[redacted] 25X1

FILE

Central Intelligence Agency

Washington, D.C. 20505

FILE

DATE 10/23/86

DOC NO EA M 86-20162

OIR 3

P & PD 1

DIRECTORATE OF INTELLIGENCE

22 October 1986

The Effectiveness of Japanese Fiscal Policy: The View From Tokyo [redacted] 25X1

Summary

Tokyo is committed to fiscal austerity, but continued sluggish economic growth is certain to heat up the debate over whether to use government spending and taxing policies to stimulate the economy. In our judgment, a fiscal policy shift would not only increase Japanese real GNP growth--by 2.5 percentage points if Tokyo boosted government spending by 10 percent--but would also raise the level of imports in the process. In addition to its direct effect on foreign purchases, more vibrant domestic demand would slow the current decline in wholesale prices and thus help US firms maintain the competitive position afforded by the recent yen appreciation. Japanese economists as well as the political leadership, however, are less convinced than we that fiscal stimulus would reduce their trade surplus. We believe Tokyo's pessimism about the effectiveness of a policy shift, along with concerns about the long-term costs of deficit financing, make it unlikely that Japan will discard its tight budget program. [redacted] 25X1

This memorandum was prepared by [redacted] Office of East Asian Analysis. 25X1
Information available as of 22 October 1986 was used in its preparation. Comments and queries are welcome and may be directed to the Chief, Japan Branch, Northeast Asia Division, OEA [redacted] 25X1

25X1

EA M 86-20162

[redacted] [redacted] 25X1

[redacted] 25X1

[redacted] 25X1

The Looming Fiscal Debate

The sluggish Japanese economy and recommendations from Washington to reflate are rekindling the debate in Tokyo over whether to stimulate the economy with increases in government spending or tax cuts. The near certainty that economic growth will fail to meet Tokyo's 4-percent growth target for the fiscal year ending next March is inducing some [redacted] 25X1 to encourage the Nakasone government to alter, at least for now, its austere fiscal stance (see figure 1). [redacted] 25X1

In our judgment, the outcome of the debate will depend on how Tokyo evaluates several factors: the effectiveness of a bond-financed increase in government spending or cut in taxes in pulling the economy out of its doldrums; whether such action would ease trade tensions with Washington; how many long-term economic problems would be caused by the policy shift; and, most important, whether the current economic deterioration is serious enough to require a boost in government spending to maintain growth. [redacted] 25X1

The Short-Term Impact of Fiscal Policy...

On the Production of Goods and Services. Virtually all the key economic policymakers in Tokyo agree that an increase in government spending or a tax cut financed by the sale of government bonds will, in the short-term, boost the production of goods and services. [redacted] 25X1

