, arguing that the burden of current account adjustment lay just as much with those countries whose current accounts were in deficit.

3. So far as we know, the Scarce Currency Clause, in IMF Article VII, a copy of which is attached, has never been used. As its drafting shows, it was designed for a quite different age from the one in which we now live - fixed exchange rates, exchange controls and domination of the current account to the neglect of the capital account.

4. I have to say that I see no scope for involving Article VII in the circumstances envisaged in your minute because:

i. The original purpose of the Article was for use in circumstances in which "a depression in a major producing country could curtail its imports to the point at which a shortage of its currency might seriously impair the flow of international trade". The present Japanese situation clearly differs from that one.

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ii. Of course, we could argue that it is legitimate to adapt the use of the Article to current circumstances. But I doubt whether we would get much support in the IMF Board. The Germans, whose current account surplus is larger in GNP terms than the Japanese, would see themselves next in line. The Americans would, I judge, not like to use the IMF for this purpose.

iii. Even if the Clause was invoked, all that the Fund would do would be to prepare a report with "recommendations designed to bring it [the scarcity of a particular currency] to an end." The Fund's recommendations could only be the normal policy prescriptions which have been made, with some, though limited, success over the last few years, for reducing the Japanese current account surplus. Much better to concentrate, both bilaterally and in international fora, on pressing the Japanese to take the necessary action rather than getting unsuccessfully bogged down, as I think would happen, in the legal minutiae of the Fund's Articles.

N.L.W.

N L WICKS

EXTRACT FROM "STERLING-DOLLAR DIPLOMACY IN CURRENT PERSPECTIVE"  
The Origins and Prospects of Our International Economic Order

RICHARD N GARDNER

*The American Debate*

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There was still, however, the 'scarce-currency' clause. Did this not establish America's responsibility for reforming its import policy in unmistakable terms? With obvious relish Taft confronted White with Keynes's statement that the clause placed upon the shoulders of the United States the main burden for correcting a disequilibrium in the balance of payments. After reading Keynes's remarks into the record, he asked: 'Now, does that state substantially the results? Do you think it states the result of this conference?'<sup>3</sup> White replied: 'I dislike very much to criticize anything that Lord Keynes has said, because I have a very high regard for his integrity and ability and understanding of the subject. . . . However, I would not have written it that way.'<sup>4</sup> How, then, would he interpret the provision? His answer was already a matter of record:

Very definitely this country assumes no moral responsibility for a scarcity of dollars. The technical representatives of the United States have made it clear to other countries in a number of memoranda that a scarcity of dollars cannot be accepted as evidence of our responsibility for the distortion of the balance of payments. I quote from such a memorandum: 'It should not be overlooked that the disequilibrium in the balance of payments cannot be manifested as a problem peculiar to one country. Whenever the supply of a member country's currency is scarce this scarcity is likely to be accompanied by excessive supplies of the currencies of other countries. In such cases the responsibility for the correction of the maladjustment is not a unilateral one. It will be the duty of the Fund to make a report not only to the country whose currency is scarce but also to the member countries who are exhausting or are using the resources of the Fund in a manner which is not consistent with the purposes of the Fund.'<sup>5</sup>

Now the critics of the Fund had been given assurances on all but one of the major grounds of misgiving. The last, however, proved the

<sup>1</sup> *The New York Herald-Tribune* (27 Feb. 1945).

<sup>2</sup> Statement of the Congress of Industrial Organizations, reported in *The New York Times* (4 Feb. 1945).

<sup>3</sup> Senate Hearings, p. 170.

<sup>4</sup> *Ibid.*

<sup>5</sup> 'The Monetary Fund: Some Criticisms Examined', *For. Aff.*, xxiii (1945), p. 205.

VII. Replenishment and Scarce Currencies

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Article VII

Replenishment and Scarce Currencies

Section 1. *Measures to replenish the Fund's holdings of currencies*

The Fund may, if it deems such action appropriate to replenish its holdings of any member's currency in the General Resources Account needed in connection with its transactions, take either or both of the following steps:

- (i) propose to the member that, on terms and conditions agreed between the Fund and the member, the latter lend its currency to the Fund or that, with the concurrence of the member, the Fund borrow such currency from some other source either within or outside the territories of the member, but no member shall be under any obligation to make such loans to the Fund or to concur in the borrowing of its currency by the Fund from any other source;
- (ii) require the member, if it is a participant, to sell its currency to the Fund for special drawing rights held in the General Resources Account, subject to Article XIX, Section 4. In replenishing with special drawing rights, the Fund shall pay due regard to the principles of designation under Article XIX, Section 5.

