Yukio Noguchi. "The Japanese Economy in a Changing World Environment." In *Half Empty or Half Full?* Tokyo and New York: Japan Center for International Exchange, 1987, 17–28.

Chapter 2

The Japanese Economy in a Changing World Environment

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Towards a New Era of Growth

THE state of the world economy during the 1970s may be described by the word "turmoil." The period began with the collapse of the Bretton Woods regime of the international currency system, followed by worldwide inflation and two major oil crises. All industrial countries have suffered seriously from these events.

During the last few years, however, the conditions that caused the difficulties have gradually disappeared, and the world economy appears to be on an upward path. The recent sharp decline in oil prices dramatically signalled the end of the "decade of oil crises and inflation"; the industrial countries have won the fight against inflation. Consumer prices rose at an average rate below 5 percent in the seven major industrial countries during 1984, the best performance since the 1960s (see table 1). The decline in oil prices has reduced inflation rates further. Wholesale prices are expected to fall in 1986 in Japan, West Germany and France. The rate of decline for Japan is expected to be as high as 6.6 percent (see table 1). As inflationary expectations disappear, interest rates fall, which will further stimulate economic growth.

In early 1986, industrialized countries were enjoying the fourth

Table 1. Rates of Increase in Price Indices (%)

Calendar Year	Wholesale Prices 1984	1985	1986	Consumer Prices 1984	1985	1986
U.S.A.	2.1	0.9	2.2	4.3	3.5	3.7
W. Germany	2.9	0.6	−1.9	2.4	2.2	1.1
France	13.3	7.0	−1.8	7.4	5.8	4.0
U.K.	6.2	6.3	4.0	5.0	6.1	4.0
Italy	10.4	7.3	5.2	10.6	8.6	7.4
Japan	−0.3	1.1	−6.6	2.3	2.0	1.3

SOURCE: Japan Economic Research Center, *Quarterly Economic Forecast*, March 1986.

Table 2. Real GNP Growth Rates (%)

Calendar Year	1980	1981	1982	1983	1984	1985	1986
U.S.A	−0.2	1.9	−2.6	3.5	6.5	2.2	2.6
Canada	1.1	3.3	−4.4	3.3	4.7	4.6	2.7
W. Germany	1.5	0.0	−1.0	1.5	2.7	2.3	2.7
France	0.7	0.8	1.8	0.7	1.6	1.1	1.7
U.K.	2.3	−1.4	1.4	3.5	1.8	3.0	1.9
Italy	3.9	0.2	−0.5	−0.4	2.6	2.1	2.3
Japan	4.3	3.7	3.1	3.2	5.1	4.6	2.7
Average	0.9	1.6	−0.8	2.8	4.9	2.7	2.5

SOURCE: Japan Economic Research Center, *Quarterly Economic Forecast*, March 1986.

consecutive year of uninterrupted economic expansion (see table 2). This is not merely a short-term recovery process, but a new phase of dynamic growth driven by rapid technological innovations, which can be expected to continue for a number of years. This trend was strengthened by the decline of oil prices. According to an estimate by the Economic Planning Agency, a 20-percent decline in oil prices will raise the economic growth rate in major countries by 0.2 percent-

Table 3. Changes in Relative Position of Nations and Regions (Percentage Share in the World GNP)

	1960	1980
Japan	2.8	10.1
U.S.A.	33.4	22.4
W. Europe	22.0	26.7
Soviet and E.Europe	19.1	17.5
Asia and Africa	14.4	14.7
Others	8.3	8.6

SOURCE: Yearbook of National Account Statistics, Economic Planning Agency of Japan

age points. A recent OECD forecast projected a rise in the average overall growth rate in OECD countries as a group of from 2.7 percent in 1985 to 3.25 percent in 1986. Although unemployment is still high in European countries, it will not worsen further.

The new era is different from the sixties in several respects. From the international point of view, the American hegemony in the world economy no longer exists. Instead, the United States, EC, and Japan have come to share leading positions in the world economy. The increase in Japan's relative position is especially remarkable. Its share in world GNP rose from 2.8 percent in 1960 to about 10 percent in 1985 (see table 3). Secondly, the exchange rate regime has been transformed from a fixed rate system to a flexible rate system. Together with the liberalization of international capital movements, this has increased the interaction of economic policies, especially monetary policy, among major nations.

It is true that the recent changes in world economic conditions favor industrialized countries over developing countries. It will therefore be necessary to spread growth more broadly to the rest of the world, including heavily-indebted developing countries, by rechannelling gains from the fall in oil prices. This should be kept in mind as we now turn to the problems among industrialized countries.