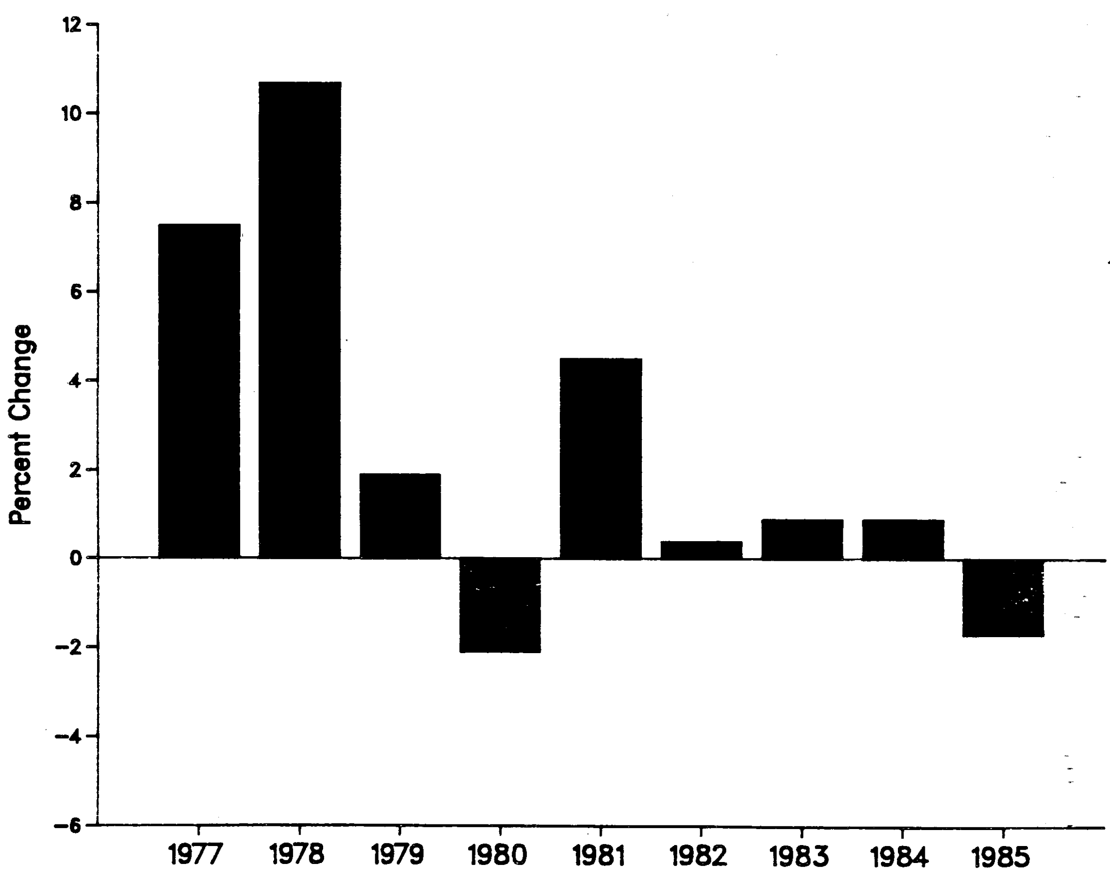
We believe there is ample evidence to support this judgment. Simulations conducted with our econometric model of Japan suggest that a sustained 10-percent increase in government spending--$35 billion roughly split between government consumption and public investment--would boost real economic growth by 2.5 percentage points in the first year and 1 percentage point in the second year (see figure 2). A study conducted by the OECD last year came to a similar conclusion. In that report, the effect on Japan's growth of a boost in government expenditures was higher than the average for similar simulations conducted on the other Big Seven countries--the United States, Great Britain, France, West Germany, Italy, and Canada. [redacted] 25X1 25X1

