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Very useful telegram – could be helpful at Venice. CDP.

MIPT: JAPAN: THE SUMIT: THE JAPANESE ECONOMY, THEN YEN AND THE SURPLUSES

SUMMARY

1. JAPAN'S CURRENT ACCOUNT SURPLUS IN DOLLAR TERMS UNLIKELY TO DECLINE IN THE MEDIUM TERM, AND WILL GROW IN THE LONGER TERM. THOUGH IT MAY DECLINE AS A PERCENTAGE OF GDP THIS IS BECAUSE, ASSUMING FREE TRADE CONDITIONS, THERE WILL STILL BE MARKETS FOR JAPAN'S VISIBLE EXPORTS, AND BECAUSE HER RAPID BUILDUP OF NET OVERSEAS ASSETS WILL PROVIDE SUBSTANTIAL INVISIBLE RECEIPTS. THE LAST YEAR HAS SEEN SUBSTANTIAL ADJUSTMENTS IN IMPORTS, EXPORTS AND INDUSTRY, BUT JAPANESE MANUFACTURERS AS A WHOLE HAVE ADAPTED TO THE HIGHER YEN AND COVERED ANY OPERATING LOSSES BY DISPOSAL OF LAND AND STOCKS. THEIR BROAD FUTURE STRATEGY IS TO MOVE UP THE TECHNOLOGICAL SCALE TO KEEP AHEAD OF THE NICS AND DEVELOP NON-PRICE ADVANTAGES. OVERSEAS INVESTMENT ESPECIALLY IN MANUFACTURE OF MEDIUM-TECH PRODUCTS WILL CONTINUE. STIMULATION OF DOMESTIC DEMAND BY THE GOVERNMENT WILL COMPENSATE FOR THE CURRENT FALL IN EXTERNAL DEMAND AND EASE THIS PROCESS OF TRANSITION, BUT WILL NOT GREATLY INCREASE IMPORTS,(HIGHEST JAPANESE ESTIMATES ARE FOR AN INCREASE OF DOLLARS 6 BILLION) UNLESS ACCOMPANIED BY MEASURES TOREMOVE IMPORT BARRIERS AND DEREGULATE MARKETS, INCREASE PERSONAL CONSUMPTION AND ENCOURAGE PRIVATE DOMESTIC INVESTMENT. SUCH MEASURES ARE LIKELY TO BE SLOW IN COMING. JAPAN LIKELY TO TRY TO MEET SHORT TERM TRADE PROBLEMS WITH AD HOC EXPORT RESTRAINT.

DETAIL

2. THE VENICE SUMMIT IS A USEFUL OPPORTUNITY TO LOOK AGAIN AT WHAT HAS HAPPENED TO JAPAN'S ECONOMY AND PROSPECTS FOR ITS TRADE BALANCES SINCE MY PREDECESSOR'S DESPATCH OF 7 JULY 1986. I WILL DELIBERATELY LEAVE ASIDE QUESTIONS OF CURRENT FISCAL POLICY AND THE RECENT PACKAGE, ALREADY REPORTED IN MY TELNO 436 AND BEING FOLLOWED UP ELSEWHERE,JND TRY TO LOOK AT THE LONGER TERM, UNDERLYING TRENDS.

3. IN THE LAST YEAR, YEN APPRECIATION HAS BROUGHT ABOUT CONSIDERABLE SHORT TERM ADJUSTMENTS IN JAPAN'S IMPORTS EXPORTS AND INDUSTRY, WITH THE SEVEREST IMPACT FALLING ON THE PROFITS AND INVESTMENT OF MANUFACTURING INDUSTRY. WITH A FURTHER 12% APPRECIATION AGAINST THE DOLLAR THIS YEAR, THE J-CURVE CONTINUES /TO

