

CONFIDENTIAL

071363
MDADAN 5251

CONFIDENTIAL

FM TOKYO

AMENDED DISTRIBUTION 041006Z JUL

TO IMMEDIATE FCO

TELNO 618

OF 040230Z JULY 89

INFO IMMEDIATE UKREP BRUSSELS, PARIS

INFO PRIORITY BONN, OTTAWA, ROME, WASHINGTON,

INFO PRIORITY HONG KONG (FOR SECRETARY OF STATE'S PARTY)

THE PARIS SUMMIT : THE JAPANESE ECONOMY AND DEBATE ON
STRUCTURAL REFORM

SUMMARY

1. CONFIDENCE IN THE DOMESTIC ECONOMY REMAINS STRONG AND GROWTH OF AROUND 5% LIKELY AGAIN THIS YEAR. CONCERN ABOUT INFLATIONARY TRENDS AND THE ADVERSE IMPACT OF DOLLAR APPRECIATION UPON PRICES AND EXTERNAL ADJUSTMENT. NOTWITHSTANDING THE PACE OF OVERSEAS DIRECT INVESTMENT, IMPROVEMENT IN THE TRADE BALANCE HAS STAGNATED, DUE MAINLY TO THE FLEXIBILITY OF JAPANESE MANUFACTURING. TRADE POLICY INFLUENCED BY BILATERAL US-JAPAN PROBLEMS. THE NEED FOR STRUCTURAL REFORM INCREASINGLY ACCEPTED, BUT NOT ONLY BY JAPAN. DESPITE THE UNPROMISING POLITICAL JUNCTURE, G7 PARTNERS SHOULD PRESS THE CASE.

DETAIL

GROWTH

2. THERE IS STILL STRONG CONFIDENCE IN THE DOMESTIC ECONOMY. INDUSTRIAL PRODUCTION INCREASED BY 8% ON AVERAGE AND BY 15% IN THE MACHINERY SECTOR IN FY 1988. BASIC INDUSTRIES SUCH AS STEEL AND SHIPBUILDING HAVE MADE A STRONG RECOVERY. PROFITS IN THE MANUFACTURING SECTOR AS A WHOLE IN OCTOBER TO MARCH 89 WERE 50% ABOVE THE PREVIOUS PERIOD. NEW CAPITAL INVESTMENT IS EXPECTED TO MAINTAIN ITS CURRENT GROWTH RATE OF NEARLY 20% FOR THE REST OF THIS YEAR, WITH A STRONG BIAS TOWARDS A TECHNOLOGY AND EFFICIENCY IMPROVEMENT RATHER THAN SHORT-TERM CAPACITY EXPANSION. AFTER REAL GNP GROWTH OF 5.1% IN FY 1988, MOST FORECASTS SUGGEST THAT THIS CONTINUING INVESTMENT DRIVE OF JAPANESE INDUSTRY AND HEALTHY PERSONAL CONSUMPTION, SUPPORTED BY REAL WAGE INCREASES OF 3-4%, WILL PRODUCE GNP GROWTH WELL ABOVE THE GOVERNMENT'S 4.0% TARGET,

AND PROBABLY CLOSER TO 5% IN 1989.

INFLATION AND THE EXCHANGE RATE

3. THE MAIN CONCERN OF THE AUTHORITIES SO FAR THIS YEAR HAS BEEN THE UPWARD TREND IN PRICES AND THE ERRATIC MOVEMENT OF THE DOLLAR AGAINST THE YEN. THE CPI IS CURRENTLY ABOUT 2.9%, AND THE WPI 3.8%, ABOVE ITS PREVIOUS YEAR'S LEVEL. MOST OF THE RECENT INCREASE ESPECIALLY IN THE CPI IS DUE TO THE INTRODUCTION OF THE CONSUMPTION TAX, THE IMPACT OF WHICH OUGHT NOW TO BE LARGELY OVER. DESPITE SOME SIGNS OF TIGHTNESS IN THE LABOUR MARKET, THERE IS STILL AMPLE DOMESTIC CAPACITY, AND RISING PRODUCTIVITY. THE GOVERNMENT BELIEVES THEREFORE THAT DOMESTIC PRICES ARE STILL FUNDAMENTALLY STABLE. HOWEVER THE FALL IN THE YEN IS BEGINNING TO HAVE SOME EFFECT ON WHOLESALE PRICES. UNLESS THE YEN STRENGTHENS SIGNIFICANTLY AND RETURNS TO THE Y120-Y130 RANGE, THE GOVERNMENT'S OFFICIAL FORECAST OF A CPI RISE OF 2% IN FY 1989 LOOKS INCREASINGLY UNREALISTIC. CONSEQUENTLY ALTHOUGH THE BANK OF JAPAN IS NOT ADVOCATING A FURTHER RISE IN THE OFFICIAL DISCOUNT RATE AT THIS STAGE, FURTHER INCREASES CANNOT BE RULED OUT.

