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Japan's Economic Policy: Conflicting Pressures on Trade and Growth

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An Intelligence Assessment

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EA 85-10100
May 1985

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An Intelligence Assessment

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EA 85-10100
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Sanitized Copy Approved for Release 2011/05/12 : CIA-RDP04T00447R000200790001-6

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Key Judgments

Information available as of 2 May 1985 was used in this report.

Prime Minister Nakasone faces a dilemma in pursuing his two main economic objectives in 1985—to continue to cut the government deficit and to lessen the tensions created by Japan's huge trade surpluses. Nakasone's commitment to a tight fiscal policy is having an effect on the deficit, but it is also producing a drag on Japan's demand for imports. Although we believe the current account surplus probably will grow less rapidly this year than in 1983-84, we expect it to reach $45 billion, producing discord between Japan and its trading partners and providing a clear target for the Prime Minister's critics at home.

Nakasone's approach to the trade problem is already under attack from his rivals in the ruling party, who have been arguing for some time that the Prime Minister should do more to stimulate the domestic economy as a way of boosting imports. Party Vice President Nikaido, who mounted a major challenge to Nakasone in last October's party presidential election, has sided with the Prime Minister's critics.

The domestic economy should continue to grow in 1985, but here, too, Nakasone and his senior policymakers face some potential problems:

- Japan's GNP should grow by 4.6 percent this year, but we expect a slowdown in export growth to force the economy to depend more on domestic demand.

- Except for the booming investment sector, however, the domestic economy's performance has been lackluster. Consumer demand—which makes up over half of GNP—has been slack, and the surge in investment may slow later in the year as the need to add capacity to meet export demand declines.

Thus far the Prime Minister has lined up with the fiscally conservative Finance Ministry against any move to stimulate domestic growth with an injection of new spending or lower taxes. Nonetheless, we believe he may reconsider this approach later this year if there are signs of a downturn in the economy—which would give more ammunition to his critics in the LDP—or more pressure from abroad to boost growth as a way of cutting Japan's massive trade surplus.

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Japan's Economic Policy: Conflicting Pressures on Trade and Growth [redacted]

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A Slowdown in Trade . . .

We do not expect Japan's trade surplus in 1985 to show the explosive growth of the past two years. Export letters of credit, a key indicator of future trends in exports, fell below last year's level in February and March, and import growth is picking up as the economy's expansion strengthens demand for foreign goods. Based on the yen's weakness and our expectation that the world's demand for imports will continue to expand, however, we do foresee some growth in the surplus. [redacted]

In 1984, Japan's current account and trade surpluses (see figure 1) were characterized by:

- Exports increasing 15.7 percent, led by office equipment, videotape recorders, semiconductors, and cars. Imports increased only 8.7 percent, largely because of lower crude oil import prices.
- A trade surplus with the United States that hit $33.1 billion (see figure 2). Exports grew 40 percent, while Japanese purchases from the United States increased only 8.9 percent. [redacted]

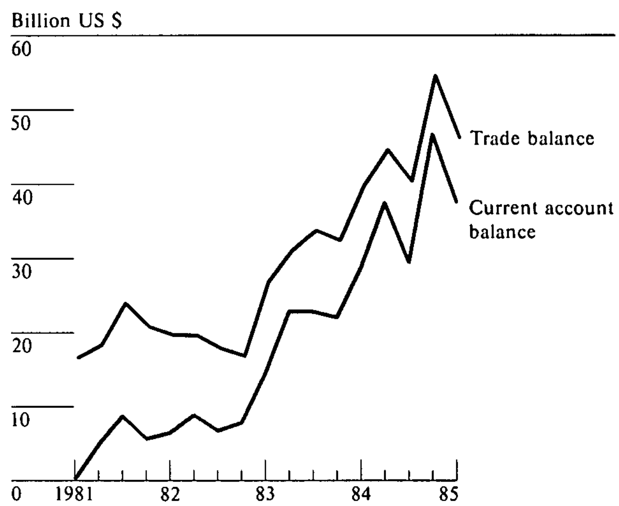
In JFY 1985 the current account surplus probably will reach $45 billion, compared with $37 billion last year, in part because of the earnings from Japan's overseas financial investments. The Economic Planning Agency (EPA) has officially—and, in our view, overoptimistically—forecast a current account surplus in JFY 1985 of $34 billion. [redacted]

. . . And in Growth?