TO INFLATE THE DOLLAR EXPORT FIGURES. THE YEN EXPORT FIGURES (WHICH THE JAPANESE ALWAYS QUOTE) SHOW A DECLINE OF 8.6% OVERALL (ALL COMPARISONS ARE BASED ON MOF STATISTICS FOR JAN-APRIL 87 OVER JAN-APRIL 86 UNLESS OTHERWISE NOTED). NOTABLE FALLS INCLUDE CARS (UNITS DOWN 6.5%), CERTAIN TEXTILES, METAL PRODUCTS, MACHINE TOOLS AND CONSUMER ELECTRICAL GOODS SUCH AS TVS AND VTRS). BUT THE PICTURE IS NOT UNIFORM. EXPORTS OF ELECTRIC COMPONENTS ARE UP 11.6%: OFFICE MACHINERY 8.9% AND CAR PARTS (REFLECTING OVERSEAS ASSEMBLY) BY 11.5%. WHILE EXPORTS TO THE US ARE DOWN 12.8% IN YEN, THEY ARE UP 7.6% TO THE EC (1% TO UK, 13.8% TO FRG). THE MOST SIGNIFICANT FIGURE, HOWEVER, CONSIDERING THE DEGREE OF EXCHANGE RATE ADJUSTMENT, IS THAT EXPORT VOLUMES (GLOBAL) ARE DOWN LESS THAN ONE PERCENT.

4. THE VOLUME OF IMPORTS, UP 6.9%, SHOWS HEALTHY GROWTH THOUGH NOW COOLING SLIGHTLY. FAST INCREASING ITEMS ARE ALCOHOLIC BEVERAGES (21% IN YEN TERMS), VEHICLES (39%), CLOTHING (35%). MANUFACTURES OVERALL ARE UP BY 29.4%, EXCLUDING GOLD. THE OVERALL IMPORT PRICE INDEX (INCLUDING OIL) FELL BY 24.6% IN YEN (YMIF IN DOLLARS). RETAIL PRICES OF CONSUMER IMPORTS HAVE DECLINED, EG FOR WHISKY, BUT THE SITUATION IS PATCHY, WITH A LOT ABSORBED BY DISTRIBUTORS. THE EC IS ENJOYING A GROWING SHARE OF JAPANESE IMPORTS (UP 8.6% IN YEN INCLUDING GOLD): FRG INCREASE IS 12.2% , FRANCE 18.2% AND UK 1.4% (EXCLUDING GOLD).

5. PERSONAL CONSUMPTION HAS HELD UP, AND AS WOULD BE EXPECTED THE POWER, SERVICE AND CONSTRUCTION SECTORS HAVE PROSPERED FROM LOWER INPUT PRICES AND LOWER INTEREST RATES. HOUSING INVESTMENT WAS UP 12% IN 1986 AND CAPITAL INVESTMENT IN THE NON-MANUFACTURING SECTOR ROSE BY 8.7%. THE MANUFACTURING SECTOR, BY CONTRAST, SUFFERED MUCH REDUCED PROFITS AND CAPITAL INVESTMENT IN 1985 AND 1986, BUT FROM VERY HIGH PREVIOUS LEVELS. ONLY IN SOME BASIC INDUSTRIES, INCLUDING SHIPBUILDING, STEEL, COAL AND ALUMINIUM IS WHOLESALE CONTRACTION TAKING PLACE UNDER GOVERNMENT GUIDANCE, WITH INEVITABLE EFFECTS ON UNEMPLOYMENT WHICH IS OVER 3%. GENERALLY THE NUMBER OF BANKRUPTCIES IS LOW. MANY COMPANIES HAVE BEEN CUSHIONED BY THE CONTINUING RISE OF LLAND AND STOCK PRICES. THE BANK OF JAPAN BELIEVES THAT ADJUSTMENTS IN THE MANUFACTURING SECTOR HAVE NOW TAKEN PLACE, THAT INVENTORIES WILL RISE AGAIN, AND MANUFACTURING PROFITS WILL RISE BY 6.9% IN THE FIRST HALF OF FY 1987. (ON THE ASSUMPTION THAT THE EXCHANGE RATE REMAINS STABLE FROM NOW ON). ALTHOUGH IN THEIR TERMS SOME SECTORS ARE UNDERGOING UNPRECEDENTED HARDSHIPS, ONE SHOULD BE SCEPTICAL OF SOME JAPANESE ACCOUNTS OF THEIR ECONOMIC PROBLEMS.