Problems of Trade Imbalances and Exchange Rates Volatility

In spite of the favorable changes in the underlying conditions mentioned earlier, the world economy is confronted with a number of difficult problems. Japan's huge trade surplus may be regarded as one of the greatest disturbing elements. In FY 1985, the surplus in the external current account amounted to $56 billion, or 4.2 percent of GNP (see table 4); the trade account surplus was $62 billion.

Although exchange rates have changed dramatically since the G-5 meeting last September (see table 5), there has been no significant change in Japan's surplus. Rather, due to the so-called "J-curve effect," the surplus has, as was to be expected, increased in the short run. The decline in oil prices further accentuated the surplus. This surplus may well grow to $70 billion to $80 billion in FY 1986 (the government estimate is $51 billion). It will take two to three years before the surplus returns to the early 1980s level. Moreover, if oil

Table 4. External Current Balances in Selected Countries ($ billion)

	1984	1985	1986	1987
Japan	35	55	80	75
	(2.8)	(3.8)	(4.9)	
U.S.A.	– 107	– 119	– 145	– 130
	(2.8)	(3.3)	(3.3)	
W. Germany	6	13	30	20
	(1.0)	(2.1)	(3.8)	

Source: OECD

Note: Figures in parentheses are ratios to GNP (%)

Table 5. Fluctuation of Yen-Dollar Rate since September 1985 (monthly averages, yen per dollar)

1985	Sept.	Oct.	Nov.	Dec.				
	236.95	214.73	203.72	202.82				
1986	Jan.	Feb.	March	April	May	June	July	Aug.
	200.07	184.64	178.93	175.62	166.83	167.95	158.60	154.00

prices remain at the present low level, it seems possible that the surplus will not shrink below the $50 billion mark. And, unless the value of the yen changes relative to European currencies, trade imbalances between Japan and European countries will probably not be corrected.

It is important to note that the shifts in exchange rates since last September have been brought about by monetary rather than fiscal policies. The initial step that the Bank of Japan took following the G-5 agreement was non-sterilized intervention in the exchange market; i.e., intervention that decreases the money supply and hence affects the domestic interest rate. The Bank of Japan then strengthened the tightening further in late October by pushing up market rates of interest. As a result, short-term interest rates rose sharply (from 6.4 percent during October 14–18 to 9.1 percent during November 18–22).

But as yen appreciation progressed far more rapidly than was expected, it became necessary to change the direction of monetary policy. On January 30, the Bank of Japan lowered the official discount rate, for the first time in more than two years, from 5.0 percent to 4.5 percent with the aim of reversing the strong revaluation of the yen. (The official discount rate was further lowered to 4.0 percent on March 10 and to 3.5 percent on April 21. But these were parts of the coordinated actions of the G-5 nations.) Other things being equal, lower interest rates in Japan should lead to a depreciation of the yen. However, this did not happen, and the yen rate has marched from one historical record level to the next, with the dollar declining from ¥240 (September 1, 1985) to close to ¥150 by mid-1986 (see table 5).

It is difficult to determine what the "optimal" value of the yen is. Many Japanese exporters feel that rates beyond ¥170 per dollar are intolerable. On the other hand, some argue that further appreciation is necessary to reduce the trade surplus. It is also true that appreciation of a currency is beneficial for industries using imported materials and for consumers. The problem, however, is the speed of appreciation. If it is too rapid, as it has been since last September, an economy cannot make the necessary adjustments to the change quickly enough.

It thus seems necessary to correct the value of the yen downward from the present level and to avoid violent swings in exchange rates.

Such a stabilization can only be brought about by international coordination. At the same time, the use of fiscal policy must be explored by the Japanese government. From the macroeconomic point of view, there are two reasons why an expansionary fiscal policy is called for. First, it will attenuate deflationary pressures on the economy caused by the excessive appreciation of the yen. Secondly, it will reduce the macroeconomic savings-investment gap, which implies a reduction in the current external surplus (see table 6).[1]

Table 6. Saving-Investment Gap by Sectors (Percentage share to GNP)

FY	1980	1981	1982	1983	1984	1985
Household	9.3	9.8	8.2	9.2	9.0	9.0
Corporations	−5.7	−5.9	−4.8	−4.0	−5.1	−5.0
Government	−4.0	−3.7	−3.4	−3.0	−1.9	−1.4
Overseas	0.6	−0.5	−0.8	−2.0	−3.0	−3.7

SOURCE: Japan Economic Research Center, *Quarterly Economic Forecast*, March 1986.

THE MAEKAWA REPORT: A TURNING POINT IN JAPAN'S ECONOMIC POLICY?

On April 7, 1986, Prime Minister Nakasone accepted the recommendations of the Advisory Group on Economic Structural Adjustment for International Harmony (the Maekawa Committee), which had been studying measures for a basic restructuring of the Japanese economy.