The foreign sector—Japan's international trade and financial flows—accounted for over a third of last year's GNP growth of 5.8 percent, the highest rate since 1973. Other indicators also reflected the economy's overall strength:

- Inflation remained at 2.2 percent, the second lowest rate in 25 years.
- The official unemployment rate was only 2.7 percent. The number of jobless has crept up in recent years, but thus far there appears to be little public concern. [redacted]

Figure 1
Japan: Current Account and Trade Balances, 1981-85[a]



[a] Seasonally adjusted at annual rates.

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We think Tokyo's official forecast for GNP growth of 4.6 percent in JFY 1985 is about right. Compared with JFY 1984, the 1985 estimate reflects some slowdown in foreign demand. It also suggests that domestic economic expansion in Japan will continue to be driven by private business investment in plant and equipment. [redacted]

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The Investment Question

In fact, judging the relative role and importance of private business investment versus foreign demand in keeping Japanese growth on track has given economic forecasters—and may give Nakasone—a thorny problem. Private investment grew at an annual rate of

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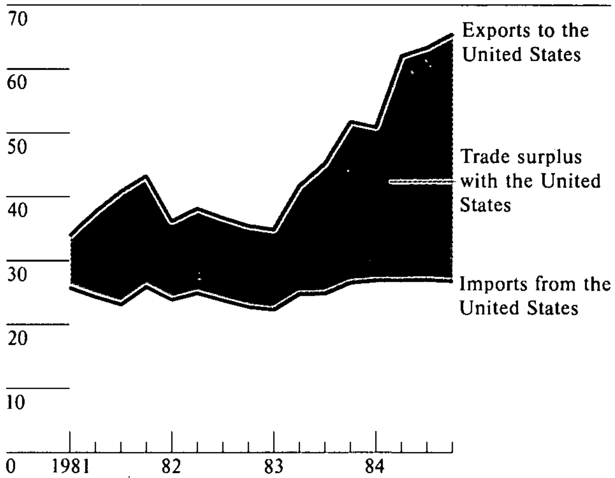
Figure 2
Japan: Trade With the United States, 1981-84[a]

Billion US $



[a] Exports F.O.B., imports C.I.F. not seasonally adjusted at annual rates.

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more than 10 percent in 1984 because of higher earnings and business expectations of continued expansion in foreign as well as domestic markets. But EPA officials disagree over whether increasing Japanese exports—of electronics and cars, for example—are necessary to continue this investment flow or whether it can be fueled mainly by ongoing technological upgrading at home. We believe investment should continue to be strong in 1985 based on business plans already in place. The incentive to invest probably will diminish later this year, however, as the requirement for added capacity to meet export demand declines.

Like the EPA officials, private Japanese forecasters are uncertain about the outlook for growth in 1985. Most expect GNP growth to be between 4 and 5 percent, but the range of forecasts is wider this year than last. As cases in point, the Mitsubishi Research Institute and the Tokai Bank expect consumption to remain stagnant and investment slow, keeping the GNP increase under 4 percent. The Research Institute of the National Economy, however, is more upbeat about both and predicts a 6-percent growth rate for GNP this year.

The Budget: No Potential Help in Time of Need

Nakasone's commitment to reduce the government deficit limits the tools he can use to stimulate the economy. Planners are counting on an increase in domestic consumption demand—which makes up over half of GNP—to aid the economy's growth:

- The official forecast calls for consumption to grow by 4 percent, compared with the laggard 3-percent pace of the past two years.

- Although we do not expect a boom, we believe spending by the average Japanese will be somewhat stronger this year, because higher wage and bonus payments—reflecting companies' higher profits—will boost disposable incomes. 25X1

Fiscal policy in 1985 will provide little stimulus to offset any shortfall in the expected growth in consumption and investment. The 1985 budget—which took effect on 1 April—raises total spending only 3.7 percent over the initial 1984 budget, the tightest since 1955:

- General expenditures—less debt service and revenue sharing with local governments—decline for the third year in a row. 25X1
- The Fiscal Loan and Investment Program, which includes expenditures on roads, water supply, and sewers, drops by 1.2 percent.
- Defense and foreign aid spending are exceptions again this year. Defense spending will be up by 6.9 percent, bringing it near the 1-percent-of-GNP limit, and foreign aid will rise by 10 percent.