Section 2. *General scarcity of currency*

If the Fund finds that a general scarcity of a particular currency is developing, the Fund may so inform members and may issue a report setting forth the causes of the scarcity and containing recommendations designed to bring it to an end. A representative of the member whose currency is involved shall participate in the preparation of the report.

Section 3. *Scarcity of the Fund's holdings*

(a) If it becomes evident to the Fund that the demand for a member's currency seriously threatens the Fund's ability to supply that currency, the Fund, whether or not it has issued a report under Section 2 of this Article, shall

VII. Replenishment and Scarce Currencies

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formally declare such currency scarce and shall thenceforth apportion its existing and accruing supply of the scarce currency with due regard to the relative needs of members, the general international economic situation, and any other pertinent considerations. The Fund shall also issue a report concerning its action.

(b) A formal declaration under (a) above shall operate as an authorization to any member, after consultation with the Fund, temporarily to impose limitations on the freedom of exchange operations in the scarce currency. Subject to the provisions of Article IV and Schedule C, the member shall have complete jurisdiction in determining the nature of such limitations, but they shall be no more restrictive than is necessary to limit the demand for the scarce currency to the supply held by, or accruing to, the member in question, and they shall be relaxed and removed as rapidly as conditions permit.

(c) The authorization under (b) above shall expire whenever the Fund formally declares the currency in question to be no longer scarce.

Section 4. *Administration of restrictions*

Any member imposing restrictions in respect of the currency of any other member pursuant to the provisions of Section 3(b) of this Article shall give sympathetic consideration to any representations by the other member regarding the administration of such restrictions.

Section 5. *Effect of other international agreements on restrictions*

Members agree not to invoke the obligations of any engagements entered into with other members prior to this Agreement in such a manner as will prevent the operation of the provisions of this Article.

## DOLLAR SHORTAGE

In August 1947 the Board considered for the first time the significance of the "scarce currency" clauses (Article VII of the Fund Agreement). There had been considerable discussion, particularly in the British press, of the phenomenon which became known as "the dollar shortage," and the question was raised whether it was appropriate for the Fund to take action under Article VII, either to declare (Section 1) that a general scarcity of dollars was developing, or to decide (Section 3) that the demand for dollars seriously threatened the Fund's ability to supply them.

The Board had no difficulty in deciding that action to declare the dollar scarce under the terms of Section 3 of Article VII was inappropriate; the Fund's holdings of dollars were almost intact, and were most certainly adequate to deal with any demands for dollars that, within the 25 per cent rule under which the Fund was working, would be likely to be received for some time to come. Moreover, its gold holdings were untouched.

A more difficult question concerned the option open to the Fund to declare that a general scarcity of dollars was developing which would make it desirable to inform the members of this fact, and to issue a report on the causes of the scarcity and on possible ways of ending it. The Executive Directors agreed that there certainly was, at that time, an unusual need and demand for dollars. However, it was pointed out that the provisions in Article VII, Section 1, were intended to cover a situation in which a depression in a major producing country could curtail its imports to the point at which a shortage of its currency might seriously impair the flow of international trade. The present situation was quite different. The disparity between the demand for and the supply of dollars did not arise from any diminution of demand for imports by the United States or any refusal by it to extend credits. The disparity arose from a shortage of productive facilities, particularly in European countries, with which dollars could be earned. The real scarcity therefore was one of production, and not of dollars.

Following this argument, the Board decided that there was no reason for the Fund, at that time, to take action, either under Article VII, Section 1, or Article VII, Section 3. It may be added that at no subsequent time did the Board have recourse to Article VII, Section 1 or Section 3. For this there were at least two good reasons: in the first place, the Board was averse to any form of discrimination, and would not have wished to impose discrimination by the use of Article VII; in the second place, once the major currencies had become convertible, the fact that the U.S. dollar was generally used to intervene in foreign exchange markets made it doubtful whether the power to impose limitations on the freedom of operations in the scarce currency would be effective in restoring equilibrium.

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AND TO PRIORITY WASHINGTON, PARIS, BONN, OTTAWA, ROME,  
AND TO PRIORITY UKDEL OECD

PS/CHANCELLOR OF THE EXCHEQUER  
TREASURY



JAPAN: DRAFT BUDGET FOR FY 1989

#### SUMMARY

1. A FORECAST OF 4% GROWTH RATE AND BUOYANT TAX REVENUES HAVE AGAIN ALLOWED THE GOVERNMENT TO PRESENT A BUDGET WHICH INCREASES SPENDING AND AT THE SAME TIME CUTS BORROWING. ODA (UP 7.8%) AND DEFENCE (UP 5.9%) THE MAIN BENEFICIARIES. PUBLIC WORKS SPENDING LITTLE CHANGED, BUT NO SUGGESTIONS THAT A HIGHER LEVEL IS NECESSARY.