[redacted] 25X1

[redacted] 25X1

Figure 1

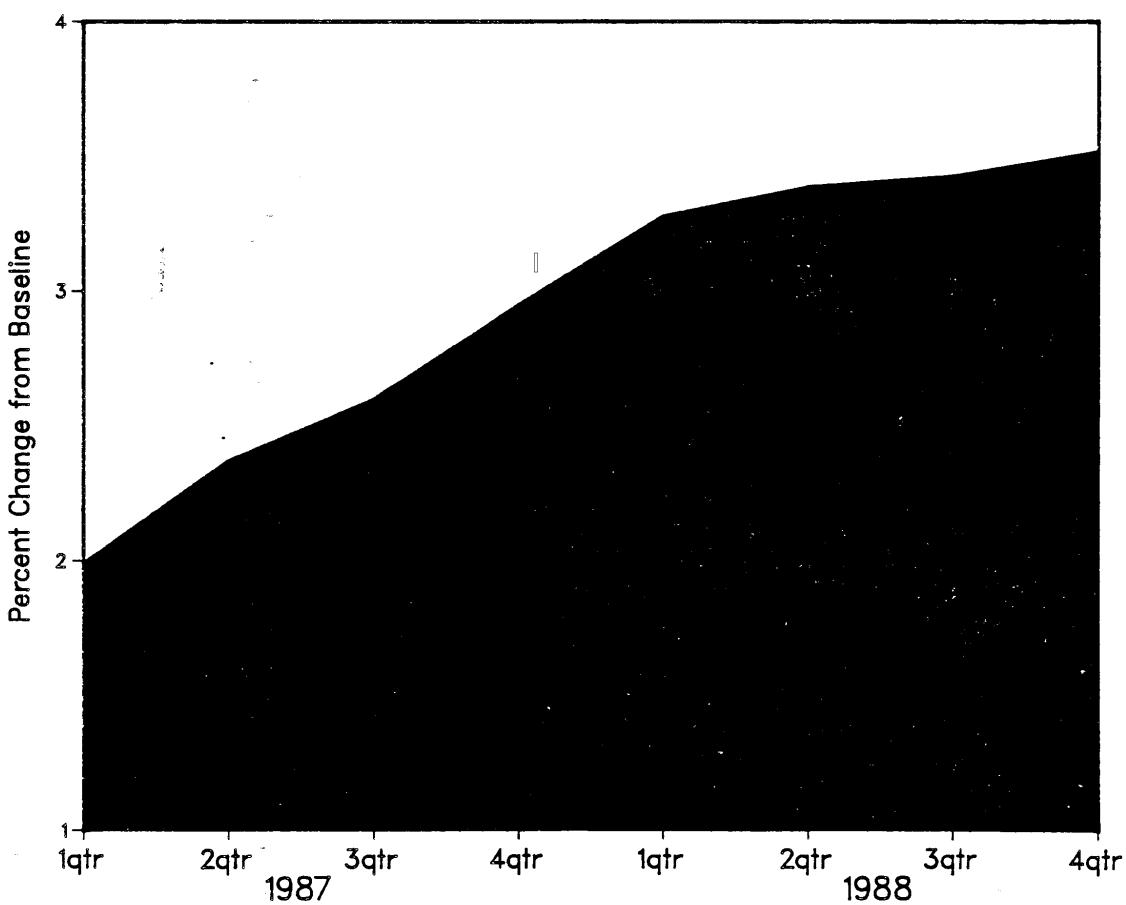
Japan: Growth in Real Government Spending



25X1

Figure 2

Japan: Effect on Real GNP of a Sustained 10–Percent Increase in Government Spending*



25X1

*Simulation assumes that spending increase begins in first quarter of 1987.

25X1

[redacted] 25X1

On the Current Account Balance. Despite the effectiveness of fiscal policy in boosting real economic growth in the short term, economic policymakers in Tokyo claim that faster growth would do little to reduce the country's large trade surplus. Indeed, EPA Director General Kondo made this argument publicly at the recent GATT talks in Uruguay. Both the Finance Ministry and the EPA argue that higher Japanese growth has a minimal effect on commodity imports, which currently constitute 55 percent of Japanese overseas purchases. Even that limited effect is further reduced because the Japanese economy is moving away from industries that are heavy users of energy and other raw materials, such as steel, nonferrous metals, and petrochemicals. [redacted] 25X1

Japanese Government economists support their judgment on the relationship between the current account and fiscal policy with data produced by large economic models.[2] The EPA model, for example, shows that a 10-percent increase in government spending would reduce the trade surplus by only $4.5 billion. According to these calculations, GNP growth would have to increase by more than 6 percentage points to achieve even a $10 billion cut in the trade surplus. For its part, the Ministry of Finance calculates that a 10-percent increase in government spending would boost imports by only $2 billion and that a $30 billion cut in taxes--one-third of present income taxes--would increase imports by only $700 million. [redacted] 25X1

Although our model and OECD studies produce similar results--a 10-percent boost in spending in our model reduces Japan's current account surplus by $8 billion in the first year and an additional $6 billion the second year (see figure 3)--the figures, in our view, substantially understate the effect on the current account of domestic economic growth induced by fiscal policy. Experience with our own large-scale macroeconomic model of Japan leads us to believe that although the Japanese models probably yield fairly accurate estimates of the effect of a demand stimulus on imports, they are likely to fail to capture two important results from a fiscal policy shift that will tend to decrease exports. [redacted] 25X1