4. THE JAPANESE GOVERNMENT HAS CONTINUED TO MAINTAIN THAT THE YEN'S SUDDEN WEAKENING WAS AN ABERRATION FED BY SPECULATION, AND THAT IT SHOULD NOW RESUME A STEADY UPWARD PATH. FOR REASONS OF STRUCTURAL ADJUSTMENT THE BANK OF JAPAN AND GOVERNMENT CONSIDER THE CURRENT LEVEL OF OVER Y140 TOO HIGH, AND OUT OF LINE WITH FUNDAMENTALS: THE BANK OF JAPAN HAS SPENT AN ESTIMATED DOLLARS 14 BILLION IN INTERVENTION IN MAY AND JUNE ALONE, AND GOVERNOR SUMITA HAS DECLARED THE BANK'S INTENTION TO KEEP INTERVENING AS APPROPRIATE TO BRING THE YEN BACK TOWARDS THE GOVERNMENT'S PREFERRED RATE OF Y130.

EXTERNAL ADJUSTMENT

5. THERE IS CONCERN ABOUT THE SLACKENING PACE OF EXTERNAL ADJUSTMENT AS MEASURED BY THE REDUCTION IN THE TRADE BALANCE, THOUGH THE PROBLEM IS CURRENTLY SEEN LARGELY AS A US-JAPAN PROBLEM DUE TO JAPAN'S CONSPICUOUS SHARE OF THE US TRADE DEFICIT AND TRADE PRESSURE FROM CONGRESS. THE TRADE SURPLUS IN FY 1989 IS EXPECTED TO BE CLOSE TO LAST YEAR'S LEVEL OF DOLLARS 95 BILLION, WITH A FURTHER SLIGHT DECLINE IN THE CURRENT ACCOUNT SURPLUS DUE MAINLY TO JAPANESE TOURISM.

THE PRINCIPAL REASON FOR THE GLOBAL TRADE IMBALANCE IS THAT INDUSTRY'S ADJUSTMENT TO THE HIGHER YEN THREE YEARS AGO SET IN TRAIN INVESTMENTS AND RESEARCH WHICH, THOUGH SUPPORTED BY STRONG DOMESTIC DEMAND, RAISED THE INTERNATIONAL COMPETITIVENESS OF JAPANESE EXPORTS PARTICULARLY IN THE MACHINERY AND INFORMATION TECHNOLOGY AREAS. ANOTHER CONTRIBUTORY FACTOR HAS BEEN THE INCREASE IN EXPORTS OF PARTS AND PLANT AS A RESULT OF JAPANESE DIRECT OVERSEAS INVESTMENT. EXPORTS HAVE BEEN ON A STEADILY RISING TREND SINCE MID 1988: IN JAN-MAY 1989 THEY WERE 4.3% IN VOLUME TERMS AND 9.4% IN DOLLAR TERMS ABOVE THEIR 1988 LEVELS. BY CONTRAST THE GROWTH IN MANUFACTURED IMPORTS WHICH HAS CONTINUED AT AN ANNUAL RATE OF 30% FOR THE LAST THREE YEARS, SHOWS SIGNS OF FALLING, LEADING TO CONCERN ABOUT THE IMPACT OF FURTHER YEN DEPRECIATION. IN TRADE WITH THE EC THE PACE OF EXPANSION HAS COOLED SLIGHTLY IN BOTH DIRECTIONS. EUROPEAN EXPORTS TO JAPAN GREW BY 17% IN JANUARY-MAY (WITH ALCOHOLIC BEVERAGES AND CARS DOING PARTICULARLY WELL). OUR OWN FIGURES SHOW A UK INCREASE OF 37% IN STERLING TERMS. HOWEVER, IT IS NOTICEABLE THAT US EXPORTS TO JAPAN, WHICH HAVE LAGGED BEHIND THE COMMUNITY IN GROWTH IN THE LAST TWO YEARS, HAVE INCREASED MARKEDLY IN RECENT MONTHS.