#### GENERAL

2. THE GOVERNMENT HAS AGREED A YEN 60.4 TRILLION (#267 BILLION) DRAFT BUDGET FOR FY 1989, WHICH WILL BE PRESENTED TO THE DIET IN FEBRUARY. THE BUDGET TIMETABLE HAS BEEN DELAYED BY ALMOST A MONTH AS A RESULT OF THE EXTENSION OF THE EXTRA-ORDINARY DIET SESSION TO THE END OF DECEMBER IN ORDER TO PASS THE TAX REFORMS BILLS. ALTHOUGH THE BUDGET IS UNLIKELY TO EXCITE MUCH CONTROVERSY IN ITSELF, THERE IS A POSSIBILITY THAT THE OPPOSITION PARTIES MAY ATTEMPT TO DELAY ITS PASSAGE THROUGH THE DIET IN ORDER TO TRY TO INCREASE THE PRESSURE ON THE GOVERNMENT TO DEAL WITH THE RECRUIT COSMOS SCANDAL. EVEN IF THEY DO NOT, THE DIET IS UNLIKELY TO COMPLETE ITS DISCUSSIONS OF THE DRAFT BEFORE THE END OF MARCH, AND IT IS THEREFORE ALMOST CERTAIN THAT A PROVISIONAL BUDGET WILL BE NECESSARY TO TIDE THE GOVERNMENT OVER THE FIRST FEW WEEKS OF APRIL.

3. THE DRAFT BUDGET IS 6.6% HIGHER THAN THE INITIAL FY 1988 BUDGET, BUT ACTUALLY A LITTLE BELOW THE 1988 OUTTURN, WHICH INCLUDES A SUPPLEMENTARY BUDGET OF ABOUT YEN 5 TRILLION (THE LATTER IS ALSO DUE TO BE PRESENTED TO THE DIET NEXT MONTH).

#### EXPENDITURE

4. AFTER ALLOWING FOR THE TWO EXOGENOUS COMPONENTS OF EXPENDITURE, DEBT SERVICE AND TRANSFERS TO LOCAL AUTHORITIES, GENERAL EXPENDITURE IS UP BY 3.3% TO YEN 34.1 BILLION. (TRANSFERS TO LOCAL AUTHORITIES ARE UP BY 22.6%, MAINLY BECAUSE

OF THE REQUIREMENT THAT THE GOVERNMENT HAS TO PASS ON A FIXED PERCENTAGE OF ITS RECEIPTS OF PERSONAL AND CORPORATE TAX REVENUES). WITHIN THE GENERAL EXPENDITURE CATEGORY, ODA IS DUE TO INCREASE BY 7.8%, AFTER A 6.5% INCREASE IN 1988. THIS REFLECTS THE GOVERNMENT'S UNDERTAKING TO COMMIT AT LEAST DOLLARS 50 BILLION IN ODA BETWEEN FY 1989 AND FY 1993. TOTAL ODA IN FY 1989 FROM ALL SOURCES, INCLUDING THOSE FUNDED FROM THE FILP, HAS BEEN ESTIMATED UNOFFICIALLY AT DOLLARS 11 BILLION, AROUND 10% UP FROM 1988: THE RELATIVE STABILITY OF THE EXCHANGE RATE DURING FY 1988 WILL PARTLY ACCOUNT FOR THE MORE MODEST INCREASE IN DOLLAR TERMS THAN IN THE PAST. DEFENCE SPENDING IS THE OTHER MAIN BENEFICIARY, WITH AN INCREASE OF 5.9% TO YEN 3.9 TRILLION, AFTER A 5.2% INCREASE IN 1988. THE RATIO OF DEFENCE SPENDING TO GNP AT 1.006% WILL EXCEED 1% OF GNP FOR THE THIRD SUCCESSIVE YEAR (A FACT WHICH HOWEVER IS NOW UNLIKELY TO EXCITE MUCH COMMENT).

