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TOKYO ECONOMIC SUMMIT : THE ECONOMIC SITUATION IN JAPAN

SUMMARY

1. THOUGH FUNDAMENTALLY STRONG, THE SHORT-TERM OUTLOOK FOR THE JAPANESE ECONOMY IS CLOUDED BY A FALLING GROWTH RATE, VARIABLE PERFORMANCE IN INDUSTRY AND CONSIDERABLE UNCERTAINTY ABOUT THE FUTURE UNDER THE HIGH YEN. MR NAKASONE IS TORN BETWEEN FOREIGN DEMANDS FOR ACTION ON THE SURPLUSES, AND CRITICISM FROM WITHIN THE PARTY OF HIS HIGH YEN AND FISCAL POLICIES. WITH THE FUTURE OF THE MAEKAWA REPORT SOMEWHAT IN THE BALANCE, SOME ENCOURAGEMENT FROM JAPAN'S PARTNERS TO STAY ON COURSE, AND ABOVE ALL TO INCREASE DOMESTIC DEMAND IS NEEDED TO KEEP MR NAKASONE'S AGENDA ALIVE.

DETAIL

GROWTH

2. JAPAN'S GROWTH RATE HAS BEEN FALLING SINCE MID 1985, AND OUTPUT IN THE MARCH QUARTER IS EXPECTED TO SHOW A THIRD SUCCESSIVE QUARTERLY DECLINE. DOMESTIC DEMAND, PARTICULARLY CONSUMER SPENDING, HAS BEEN WEAK, REFLECTING TIGHT FISCAL POLICY ON THE ONE HAND AND SLOW GROWTH OF REAL INCOME ON THE OTHER. THE GOVERNMENT'S TARGET OF 4% GROWTH IN 1986-7 IS WIDELY REGARDED AS OPTIMISTIC, EVEN AFTER THE EFFECT OF LOWER OIL AND RAW MATERIAL PRICES IS TAKEN INTO ACCOUNT. PRIVATE FORECASTS ARE PREDICTING ONLY 3% GROWTH IN THE ABSENCE OF FURTHER STIMULATORY MEASURES. THEY BELIEVE THAT THE DEFLATIONARY IMPACT OF THE YEN'S APPRECIATION WILL PREDOMINATE INITIALLY, WITH THE FULL BENEFITS REACHING THE ECONOMY GENERALLY ONLY IN EARLY 1987.

THE STATE OF INDUSTRY

3. ALTHOUGH SOME SECTORS, NOTABLY STEEL AND SHIP-BUILDING, ARE IN CHRONIC DIFFICULTIES, CORPORATE INDUSTRY AS A WHOLE, RECORDED HIGH PROFITS IN 1985. BUT THESE ARE BEING RAPIDLY ERODED BY THE YEN'S APPRECIATION. LARGE COMPANIES IN THE AUTOMOBILE AND ELECTRONIC SECTORS ARE TIGHTENING THEIR BELTS, WHILE READJUSTING TO MUCH LOWER PROFIT MARGINS, LOOKING TO NEW, HIGHER VALUE-ADDED PRODUCTS, MORE PROCUREMENT FROM ABROAD, DIRECT FOREIGN INVESTMENT, AND HOPES OF INCREASED INTERNAL DEMAND. THE SMALL AND MEDIUM BUSINESS SECTOR HAS FARED WORSE, BEING SQUEEZED BY COMPETITION FROM THE NICS, PRESSURE TO CUT THEIR PRICES TO LARGE INDUSTRIES, AND THE LOSS OF THEIR OWN EXPORT MARKETS. US AND EC OBJECTIONS TO THE PRINCIPLE OF ADJUSTMENT ASSISTANCE TO SMALL AND MEDIUM INDUSTRIES HAVE BEEN REGISTERED, BUT MR NAKASONE CANNOT AFFORD COMPLETELY TO NEGLECT APPEALS FROM THIS POLITICALLY SENSITIVE SECTOR, AND IN DOUBT WHETHER WE WILL GAIN BY DWELLING FURTHER ON THIS POINT.

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EXTERNAL SURPLUSES

4. ALTHOUGH THE VOLUMES AND YEN VALUE OF EXPORTS ARE NOW BEGINNING TO FALL, MORE NOTICEABLY TOWARDS THE US THAN TOWARDS EUROPE, THE GOVERNMENT ARE ACUTELY AWARE THAT THE CURRENT ACCOUNT SURPLUS MAY WELL EXCEED DOLLARS 80 BILLION THIS YEAR. WITH THE YEN NOW RISING FURTHER THE FEAR IS THAT DEFLATION WILL INTENSIFY, WHILE THE BALANCE OF PAYMENTS SURPLUS IN DOLLAR TERMS CONTINUES TO GROW. SO FAR THE JAPANESE GOVERNMENT HAS DECIDED THAT THE BENEFITS OF THE FALL IN THE OIL PRICES SHOULD BE DIRECTED INTO THE DOMESTIC ECONOMY BY ENCOURAGING REDUCTIONS IN IMPORT PRICES AND ORDERING REBATES TO CONSUMERS ON ENERGY COSTS. THOUGH AWARE OF PRESSURE, FROM OURSELVES AND OTHERS, TO RECYCLE THE WINDFALL TOWARDS LDCS, THE GOVERNMENT HAVE NOT YET SHOWN THEIR FULL HAND IN THIS AREA.