OVERSEAS INVESTMENT

6. THE STRONG TREND IN OVERSEAS PRODUCTION CONTINUES. THE TOTAL DIRECT INVESTMENT REPORTED IN FY 1988 WAS DOLLARS 47 BILLION, OF WHICH DOLLARS 13.8 BN WAS IN MANUFACTURING. 20% OF THE TOTAL WENT TO EUROPE. DESPITE THE BLUSTER ABOUT FORTRESS EUROPE 1992 IS ACTING AS A MAJOR INCENTIVE TO JAPANESE BUSINESSES, ESPECIALLY IN FINANCIAL SERVICES, TO ESTABLISH THEMSELVES INSIDE THE MARKET. MANY MANUFACTURING COMPANIES ARE NOW BEGINNING TO ESTABLISH R AND D CENTRES IN THE COMMUNITY WHICH WILL MAKE THEM AT THE SAME TIME MORE EUROPEAN AND MORE COMPETITIVE WORLD-WIDE.

FISCAL POLICY

7. THE PRIMARY CONCERN OF GOVERNMENT ECONOMIC POLICY IS TO PROLONG THE CURRENT EXPANSION IN THE DOMESTIC GROWTH AND AVOID INFLATION. WITH THE EFFECT OF NET TAX DECREASES IN FY 1988/89 STILL WORKING THROUGH AND REAL WAGES RISING THERE IS NO CALL FOR OTHER EXPANSIONARY MEASURES. THE CURRENT OUTLINE OF THE BUDGET FOR FY 1990 CONTINUES THIS YEAR'S

LEVELS OF PUBLIC WORKS EXPENDITURE WHILE FURTHER RESTRICTING GOVERNMENT CURRENT EXPENDITURE, EXCEPT FOR FURTHER INCREASES IN ODA AND DEFENCE BUDGET.

TRADE POLICY

8. RELATIONS WITH THE US CONTINUE TO COLOUR THE JAPANESE APPROACH TO TRADE POLICY AND STRUCTURAL REFORM. THEY HAVE JUST CONCLUDED A NEW AGREEMENT ON TELECOMMUNICATIONS UNDER THREAT OF U.S. SANCTIONS, AND, DESPITE THEIR FORMAL POSITION THAT THEY WILL NOT FORMALLY NEGOTIATE ON THE THREE SUPER 301 ITEMS (SUPERCOMPUTER PROCUREMENT, SATELLITES AND FOOD PRODUCTS) THE JAPANESE INSTINCT WILL BE TO TRY TO FIND WAYS OF SATISFYING THE US IN SUBSTANCE. COINCIDENTALLY THE MITI MINISTER HAS LAUNCHED AN APPEAL TO MAJOR IMPORTING COMPANIES TO INCREASE THEIR IMPORTS IN FY 1989 TO LEVELS SIMILAR TO LAST YEAR (30%) WHICH HAS BEEN INTERPRETED AS PART OF A RICH TO INCREASE IMPORTS FROM THE UNITED STATES (ALTHOUGH BUSINESSMEN ARE FAIRLY SCEPTICAL ABOUT THE LIKELY SUCCESS OF THIS). THE JAPANESE CONTINUALLY AFFIRM THAT THE RESULTS OF THEIR NEGOTIATIONS WILL BE APPLIED ON AN MFN BASIS BUT THE EC NEEDS TO WATCH THIS AREA CLOSELY, BOTH BY ENSURING THAT ITS OWN REQUESTS FOR TARIFF AND SECTORAL IMPROVEMENTS ARE FIRMLY IN FRONT OF THE JAPANESE AND BY ENCOURAGING THE JAPANESE TO ENSURE THAT THE SETTLEMENT OF US-JAPAN ISSUES IS CONSISTENT WITH MULTILATERAL TRADE RULES.

THE IMPORTANCE OF STRUCTURAL REFORM

9. THE REMOVAL OF MANY TRADE BARRIERS AND THE RECENT RAPID GROWTH IN IMPORTS UNDERLINE THE OPPORTUNITIES NOW AVAILABLE TO FOREIGN COMPANIES IN THIS MARKET. WE SHOULD GIVE CREDIT FOR THE PROGRESS THAT HAS BEEN MADE AND KEEP ENCOURAGING BRITISH COMPANIES TO SELL AND INVEST HERE. NONETHELESS AS SEEN FROM HERE, THE CONTINUING TRADE IMBALANCE CASTS A DANGEROUS SHADOW OVER THE FREE TRADE SYSTEM, AND ITS REDUCTION SHOULD CONTINUE TO BE A MAJOR PRIORITY FOR G7 COORDINATION. THE US IN PARTICULAR CANNOT GO ON PILING UP INDEBTEDNESS WITHOUT AT SOME STAGE RISKING A MAJOR FINANCIAL CRISIS. EQUALLY THE PERSISTENCE OF THE JAPANESE TRADE SURPLUS SINCE THE PLAZA AGREEMENT, AND THE RECENT UNCONTROLLABLE MOVEMENT OF THE DOLLAR SHOW AN ADJUSTMENT POLICY BASED ON EXCHANGE RATES ALONE IS INADEQUATE. GIVEN THE UNDOUBTED CAPACITY OF JAPANESE COMPANIES TO ADJUST FURTHER IF NECESSARY, EXCESSIVE APPRECIATION COULD IN ANY CASE