The committee's report analyzed the present situation as follows. First, continued large current account imbalances create a critical situation, not only for the management of the Japanese economy but also for the harmonious development of the world economy as a whole. Consequently, Japan should undertake "a historical transformation in its traditional policies on economic management and the nation's life style." The government should therefore establish a medium-term national objective to reduce the imbalance to a level consistent with international harmony. Second, while efforts to further open the domestic market, improve market access, and encourage imports of manufactured goods, etc. are important and should be continued, a significant reduction of the trade imbalance requires more fundamental changes in industrial structure and macroeconomic policies. Specifically, it is necessary to change Japan's basic economic structure from an export-oriented one to a domestic-demand-oriented one by encouraging investment and/or private consumption.

The report proposes the following medium-term policies in order to achieve these goals. First, to expand domestic demand by promoting housing construction and urban redevelopment by easing building restrictions and strengthening tax incentives, and by stimulating private consumption by boosting wages, cutting income taxes, and reducing working hours. Second, to transform the industrial structure by encouraging investment in manufacturing abroad; by rationalizing depressed industries; and by easing restrictions on agricultural imports. Third, to continue to improve market access by promoting greater imports of manufactured goods and streamlining the distribution system. Fourth, to further liberalize capital and financial markets. Fifth, to expand international economic cooperation. The report also recommends a review of preferential tax treatment for interest income on small-account savings.

The report was initially highly praised in the international community. But most of its policy recommendations are still rather abstract. Although such proposals as setting a target level for the current account surplus of around 1.5 percent of GNP were discussed, they were not adopted in the final report. It is also uncertain whether the policies proposed in the report will in fact be implemented by the government, because many of them require basic changes in present government policies.

The Maekawa Report states that "in the implementation of the recommendations, fiscal and monetary policy has a significant part to play." If one follows the line of reasoning in the section above on problems of trade imbalances and exchange rate volatility, the logical meaning of this statement should be a change of fiscal policy from the present tight one to a more expansionary one. But the report does not propose any such change. Rather, it states: "In implementing fiscal policy, it is necessary to maintain a basic policy stance of fiscal reform to end its dependency on deficit-financing bonds." The background to these somewhat contradictory statements can be found in the so-called "fiscal crisis."

Since FY 1975, Japan's national budget has been suffering from a huge deficit. The share of bond revenue to total revenue climbed to almost 40 percent in the initial FY 1979 budget. Since then, it has gone down, but the share is still around 20 percent. This has been regarded as a critical problem, and deficit reduction, usually called "fiscal reconstruction," has been the basic objective in fiscal management for more than a decade.

The initial strategy of the government was to reduce the deficit by introducing a new tax. A general consumption tax, similar to the value-added taxes in European countries, was proposed by the government in 1977, but was blocked by strong political opposition.

The government was thus forced to change its strategy. The Ad Hoc Council on Administration Reform, established in March 1983, recommended the basic strategy of "fiscal reconstruction with tax increase," which meant that deficit reduction should be achieved by expenditure cuts. The current economic plan, "Outlook and Guidelines for the Economy in the 1980s," formulated in August 1983, designates deficit reduction as one of the main policy targets to be realized by the end of the decade. Accordingly, severe tight budget policies have been pursued during the past several years.

Although the government has not changed its basic stance of maintaining this tight budget policy, this has not been uncontroversial. The alternative course of expansionary policies has been the subject of heated debate during recent years. Some suggest that national bonds to finance capital outlays should be increased because this would not contradict the principle of "healthy fiscal management." Others argue that the general consumption tax should be revived as a means to reduce the deficit and that this should be the central element of the basic tax reform, another major current policy issue in Japan.

Conditions for New Growth: A Successful New GATT Round, Enhanced Policy Coordination

So far, this paper has focused on Japan and its possible contribution to world economic prosperity. But sustained growth will not be brought about by Japan's action alone—quite apart from the fact that, as indicated, there are also serious domestic constraints which circumscribe the margin for political measures. Wider efforts will be needed to turn into reality the opportunities provided by dynamic technological processes of innovation for sustained and worldwide economic growth. Two sets of conditions are particularly critical in this respect—the strengthening of the liberal international trading system and a better coordination of economic policies between industrialized countries.

The basic condition for preserving and strengthening the open trading system is the establishment of international rules for trade. In view of increased demands for protection in many countries, a strengthening of the GATT through a new round of trade negotiations is an urgent task. Protectionism may be inevitable during periods of economic stagnation, but it becomes a serious obstacle when the world economy is about to take advantage of opportunities for new growth. If the trend towards protectionism continues, the realization of the era of new worldwide growth mentioned above will become impossible.