#### PUBLIC WORKS/FILP

5. PUBLIC WORKS SPENDING IN THE GENERAL BUDGET IS DUE TO RISE BY ONLY 1.9%, AFTER ITS 20% INCREASE IN 1988. THE FISCAL INVESTMENT AND LOAN PROGRAMME, HOWEVER, IS DUE TO EXPAND BY 9.1%. IT IS EXPECTED THAT SPENDING BY THE PRIVATE SECTOR ON CONSTRUCTION AND INFRASTRUCTURE PROJECTS WILL CONTINUE TO BE VERY BUOYANT, SO THERE IS NO PRESSURE FOR STIMULATORY MEASURES FROM THE PUBLIC SECTOR.

#### REVENUES AND BORROWING

6. TAX REVENUES ARE EXPECTED TO RISE BY 13.1%, TO YEN 51.0 TRILLION. THIS IS DESPITE THE IMPACT OF THE TAX REFORM PACKAGE, WHICH IS EXPECTED TO LEAD TO A NET REVENUE LOSS OF AROUND YEN 2.6 TRILLION IN A FULL YEAR, BUT MAY PRODUCE A GREATER REVNUUE LOSS IN FY 1989 BECAUSE THE SALES TAX WILL ONLY BE INTRODUCED GRADUALLY DURING THE FIRST SIX MONTHS. THE GOVERNMENT'S OVERALL BORROWING REQUIREMENT IS DOWN NEARLY 20%, TO YEN 7.1 TRILLION. OF THIS TOTAL 'DEFICIT FINANCING' BONDS, WHICH COVER CURRENT SPENDING, WILL ACCOUNT FOR ONLY YEN 1.3 TRILLION, LESS THAN HALF THE 1988 TOTAL. IT SHOULD THEREFORE BE RELATIVELY EASY FOR THE GOVERNMENT TO REACH ITS TARGET OF ELIMINATING DEFICIT FINANCING BONDS COMPLETELY BY 1990. OVERALL, BORROWING WILL FINANCE 11.8% OF THE GENERAL ACCOUNT BUDGET AND REPRESENT 1.8% OF NOMINAL GNP.

#### COMMENT

7. AS LAST YEAR, THE STRENGTH OF THE ECONOMY AND THE BUOYANCY OF TAX REVENUES HAS ENABLED THE GOVERNMENT TO OFFER SOMETHING



TO ALMOST EVERYONE. THE INCREASES IN ODA AND IN DEFENCE SPENDING WILL HELP TO MEET JAPAN'S INTERNATIONAL COMMITMENTS, WHILE THE MAJOR DOMESTIC SPENDING MINISTRIES HAVE ALSO OBTAINED MOST OF WHAT THEY WANTED. AT THE SAME TIME, BORROWING HAS BEEN SHARPLY REDUCED AND THE ELIMINATION OF DEFICIT BONDS BY 1990 - WHICH WAS THOUGHT TO BE AN AMBITIOUS TARGET 2 YEARS AGO - SHOULD NOW BE ACHEIVED EASILY.

8. FURTHER REPORTS ON THE BUDGET WILL FOLLOW BY BAG.

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PS/CHANCELLOR OF THE EXCHEQUER  
TREASURY

RECRUIT SCANDAL: RESIGNATION OF ECONOMIC PLANNING AGENCY  
(EPA) DIRECTOR-GENERAL HARADA

SUMMARY

1. ANOTHER CABINET MINISTER (THE SECOND WITHIN A MONTH) RESIGNS OVER LINKS WITH RECRUIT CO. A SETBACK FOR TAKESHITA BUT THERE IS NO IMMEDIATE DANGER FOR HIS ADMINISTRATION.

DETAIL

2. THE RECRUIT SCANDAL CLAIMED ITS THIRD MINISTERIAL VICTIM YESTERDAY WHEN EPA DIRECTOR GENERAL HARADA RESIGNED AFTER HE REVEALED THAT ONE OF HIS POLITICAL SUPPORT GROUPS HAD RECEIVED DONATIONS FROM RECRUIT CO AND ITS SUBSIDIARY, RECRUIT COSMOS. HARADA HAD CLAIMED IN NOVEMBER LAST YEAR WHEN HE BECAME CHAIRMAN OF THE SPECIAL DIET COMMITTEE ON RECRUIT THAT HE HAD SEVERED ALL LINKS WITH THE COMPANY. MANY SUSPECT THAT THE FULL STORY HAS NOT YET COME OUT, BUT HARADA HAS HIMSELF ADMITTED CONTINUING TO RECEIVE DONATIONS UNTIL WELL AFTER THE RECRUIT AFFAIR FIRST SURFACED LAST JULY. HARADA'S SUCCESSOR IS KOICHIRO AINO, LIKewise A MEMBER OF THE TAKESHITA FACTION.