HAVE PERVERSE EFFECTS: A CHEAP DOLLAR AND DEPENDENCE ON JAPANESE SAVINGS TO FUND THE US DEFICIT COULD ULTIMATELY UNDERMINE THE POLITICAL RELATIONSHIP BETWEEN THE US AND JAPAN.

10. THE JAPANESE GOVERNMENT HAS ACCEPTED AND EVEN ESPOUSED THE ANALYSIS THAT FURTHER STRUCTURAL CHANGES ARE REQUIRED TO REMOVE THE ORIGINS OF US-JAPAN TRADE FRICTION, THOUGH THEY NO LONGER HESITATE TO POINT OUT THAT CHANGES ARE NECESSARY ON THE U.S. SIDE IN REDUCING ITS DEFICITS, RAISING SAVINGS RATES AND ENCOURAGING MANUFACTURING TO ADOPT A LONGER-TERM VIEW.

11. WITH A CERTAIN AMOUNT OF IMPETUS FROM BODIES SUCH AS THE IMF AND OECD, AS WELL AS BILATERAL PRESSURE, JAPANESE THINKING ABOUT THEIR OWN ECONOMY AND LIFESTYLE IS BEGINNING TO CHANGE. WORKING HOURS, DIFFERENCES BETWEEN DOMESTIC AND OVERSEAS PRICES OF GOODS, ANTI-COMPETITIVE ASPECTS OF THE DISTRIBUTION SYSTEM AND THE RELATIONSHIP OF HIGH LAND PRICES TO OTHER STRUCTURAL ISSUES ARE BEING DISCUSSED, AND THE INTEREST OF THE CONSUMER EVEN ADVANCED AS A REASON FOR CHANGE. THESE REFORMS - AND MUCH MORE THROUGH DEREGULATION ACROSS THE BOARD - WOULD, IF EFFECTED, HELP TO MAKE THE CONSUMPTION AND IMPORT SIDE OF THE ECONOMY ADJUST AS EFFICIENTLY AS THE MANUFACTURING SECTOR HAS IN THE LAST THREE YEARS. FOR THE LONGER TERM STABILITY OF THE SYSTEM WE SHOULD BE ENCOURAGING THE JAPANESE TO ABSORB MORE OF THEIR OWN SAVINGS AT HOME THROUGH HIGHER CONSUMPTION AND DEVELOPMENT OF BACKWARD PUBLIC INFRASTRUCTURE WHICH WOULD ENHANCE PERSONAL LIVING STANDARDS TO A LEVEL COMMENSURATE WITH THE COUNTRY'S INTERNATIONAL STATUS.

12. HOWEVER, AS REFLECTED IN MITI'S PROPOSALS FOR DISTRIBUTION (MY TELNO 608) AND THE LIKELIHOOD OF A POLITICAL DECISION NOT TO REDUCE THE RICE PRICE THIS YEAR, THE WILL FOR REFORM WHICH WOULD TOUCH THE INTERESTS OF TRADITIONAL LDP SUPPORTERS IS AT A LOW EBB. NONETHELESS THE BUREAUCRATIC MACHINERY STUDYING DEREGULATION AND REFORMS GRINDS ON, AND WILL BE INFLUENCED BY THE STRENGTH OF G7 VIEWS. THERE IS THEREFORE EVERY REASON TO PURSUE THESE ISSUES AT THE SUMMIT EVEN THOUGH, GIVEN THE NATURE OF THE ISSUES, THE PROCESS WILL TAKE TIME AND DECISION-TAKING WILL BE DIFFICULT IN THE SHORT TERM BECAUSE OF THE CURRENT POLITICAL SITUATION.

FIELD

CONFIDENTIAL

071363
MDADAN 5251

YYYY

DISTRIBUTION

7

ADVANCE

7

.ECONOMIC SUMMIT
MR BAYNE
MR CARRICK
MR N WICKS, NO 10 D.S.

HD/ERD
HD/PLANNING STAFF
NO 11 DOWNING ST

NNNN