6. REAL ADJUSTMENTS ARE NONETHELESS TAKING PLACE IN JAPANESE EXPORTING COMPANIES WHICH WILL ENSURE THEIR ABILTIY TO CONTINUE TO COMPETE INTERNATIONALLY AT EVEN HIGHER LEVELS OF THE YEN THAN AT PRESENT AND TO FULFIL THEIR OBLIGATIONS TO MAINTAIN EMPLOYMENT IN JAPAN. AS SHORT TERM MEASURES THEY HAVE CUT UNIT EXPORT PRICES AND CUT COSTS AT SACRIFICE TO WAGES AND THEIR SUBCONTRACTORS. STRATEGICALLY, THE MAJOR COMPANIES ARE /PLANNING

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PLANNING TO KEEP AHEAD OF THE NICS BY MOVING FROM MEDIUM-TECH, LOW COST, HIGH-VOUME PRODUCTION INTO PRODUCTION OF HIGH-TECH, LOWER VOLUME ITEMS WHICH, BEING UNAVAILABLE ELSEWHERE, CAN STILL BE MADE IN JAPAN AND EXPORTED PROFITABLY DESPITE A HIGH YEN. COMPANIES ALREADY IN THESE FIELDS, EG NEC, FUJITSU AND HITACHI, HAVE INCREASED THEIR EXPORTS OF DISK-DRIVES THIS YEAR AND ANTICIPATE STRONG SALES OF THEIR MAIN FRAME COMPUTERS. SOME MAJOR COMPANIES ARE ALSO LOOKING AT MAJOR DIVERSIFICATION IN THE NEXT CENTRY (TOYOTA INTO TELECOMMUNICATIONS AND REAL ESTATE. NISSAN AND MITSUBISHI INTO AEROSPACE). CONCURRENTLY THE JAPANESE WILL CONTINUE TO SHIFT ABROAD THE PRODUCTION OF MORE MEDIUM TECHNOLOGY, PRICE-SENSITIVE PRODUCTS, SUCH AS VTRS, AUDIO PRODUCTS, PRINTERS, MICROWAVE OVENS ETC.

7. NEW DIRECT INVESTMENT AT US DOLLARS 14BILLION WAS HOWEVER ONLY 11% OF TOTAL JAPANESE LONG TERM OVERSEAS INVESTMENT IN 1986. JAPANESE COMPANIES HAVE INVESTED HEAVILY IN FOREIGN SECURITIES AND REAL ESTATE AND THEIR WEIGHT IS NOW A SIGNIFICANT FACTOR IN THE US AND OTHER BOND MARKETS. NET OVERSEAS ASSETS TOTALLING US DOLLARS 180 BILLION AT THE END OF FY 1986, AND ARE EXPECTED TO QUADRUPLE IN THE NEXT DECADE. THE JAPAN ECONOMIC RESEARCH CENTRE PREDICTS THAT HALF OF JAPAN'S CURRENT ACCOUNT SURPLUS OF US DOLLARS 200 BILLION IN 2000 WILL BE IN NET RECEIPTS FROM OVERSEAS INVESTMENTS, AND THAT SERVICES WILL ALSO BE A MAJOR SURPLUS ITEM IN THE CURRENT ACCOUNT.