First, the models do not account for the fact that increasing domestic demand boosts the return to investments in nonexport-related industries. Consequently, their forecasts understate the drop in exports as investment shifts away from export industries and toward products geared to domestic sales.[3] Second, the models fail to accommodate the dynamic interrelationship between the domestic economy, its effect

---

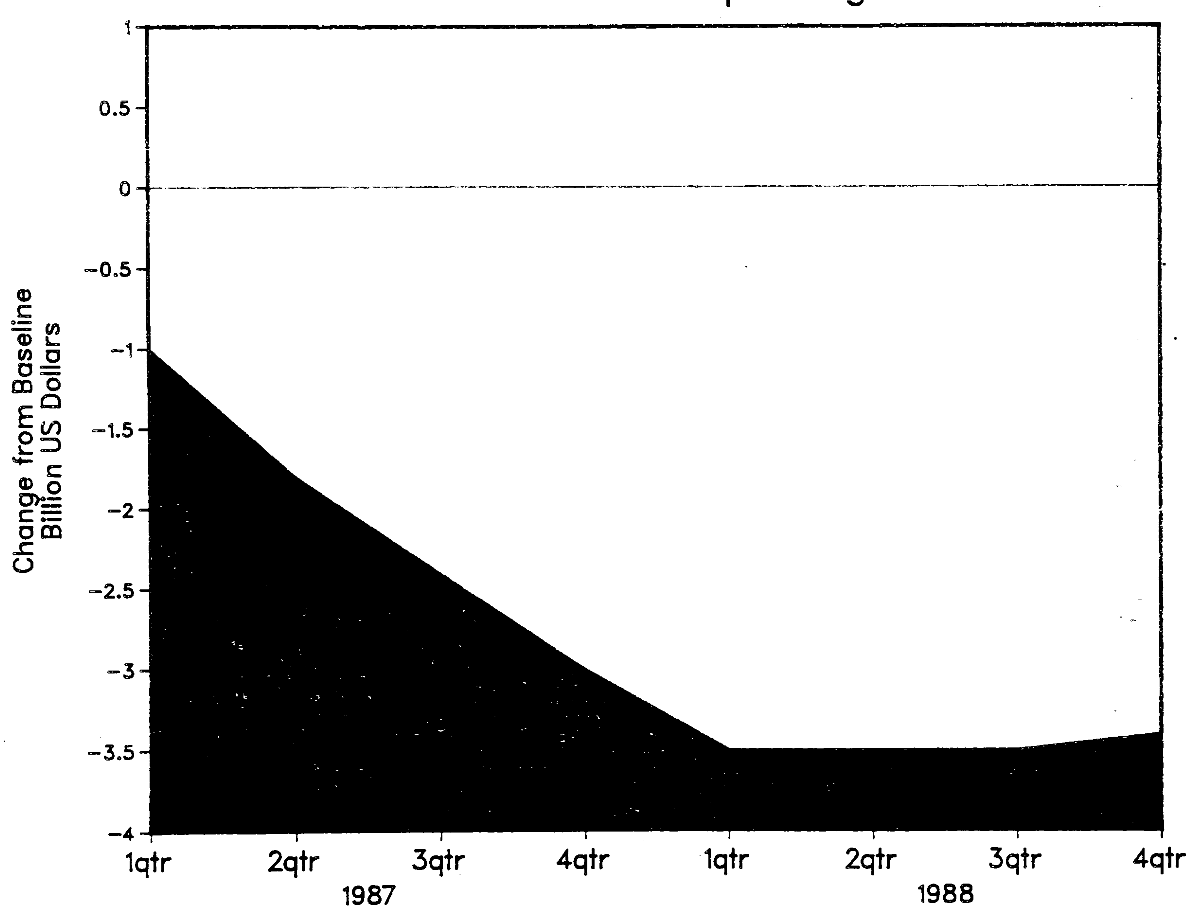
[2] Both the EPA and the Ministry of Finance maintain large economic models. These models consist of several hundred equations and are designed to mimic the behavior of the economy. [redacted] 25X1