3. THE LOSS OF HARADA IS A BLOW TO TAKESHITA. HE IS A CLOSE CONFIDENT OF TAKESHITA, A SENIOR MEMBER OF HIS FACTION AND WAS ALSO, UNOFFICIALLY, THE NUMBER TWO IN HIS GOVERNMENT. TAKESHITA'S POLITICAL JUDGEMENT IN APPOINTING HIM IS THEREFORE BEING QUESTIONED. THIS IS PARTICULARLY UNWELCOME WHEN THE OPINION POLLS HAVE BEEN SHOWING A CONTINUING SHARP DROP IN HIS POPULARITY, AND IN THE WAKE OF FOUR OTHER MINISTERIAL RESIGNATIONS IN LITTLE OVER A YEAR.

4. THE OPPOSITION PARTIES HAVE ALL CONDEMNED THIS LATEST INCIDENT WITH THE SOCIALISTS AND COMMUNISTS DEMANDING THE COLLECTIVE RESIGNATION OF THE TAKESHITA CABINET. HOWEVER THE DEMOCRATIC SOCIALIST PARTY (DSP), WHOSE CHAIRMAN TSUKAMOTO HAS BEEN IMPLICATED IN RECRUIT, AND THE KOMEITO WHOSE CHAIRMAN YANO HAS BEEN IMPLICATED IN ANOTHER FINANCIAL SCANDAL, WHILST JOINING IN THE CHORUS, HAVE BEEN A LITTLE MORE CIRCUMSPECT.

5. FOR THE TIME BEING TAKESHITA SEEMS IN NO IMMEDIATE DANGER. HIS STANDING IN THE LDP, WHO HAVE PREDICTABLY CLOSED RANKS, REMAINS ESSENTIALLY UNDAMAGED. HE WAS ABLE TO MINIMISE THE POLITICAL FALL OUT BY DELAYING THE ANNOUNCEMENT OF HARADA'S RESIGNATION UNTIL AFTER THE SUCCESSFUL CONCLUSION OF THIS YEAR'S BUDGET NEGOTIATIONS. A BY-ELECTION IN FEBRUARY WILL PROVIDE AN EARLY INDICATOR OF THE ELECTORAL CONSEQUENCES. THE PUBLIC HAVE BECOME SO CYNICAL ABOUT MONEY POLITICS, THAT THEY SEEM LARGELY UNMOVED BY THIS LATEST REVELATION. TAKESHITA'S MARGIN FOR ERROR IN THE NEXT DIET SESSION HAS BEEN REDUCED SOMEWHAT, BUT THE LDP SEEM CONFIDENT THAT THEY CAN RIDE OUT THE IMMEDIATE STORM.

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JAPAN POLITICAL AND ECONOMIC

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FROM: A C S ALLAN  
DATE: 27 January 1989

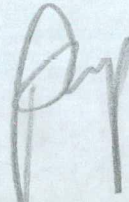
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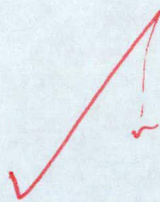
cc Mr Lankester  
Mr H P Evans  
Mr Peretz  
Mr Walsh

**JAPAN: THE SCARCE CURRENCY CLAUSE**

The Chancellor was grateful for your minute of 25 January. If using the scarce currency clause is (a) ultra vires in present circumstances and (b) ineffective, then there is clearly no need to pursue this any further!

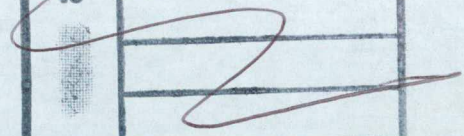
  
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SUMMARY

JAPAN: ANNUAL REVIEW 1988

1. A generally good year for Japan; an excellent year for Anglo-Japanese relations. (para 1)
2. Launching of a new dynamic plain-speaking political partnership and the "Opportunity Japan" campaign to heighten British business' awareness of the Japanese market represented major changes in our bilateral relationship. Well received by the Japanese. (paras 2-3)
3. Whisky issue finally settled; two applications for membership of the Tokyo Stock Exchange still outstanding. Japanese investment in the UK a continuing success story. We should look hard at where the Japanese are going in science and technology, where they are investing more than 5 times as much as the UK. (paras 4-6)
4. 1992 became a major Japanese preoccupation. (para 7)
5. Restructuring of Japanese industry a resounding success. Domestic demand-led growth of 5% and interest rates at 2½% mean that Japan is doing much that the world has been demanding. But Japanese exports are again on an upward trend. Relationship with the US still sound but more choppy water ahead. (paras 8-9)
6. Economic success is now leading to greater political involvement: largest aid donor, first steps to participate in peace-keeping, and much cultural exchange. The "free-ride" period is substantially over. (paras 10-11)
7. Takeshita's success in steering through tax reforms. But financial scandal and the Emperor's terminal illness gave a feeling of drift in the autumn. The Japanese mourned their Emperor before his death. No nationalistic stirrings. (paras 12-13)