THE EXCHANGE RATE

5. DESPITE COMPLAINTS FROM SMALLER INDUSTRIES, THE GOVERNMENT HAD BROAD SUPPORT IN ALLOWING THE YEN TO APPRECIATE TO THE Y180 LEVEL WITHIN THE FRAMEWORK OF INTERNATIONAL COORDINATION SINCE THE PLAZA AGREEMENT. THE ECONOMIC PACKAGE OF 8 APRIL WAS DESIGNED TO SMOOTH THE TRANSITION TO A NEW PERIOD OF STABILITY AT THAT LEVEL. BUT THE FURTHER STEEP RISE IN THE LAST 10 DAYS ENCOURAGED BY STATEMENTS FROM WASHINGTON AND ELSEWHERE, HAS PRODUCED A SENSE OF CRISIS AND MADE THE GOVERNMENT'S CONTROL OVER EVENTS LOOK MUCH SHAKIER.

THE MAEKAWA REPORT

6. THE REPORT OF THE MAEKAWA COMMITTEE ON STRUCTURAL REFORM IN THE JAPANESE ECONOMY WAS A SYSTEMATIC RESPONSE TO THE PROBLEM OF THE EXTERNAL SURPLUSES AND FOREIGN PRESSURE ON A VARIETY OF FRONTS, ALBEIT CALCULATED WITH THE SUMMIT IN MIND. MR NAKASONE REMAINS PERSONALLY COMMITTED TO ITS RECOMMENDATIONS: A NEW GOVERNMENT/LDP COMMITTEE TO PROMOTE STRUCTURAL ADJUSTMENT WAS SET UP ON 22 APRIL: THE TIME TABLE FOR FOLLOWUP AND MAYBE SOME FIRST MEASURES, COULD STILL BE ANNOUNCED BEFORE THE SUMMIT. BUT IN THE ABSENCE OF CONSTRUCTIVE FOREIGN PRESSURE THE PACE IS GOING TO BE SLOW. THE INFLUENCE OF THE MINISTRY OF FINANCE IS HEAVILY AGAINST NEW GOVERNMENT SPENDING. SUPPORT FOR THE REPORT IN THE PARTY IS LARGELY CONFINED TO ITS GENERAL PRINCIPLES. MR ABE AND MR TAKESHITA HAVE KEPT SILENT ABOUT IT. WHILE FOR EXAMPLE THERE IS SOME UNDERSTANDING OF THE NEED FOR TAXATION OF SMALL SAVINGS TO CORRECT THE IMBALANCE BETWEEN SAVINGS AND CONSUMPTION, AND SUPPORT FOR STIMULATORY MEASURES IN THE HOUSING SECTOR, PROSPECTS ARE POOR FOR ANY REAL MOVEMENT ON AGRICULTURAL IMPORTS, AND THERE REMAINS STRONG RESISTANCE TO RESTRUCTURING AND RUNDOWN OF REGIONALLY SIGNIFICANT SMALL INDUSTRIES. TAX REFORM IS ADVANCING SLOWLY BUT THE NECESSARY CHANGES WILL ONLY BEGIN TO BE IMPLEMENTED FROM APRIL 1987 AT THE EARLIEST.

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7. FURTHERMORE, THE FACT THAT MR NAKASONE'S HOPES OF PROLONGING HIS TERM OF OFFICE ARE WIDELY ASSUMED TO BE RIDING ON AN EARLY ELECTION FOLLOWING A SUCCESSFUL SUMMIT, HAS CAUSED THE OPPOSING FACTIONS IN HIS PARTY TO INTENSIFY THEIR CRITICISM OF HIS ECONOMIC MANAGEMENT AT HOME, AND OF HIS PROMISES TO THE OUTSIDE WORLD TO TRY TO FORCE THE PACE OF JAPAN'S STRUCTURAL CHANGE (MY TELNO 441). THOUGH HE STILL SEEMS TO HAVE THE INITIATIVE, MR NAKASONE'S ROOM FOR MANOEUVRE IN THE INTERNATIONAL ECONOMIC AREA IS LESS THAN THE EXTERNAL STRENGTH OF THE JAPANESE ECONOMY WOULD SEEM TO IMPLY.

CONCLUSION

8. WHATEVER MR NAKASONE'S OWN FORTUNES ONCE THE SUMMIT AND ROYAL VISIT ARE OVER, IT IS VERY MUCH IN OUR INTEREST THAT HIS POLICIES SHOULD SURVIVE INTO THE NEXT POLITICAL PHASE, AND THEREFORE THAT HIS PARTNERS SHOULD SUPPORT AND WELCOME THE LONG-TERM GOALS IN THE MAEKAWA REPORT. A PUBLIC COMMITMENT BY JAPAN TO REDUCE ITS IMBALANCES AND TAKE EARLY ACTION TO IMPLEMENT PROPOSALS FOR STRUCTURAL REFORM WOULD BE A VALUABLE OUTCOME OF THE SUMMIT. TO GIVE CREDIBILITY TO THIS EFFORT, ACTION IS REQUIRED ABOVE ALL TO INCREASE DOMESTIC DEMAND AND CONSUMPTION, AND FURTHER TO IMPROVE MARKET ACCESS. MR NAKASONE MAY WELL COUNTER PRESSURE FOR SUCH ACTION WITH A REQUEST FOR MORE COORDINATED MEASURES TO STABILISE THE YEN. SPECIFIC PRESSURE ON SHORT TERM IMPORT PROPENSITY IS LIKELY TO BE MET WITH REFERENCE TO THE FAVOURABLE CLIMATE CREATED FOR FOREIGN EXPORTERS BY THE EXCHANGE RATE. BUT THERE WILL BE OPPORTUNITIES IN PRIVATE CONVERSATION FOR MENTIONING SPECIFICALLY BRITISH INTERESTS IN THE TRADE AREA

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