It is also important to revise the rules in line with changing patterns of trade. In this respect, the growth of service trade is particularly noteworthy. Reflecting the relative decline of manufacturing and the rapid growth of the service sector in many industrialized countries, such service industries as finance, insurance, security, transportation, and information are increasing. According to an estimate by the Ministry of International Trade and Industry (MITI), worldwide service trade increased at an annual rate of 18.7 percent during the 1970s. The relative share of service export to commodity export is 11 percent for Japan, 15 percent for the United States, and 27 percent for the EC. Many countries, including Japan, would benefit from increasing the use of foreign services in such fields as management consulting, data banks, VAN (Value Added Networks), care for the aged, and financial consulting.

Given the growth of service trade, the absence of adequate rules for this trade makes the establishment of international rules through a new round of multilateral trade negotiations in the GATT an urgent task.

It is also important to discuss protection of intellectual property rights and to conclude international agreements that reflect the catching-up process in the Third World, notably in the newly industrializing countries (NICs). This problem should be settled multilaterally, since bilateral treatments cannot prevent knowledge to flow out to a third country.

Clearly, it will not be easy to come to agreements in these areas. Service trade is often intimately linked to deep-seated economic and social structures of a country. For example, complete liberalization of financial services in Japan cannot be achieved without revising the separation of banking from the security business, which is a key element in the Japanese financial market. There are also services which are closely related to cultural features of a society. Many developing countries try to protect such industries as finance, transportation, and communication since they are seen as vital to their national interests.

But even if progress is made in strengthening and separating the present international trading regime, this will not be sufficient. As mentioned earlier, one of the key characteristics of the new growth process is the increased interaction of economic policy coordination. Such policy coordination has played some role throughout the 1970s, and especially since the Versailles summit when it was agreed that the major industrial countries should work to achieve a better convergence of economic results. There have been frequent and regular meetings since then—with substantial positive effects. Coordination of exchange market interventions and monetary policies among the G-5 countries in September 1985 perhaps provided the most remarkable example.

Recently high-level governmental talks have begun to discuss fiscal, monetary and industrial policies between Japan and the United States (implementation of the Maekawa Report recommendations has been one of the major topics). It may be desirable to establish a similar channel between Japan and European countries.

The results of this process, as well as those of exchange rate coordination, have so far been somewhat insufficient. Little concrete has resulted from bilateral Japanese-American talks so far. The wider discussion between the U.S. government on the one side, and Japan and West Germany on the other side, about the need for expansionary domestic economic policies in the latter two economies had, until autumn 1986, also brought acrimonious exchanges but few, if any results. Japan's decision to adopt additional stimulative government expenditure programs was at least as much motivated by concern about faltering economic growth in Japan itself than by U.S. pressure and were hardly unusual in their scope under prevailing circumstances. And West Germany altogether refused to take additional expansionary steps. The agreement on exchange rate coordination reached in September 1985 also seemed to disintegrate rapidly, with the U.S. and the other industrialized countries pursuing different tracks. Washington sought a further devaluation of the dollar to alleviate trade pressures, while Japan became increasingly concerned about prevailing exchange rate levels, and West Germany also was unhappy to see the dollar decline further.

The record on policy coordination so far thus seems mixed. There were some successes, but also important shortcomings and failures, and much remains to be done. Moreover, although convergence of economic policies in general is clearly desirable, this should not obstruct due attention to conditions specific to a country. For example, there may be differences in the extent to which policy may be changed flexibly. In the case of Japan, fiscal policies cannot easily be reversed because of rigid administrative and political decision-making processes. There are also factors other than fiscal expansion that are necessary for domestic demand to expand. In the case of Japan, this is especially true for housing, construction, and urban redevelopment, where the extremely high price of land is a serious obstacle. Overcoming the land problem, rather than simply changing fiscal policy, is the key for changing Japan's economic structure.

Lastly, one has to take into account differences in such basic socio-economic factors as population structure. Compared to most

Table 7. Ratios of People of Age 65 and over (%)

	1970	1985	2000	2015
Japan	7.1	10.1	15.6	21.1
U.S.A.	9.9	11.0	11.3	
U.K.	12.9	15.0	15.3	
France	12.9	12.5	14.6	
W. Germany	13.2	13.7	15.4	

SOURCE: U.N. World Population and Its Age-Sex Composition by Country, 1950–2025, Demographic Estimation and Projection in 1980.

European countries, Japan's population structure is skewered to younger generations (see table 7). In this light, Japan's high saving ratio can be regarded as a normal phenomenon. As a rapid aging of the population is expected in the coming decades, it can be argued that it will be necessary to preserve the present high saving ratio in order to make investments for the future.

Note

1. An expansionary fiscal policy pushes interest rates up. In an economy where the exchange rate is flexible and where international capital movements are free, this makes the currency appreciate. If the present rate of the yen is to be corrected downwards, a further loosening of monetary policy therefore becomes necessary.