BRITISH EMBASSY  
TOKYO

30 January 1989

The Rt Hon Sir Geoffrey Howe QC MP  
Secretary of State for Foreign and  
Commonwealth Affairs  
London

Sir

JAPAN: ANNUAL REVIEW FOR 1988

1. A generally good year for Japan; and an excellent year for Anglo-Japanese relations.
2. 1988 saw a new look in our political and commercial relations. Your visit in January led to the launching of a new dynamic, plain-speaking partnership. The Japanese responded wholeheartedly. The reasons for putting our relations into high gear were compelling: a recognition of Japan's emerging political and macro-economic importance as well as its well-established commercial role; Japanese realisation that she needed to move away from an overgreat reliance on the US; a recognition of Britain's role in the world as a force for stability; a wish on both sides to move towards a constructive relationship over global as well as bilateral issues now that earlier trade disputes had been substantially settled. As a result, the pace and content of political consultations has been transformed and there is a clearly stated wish on both sides that this should lead in short order to more practical cooperation around the world.
3. The trading counterpart of the new political relationship followed at the end of February when Lord Young launched the "Opportunity Japan" campaign. This was designed to encourage British businessmen to see Japan as an opportunity rather than a closed market. It has undoubtedly been successful in bringing the Japanese market more into perspective for many British businessmen. In this the active support of Ministers and of HRH The Duke of Kent has been invaluable - and essential. But the campaign will have to be sustained for some time yet if the hard work is to be reflected in the proposed doubling of British exports in 1988-90. A nearly 20% increase in 1988 is creditable but we shall have to do better in the next two years.
4. The vexed issue of whisky was finally dealt with. The result should offer scope for our whisky exporters to make a major effort

in this market, at last unencumbered by a highly discriminatory Japanese tax system. Four further British firms started trading on the Tokyo Stock Exchange in the spring. But the applications of BZW and James Capel for seats were still outstanding at the end of the year despite discussions at Prime Minister level. This issue was handled less adroitly - too many changes of tack on policy and too much mutual denigration by British securities houses, neither of which enhances our standing with the Japanese or the prospects of obtaining a solution satisfactory to British interests.

5. Japanese investment in the UK has continued to leap ahead both in quantity and quality. Nissan's announcement of stage two of their investment in the North East should be given pride of place but 16 other firms announced new investment decisions and a further 2, Canon and Kobe Steel, decided to establish R&D operations in the UK, while Matsushita chose to site the headquarters of its European operations in London. We should comfortably pass the 100 mark of Japanese investments in the manufacturing sector in the UK during the course of 1989 and maintain our share of roughly one-third of all Japanese investment in Europe.

6. There were also the first stirrings of movement in the science and technology field. A high-powered and highly successful opto-electronics mission visited Japan in the spring. With the Japanese investing more than 5 times as much as the UK in R&D there is an urgent need for more scientific missions to see for themselves at least what challenges the Japanese are likely to be mounting and, preferably more positively, to assess the scope for cooperation which could be of benefit to British industry.

7. 1992 scarcely impinged on Japanese consciousness at the beginning of the year; by the end it had become a major preoccupation. The Japanese professed considerable concern, only partially reassured by statements by EC Commissioners and national governments. They recognised the potential advantage within the EC but were worried by the prospect of a significant move towards regionalism among major trading partners. Japanese fire was concentrated in particular in three main areas: antidumping levies imposed by the European Commission (which the Japanese pressed as far as a GATT case); quantitative restrictions (QRs) still maintained by some EC countries, which the Japanese were also threatening to take to GATT; and moves designed to impose rigid reciprocity requirements when dealing with Japanese concerns. This last issue has come up particularly in the financial services sector. It is reminiscent of Japanese objections to "balance of benefits" arguments at the launch of the Uruguay Round. Then they argued that opportunities in each other's markets should be based on favourable treatment within the framework of each nation's own separate regulations. Now they are prepared to agree that each side should offer opportunities within broadly similar regulatory

systems. But they are resisting any suggestion that it is in actual results that a reasonable balance must be struck. In short, a level playing field as far as regulations and ostensible opportunities are concerned will almost certainly lead, because of Japanese social attitudes and the high cost of establishing a presence in Japan, to the Japanese scoring more goals than a European team.