The Ministry of Finance pushed hard for spending controls and steps to increase revenue. As a result, the 1985 budget also includes additional taxes to cut new bond issues by $4 billion from last year's level. The net effect of the budget lowers the central government's deficit in 1985 to 22 percent of total spending, or about 4 percent of GNP. 25X1

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The Political and Economic Dilemma

Beyond the difficulties a tight budget poses for the Prime Minister should Japan's domestic growth tail off more dramatically than expected later this year, Nakasone's fiscal policy, in our view, is already adding to the problem of Japan's trade surplus.

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Nakasone is continuing government tax and spending policies that since 1979 have reduced the deficit as a share of GNP. But the private sector's savings rate has remained high—well above the domestic investment rate—producing a surplus of private domestic savings. Because the central government's budget deficit financing needs have been too small to absorb the domestic savings surplus, funds have moved abroad. Last year's record $50 billion net long-term capital outflow kept the yen's value low, in turn supporting the export boom already under way because of strong foreign demand for Japanese products. Strong foreign demand has made up for the lack of stimulus from the government and kept growth healthy enough to mute criticism of the government's deficit-trimming fiscal policy. [redacted]

Tokyo's austerity has not been the only reason for the trade surpluses, but our econometric modeling suggests that a 10-percent increase in the level of government spending in 1982-84 would have cut $10 billion from Japan's current account surplus in 1984. A 10-percent cut in the level of taxes over the same period would have reduced the surplus by $4 billion. [redacted]

Nakasone's tight fiscal policy in any case is still supported within the government, but there are concerns about how the United States views its effects, as well as signs of simmering political opposition at home. On the one hand, some officials in Tokyo are concerned about a US perception that Japan is using exports to keep the government's tight fiscal policy from slowing the economy. In meetings with foreigners, the Japanese have attempted to portray their recovery and expansion as based on domestic demand. For example, in the EPA's official forecasts, coordinated with the Ministries of Trade, Finance, and Foreign Affairs, Tokyo has consistently underestimated the strength and importance of foreign demand, as well as the size of the trade and current account surpluses. According to the US Embassy in Tokyo, the Ministry of International Trade and Industry (MITI), the EPA, and the Ministry of Foreign Affairs fought hard for a JFY 1985 forecast that depicted strong growth based on domestic demand, which would suggest increased Japanese imports. [redacted]

The Finance Ministry has also been concerned this year that Washington will push Tokyo to stimulate the economy in order to boost Japanese demand for imports. [redacted]

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On the other hand, some opposition to Nakasone's fiscal austerity is surfacing again in his own party. Before Nakasone's reelection as president of the Liberal Democratic Party (LDP), some of his chief rivals argued for a spending increase. In the last month or so, versions of their ideas have reappeared: 25X1

- Kiichi Miyazawa, the heir of the Suzuki faction, proposed an "asset-doubling" plan, reminiscent of the official "income doubling" theme associated with Japan's spectacular growth in the 1960s, that would increase public works spending. 25X1

- State Minister Toshio Komoto, head of a competing LDP faction, has continued to push his long-favored fiscal stimulus ideas to boost growth and imports.

- LDP Secretary General Shin Kanemaru, who was critical of the Finance Ministry's austere 1985 budget proposal, has advocated more spending and other measures to boost domestic demand.

- More recently, the issue was raised by LDP Vice President Nikaido, who suggested pump priming may be in order to reduce trade friction. [redacted] 25X1

The opposition parties, while considerably less influential politically, have maintained a similar chorus. The Japan Socialist Party has led the way by proposing a 1.1 trillion yen ($4 billion) tax cut and boycotting Diet sessions to protest this year's tight budget. [redacted] 25X1

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The Chances for Change: The Consensus Position

At this point, Prime Minister Nakasone is not being driven by a political groundswell to consider new fiscal initiatives. Economic policy is not seen in Tokyo as one of his strengths, and he would be certain to be attacked if he undertook new policies that would widen the budget gap and undercut the five-year effort to cut back the bureaucracy. For example, both Keidanren and Nikkeiren—Japan's two most prestigious business umbrella groups—recently have attacked the idea of government economic stimulation. Nakasone's tight fiscal policy has stronger backing from the LDP's supporters in the business and financial worlds than does a stimulatory approach.