8. THE MAIN EFFECT OF THE ECONOMIC PACKAGE OF 29 MAY WILL BE TO COUNTER THE DEFLATIONARY IMPACT OF THE FALL IN NET EXTERNAL DEMAND AND THEREBY REDUCE THE FRICTIONS FROM THE PROCESS OF TRANSITION DESCRIBED ABOVE. PRIVATE FORECASTS SUGGEST IT WILL BOOST GNP GROWTH BY BETWEEN 0.6 AND 0.9 PERCENT IN THIS FY TO AROUND 2.8 PERCENT AND REDUCE THE TRADE SURPLUS BY BETWEEN US DOLLARS 3 AND 6 BILLION (ONLY 0.3 BILLION BEING ATTRIBUTABLE TO REDUCED EXPORTS DUE TO INCREASED INTERNAL DEMAND). THE GOVERNMENT ESTIMATE FOR TOTAL IMPORT OF 2% ON GNP, ENABLING THEM TO REACH THEIR TARGET OF 3.5% IN 1987.

9. APPROVAL HERE FOR THE GOVERNMENT'S INCREASED SPENDING PLANS HAS BEEN ACCOMPANIED BY DOUBTS AS TO WHETHER PERSONAL CONSUMPTION AND PRIVATE CAPITAL INVESTMENT WILL FOLLOW SUIT, AND A RECOGNITION IN PRESS AND ACADEMIC COMMENT THAT SUCH POLICIES WILL HAVE LITTLE EFFECT ON THE TRADE IMBALANCE UNLESS FAR MORE RADICAL MEASURES ARE TAKEN TO REMOVE IMPORT BARRIERS (INCLUDING ON AGRICULTURAL PRODUCTS) TO OPEN DOMESTIC MARKETS IN AREAS SUCH AS CONSTRUCTION, AND PROMOTE PRIVATE INVESTMENT AND CONSUMPTION BY RAPID DEREGULATION AND FISCAL INCENTIVES.

10. SO FAR THE JAPANESE GOVERNMENT HAS RESPONDED ONLY WEAKLY TO THIS MESSAGE. OF THE VARIOUS MEASURES PROPOSED IN THE MAEKAWA REPORT THE ACCELERATION OF JAPAN'S AID TARGET, SOME MINOR MEASURES FOR REGIONAL ECONOMIES AND SMALL AND MEDIUM ENTERPRISES AND SOME DERESTRICTION OF LAND WOULD HAVE OCCURED IN ANY EVENT. THE PACKAGE ITSELF INCLUDES A MASSIVE PLAN TO RECYCLE SURPLUS YEN

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TO LDC'S, AND GOVERNMENT LED EXPANSION OF SOCIAL CAPITAL AND HOUSING. PRODUCER PRICES FOR SOME AGRICULTURAL PRODUCTS WILL BE CUT THIS YEAR, LARGELY TO HELP THE FOOD PROCESSING INDUSTRY. THERE IS TALK OF SOME REFORM OF PROTECTED PETROLEUM REFINING INDUSTRY. BUT ISSUES SUCH AS TAX REFORM, AGRICULTURAL LIBERALISATION, LAND POLICY, REDUCTIONS IN WORKING HOURS, DEREGULATION AND STREAMLINING OF THE DISTRIBUTION SYSTEM WHICH MIGHT CUMULATIVELY RAISE JAPAN'S IMPORTS QUITE CONSIDERABLY, ARE STILL REGARDED AS TOO SENSITIVE TO RUSH.

11. ASSUMING NO MAJOR NEW CHANGES, THOSE LIKELY TO BENEFIT MOST FROM ANY RISE IN JAPAN'S IMPORTS ARE THE ASIAN NICS, WHO ON CURRENT TRENDS ARE EXPECTED TO TAKE AN INCREASING SHARE OF JAPANESE INVESTMENT AND TRADE. TRADE WITH THE US AND EUROPE SEEMS LIKELY TO REMAIN IN SUSTAINED SURPLUS. THE JAPANESE ARE LIKELY TO MEET ANY RENEWED TRADE FRICTION FROM THEIR PARTNERS WITH AD HOC OFFERS OF VOLUNTARY EXPORT RESTRAINT.

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