8. Nevertheless the year has seen very substantial changes both on the domestic economic scene and in Japan's trade with other countries. Pride of place must go to the amazing speed with which large parts of Japanese industry restructured itself successfully to take account of the earlier rapid appreciation of the yen and the need to move up the high technology ladder. The massive stimulus provided by the Japanese government in 1987, together with the buoyancy of the Tokyo Stock Exchange which provided many Japanese companies with substantial profits (the Nikkei index rose by 40% in 1988 leaving far behind the levels reached before Black Monday in October 1987), meant that capital investment rose by nearly 20% on average, 30% in manufacturing industries. This, together with a consumer boom, has meant that 1988 has witnessed strong growth in the economy based mainly on domestic demand. GNP growth of around 4% in FY 1988 may well be repeated in 1989; and the official economic forecasts are for growth of more than 4% a year over the next 4 years. Unemployment fell to 2.5%, basic interest rates reached an historic low of 2.5%, inflation was less than 1%, savings levels remained high (partly induced by the high cost of housing).

9. In 1988 Japan has therefore been the principal locomotive in the world economy and her macro-economic policies have been much in line with what other countries have been demanding. Progress has been less satisfactory over agriculture and the continuing high level of Japanese trading surpluses. On agriculture, American pressure scored some notable successes: bilaterally over beef and citrus, through the GATT over 10 other agricultural items, and towards the end of the year over rice which induced the Japanese to contemplate some liberalisation in return for American agreement to deal with the issue in the context of the Uruguay Round. Despite this, the very success of Japanese industry meant that by the end of 1988 Japanese exports were beginning to move on to an upward trend even in yen terms for the first time for three years. As a result Japanese surpluses came down very slowly in dollar terms (from \$79.8 billion to \$77.4 billion) although they represented only 2.8% of GNP by comparison with 3.6% a year earlier. Japanese institutions have continued to buy US Treasury Bonds heavily while the private sector has maintained its strong rate of investment in real estate and the manufacturing sector in the United States. At the policy level the Japanese continue to argue that a large part of the solution must lie with the Americans: eliminate the budget deficit and increase the savings ratio. There is still much choppy water to be navigated in Japan/US relations in 1989 and beyond but the framework of relations is still sound.



10. The scale of Japanese economic success and the speed with which the most recent moves have taken place has surprised the Japanese themselves as well as much of the rest of the world. It has necessitated policy changes by the Japanese and changed perceptions by others. It was always likely that at some point Japan's economic success would ineluctably lead it into an increasingly influential role in the world politically. 1988 may well be seen in historical perspective as the threshold year in this process.

11. The Japanese have evolved a conceptual framework for this greater political involvement. Prime Minister Takeshita spelt it out in general terms in his Mansion House speech in May: Japan would contribute to the world in 3 ways in particular - through increased aid (where she is just overtaking the United States as the world's largest donor); by contributing to peacekeeping activities, at this stage primarily under the auspices of the United Nations; and through much increased cultural links particularly in the field of language teaching and academic exchanges. The key point in this was highlighted in the annual review of Japanese foreign policy for 1988: "the days have gone when Japan can regard the international environment as a given. Japan's economic weight means that her actions have a major impact not only economically but across the entire spectrum of international relations". From a passive and reactive role which has been the hallmark of Japanese foreign policy for 40 years we are now faced with the prospect of a generally more active role and a variety of initiatives.

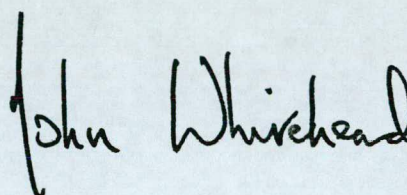
12. On the domestic political scene Takeshita matched expectations: he showed that he has the skill of a wheeler-dealer and remarkable staying power. Both were needed to ensure that the package of tax bills, including the new consumption tax over which two former Prime Ministers had nearly come to grief, were passed by the end of the year. At the same time there was a general feeling of drift, heightened by the Recruit Cosmos scandal with Miyazawa, the Deputy Prime Minister, and Shinto, the long dominant head of NTT, being only the two most prominent figures to resign in the face of accusations that they and many others had received financial favours from a company hell-bent on a very rapid increase in its influence in political, official and business circles. By the end of the year the scandal seemed unlikely to lead to Takeshita's downfall but the popularity of his government had fallen to less than 30% with nearly half those polled being dissatisfied with his performance.