The Finance Ministry, which has the upper hand on macroeconomic policy, is also ready with a counterattack if it faces a political campaign for more stimulus.

In our judgment, massive fiscal stimulus would be needed to significantly affect growth and the current account surplus in the short term. A $4 billion increase in government spending in JFY 1985, for example, would boost growth by only 0.3 percent and cut only $1 billion from Japan's current account surplus, according to our model.

What Could Move Nakasone?

The attractiveness to Nakasone of new policy departures will depend, in our view, on his judgment of the cost of inaction abroad as well as at home. US Congressional action because of a perceived Japanese unwillingness to deal with the current trade imbalance—even if the rate of growth in Japan's surplus declines—could well force Nakasone to consider new steps. For Japan—and for Nakasone—the international economic environment in 1985 will be less predictable than in 1984. In our view, it could present conditions that reverse the slowdown we now expect in growth of the trade surplus and bring about a corresponding upswing in international pressure on Japan:

- Continued weakening of the yen compared with the dollar—a situation that already has contributed greatly to Tokyo's trade problems—would make the surpluses difficult to contain.

- An increase in the rate of growth of world import volume, which began to stagnate last year and limit Japan's exports, would induce further growth in Japan's export markets. So, too, could better-than-expected economic performance in the United States that fueled rapid growth in world trade and boosted the surpluses even more than we project.

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At home, Nakasone must address fiscal policy decisions driven by his deficit reduction goals that could complicate both trade and growth problems. The Finance Ministry is pushing for another tax increase in JFY 1986 to further reduce issuance of deficit bonds. Large amounts of older bonds that come due this year and next will push up debt servicing expenses. We expect refinancing will not have as strong an impact on credit markets and interest rates as some have feared, because redemption of the old bonds will provide investors with sufficient capital to buy the new issues. Nevertheless, refinancing provides more ammunition for the Ministry in pushing its tax increase plan.

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The Ministry argues that only new revenues will enable the government to meet its goal of eliminating deficit financing bonds by 1990. The Ministry proposes the introduction of a European-style value-added tax, coupled with cuts in the income tax and packaged as "tax reform." Finance Minister Takeshita has hinted he wants to see the reform effective as soon as JFY 1986. The LDP's Tax Research Council, which has dominated decisionmaking on taxes in the past, has come out in favor of the Finance Ministry's proposal.

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If Prime Minister Nakasone chooses to attack the budget deficit with new taxes, he risks slowing growth and—by cutting future demand for imports—worsening trade frictions. Our analysis indicates the short-run effect of the taxes would be small. A $4 billion increase in indirect taxes, for example, would add only $76 million to Japan's trade surplus by the end of the first year, according to CIA's econometric model. If other voices—either abroad or at home—are quiet on trade issues, we believe Nakasone will follow the Finance Ministry's lead. In recent statements, for example, he has left open the possibility of a value-added tax, even though he has publicly opposed tax increases in the past. 25X1

There are signs that Japanese concern with US retaliation for perceived inaction on trade has reinvigorated Komoto, Miyazawa, and others who are again publicly suggesting fiscal stimulus to deal with the current account surplus. Political crosscurrents in the LDP stimulated by the incapacitation of former Prime Minister Tanaka—Nakasone's main backer in the party—also appear to be a factor behind the use Nakasone's rivals have made of the issue. As a case in point, the two main contenders for leadership of the Tanaka faction, which comprises one-third of the ruling party's membership, have squared off on the fiscal stimulus question. Both men are aspirants for prime minister. Finance Minister Takeshita has continued to champion the current conservative approach to budget cutting, but senior faction leader Susumu Nikaido, echoing the views of Komoto and Miyazawa, now publicly advocates more spending to solve the import problem. The issue is politically sensitive and could prompt Nakasone to rethink his own policy—particularly if further friction with the United States leads contenders for the prime-ministership to blame him for failure to resolve the problem. 25X1