13. The drift was also underlined by the Emperor's terminal illness in the autumn when much of the country practised a measure of respectful self-restraint. The lead was set by Takeshita, who banned overseas visits by his Cabinet colleagues and for nearly a month refused even to go far from Tokyo. Seen from a January vantage point after the death of the Emperor, with the country moving back to normality within 2 or 3 days, it is clear that Japan mourned its Emperor while he was dying rather

than afterwards. Suggestions in the media that this would be a period when the right would attempt to turn the clock back by seeking to raise the Emperor to something like the demi-god status with which he was invested until 1945 have, not surprisingly, been proved to be very wide of the mark. There was undoubtedly a welling up of sentiment among the over forties in Japan for an old man who had suffered with them through bad times and good and who had spent more than half of his life taking responsibility and apologising for the war and then watching over one of the most remarkable economic revivals in history. But there was no widespread nationalistic stirring. The most emotionally charged moments were sparked by attacks on the Emperor in the foreign media, such as the Sun and Star. These led the Japanese to close ranks in a way which substantially ruled out a period of introspection and reflection about the real causes of the war and the atrocities committed during it. Late 1988 would have been the time for this. But the moment passed, partly because of the constrained nature of the Japanese character and partly because of the intemperate and almost certainly ill-directed criticism of the Emperor personally.

14. I am sending copies of this despatch to the Chancellor of the Exchequer, the Secretary of State for Trade and Industry, to HM Representatives in Washington and at UKREP Brussels and to HM Consul General in Osaka.

I am, Sir,  
Yours faithfully



John Whitehead

# dti

the department for Enterprise

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Direct line  
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Date

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23 February 1989

2

### FUJITSU SEMICONDUCTOR PROJECTS

Thank you for your letter of 2 February in which you raised a number of points about our negotiations with Fujitsu.

The Fujitsu negotiating team came to the UK in January. At a late stage and just before they left Japan they approached the DTI through our Embassy in Tokyo about the possibility of Regional Selective Assistance, making it clear that their preferred site in the UK was Newton Aycliffe in County Durham and asking that Locate in Scotland (LIS) should not be informed of their visit to the UK. We found this latter request perplexing but felt bound to respect it since we did not wish to prejudice the chances of their choosing a UK location. We did, however, inform a senior official in IDS about the visit and their unusual request, both as a precaution to ensure that Fujitsu were not conducting parallel negotiations with LIS and as a courtesy in view of Scottish interest in the project.

During the discussions with the IDU it was made clear to Fujitsu that any indicative offer would be equally applicable in any Development Area in England, Scotland, or Wales and this was also stated explicitly in the letter which was subsequently sent to the company and copied to IDS. The contents of that letter were discussed with an IDS official before it was sent. I do not think that there can have been any misunderstanding in the

ROSAAH



the department for Enterprise

Fujitsu negotiating team about the UK basis of the letter. However, it is possible that the company might have felt the need to claim the contrary in subsequent discussions with LIS. No doubt LIS will by now have informed Fujitsu that Cumbernauld would rank similarly for grant and dispelled any lingering illusions some in the company might have had about Scotland and England bidding against each other for the project. I believe that any apparent division between us is more likely to lead to the loss of this important project for the UK than to increase our chances of securing it.

Since Fujitsu were considering locations in different GB territories, a joint assessment of this project might well have avoided the misunderstandings which have arisen. The suggestion for a joint assessment was made by DTI officials, as you say, but was rejected by LIS. Following discussion between senior officials in IDS and DTI it was left that any assessment would be carried out by LIS if Fujitsu decided on a Scottish location and by the DTI/IDU if they decided on an English location. In the event, as Fujitsu informed us that Newton Aycliffe was their preferred location, the negotiation and assessment naturally fell to IDU. I believe that insisting on a joint appraisal and negotiation during their visit would have offended the Fujitsu team especially in view of their specific request that we did not inform LIS of their presence.

I regret that the way in which this matter has developed should have caused you concern. But as you will see from the foregoing we were fully aware of Scottish concerns, and within the peculiar constraints imposed by Fujitsu sought to ensure that your officials were fully in the picture. I can of course gladly respond to your request for consultation on any future dealings with Fujitsu. But might it not help to avoid similar misunderstandings arising in future if we were to come to some arrangement to ensure that information on negotiations for major internationally mobile projects is more widely exchanged between the agencies in the three territories?

I am copying this letter to the recipients of yours.

TONY NEWTON

ROSAAH