[3] In contrast, as Japan's domestic demand slowed in the 1970s and the early 1980s, firms looked to export markets to maintain sales. Indeed, 30 percent of Japan's investment spending during the 1980s has been export related, according to estimates made by the US Embassy. This investment paid off well. Nearly a third of the increase in manufacturing sales by Japanese firms from 1974 to 1985 was accounted for by exports, so that the share of exports in total sales increased from less than 20 percent in 1974 to 26 percent last year, according to Japanese Government statistics. [redacted] 25X1

[redacted] 25X1

Figure 3

Japan: Effect on the Current Account Surplus of a Sustained 10-Percent Increase in Government Spending*



*Simulation assumes that spending increase begins in first quarter of 1987.

25X1

[redacted] 25X1

on exchange rates, and the consequences in trade. Most economists contend that more robust domestic demand is necessary for yen appreciation to begin correcting the trade imbalance. Without an increase in domestic demand, we believe even the gains thus far--export volume has declined since early this year, while import volume is up sharply--could erode. [redacted] 25X1

In some respects, this adjustment process is already occurring. Failure to stimulate the economy could lead to price reductions that would go far in restoring the competitive position Japan enjoyed before the yen appreciation. Wholesale prices of domestic goods, which have fallen for 17 consecutive months, are now declining at an annual rate of over 10 percent. An increase in domestic demand would decrease their slide and contribute to maintaining the competitive position gained by US firms after the appreciation. [redacted] 25X1

Long-Term Problems

While Japanese policymakers agree that a large government role in the economy can provide short-term stimulus, they are equally convinced that in the long run it leads to numerous economic problems. They believe, for example, that a bond-financed fiscal expansion increases inflation and interest rates, thereby discouraging domestic investment and reducing potential real production. A recent statement by Director General Umezawa of the Finance Ministry Tax Bureau, who suggested that expansionary fiscal policy actually reduces economic growth, typifies this perception. Indeed, many of the individuals and organizations who are in positions to influence fiscal poilcy--such as close advisers to Nakasone and the Finance Ministry--appear to be the most concerned about the long-term implications of adopting a policy of fiscal expansion. Last month's $23 billion economic stimulus package demonstrates their views in action. Implementation details have yet to be announced, but it appears that only small amounts of new funds will be involved, making the effect on growth minimal. [redacted] 25X1

A study by the OECD suggests that Tokyo's concerns about the long-term effects of fiscal stimulus may be valid. OECD simulations show that long-term interest rates--an important determinant of the cost of capital for private investment--increase sharply in Japan following a bond-financed increase in government spending. Indeed, the OECD study suggests that interest rates rise more in Japan than in the other Big Seven countries for a similar increase in government spending. [redacted] 25X1

We suspect that the narrow and tightly regulated government bond market accounts for these results. Government bonds are sold primarily to a syndicate of Japanese banks, who must hold the bonds for at least one year before resale. This restriction and tax considerations make these bonds relatively unattractive investments to banks. With financial liberalization increasing their options, syndicate members have been demanding higher interest rates as compensation for large purchases of new government bond issues. [redacted] 25X1

In addition, many Japanese Government bureaucrats--particularly in the Finance Ministry--argue that over the long term increased spending financed with bonds will

[redacted] 25X1

[redacted] 25X1

limit Tokyo's ability to use fiscal policy to react to emergencies, such as funding relief after a natural disaster or countering the effects of a full-fledged recession. [redacted] 25X1

Pressures for Change

Taken together, these long-term concerns have formed the basis for Tokyo's policy of fiscal austerity, but a growing number of Japanese officials are arguing that Tokyo should reverse that policy and stimulate the economy. They apparently believe that the current economic slowdown is serious enough to warrant acceptance of some longer term costs. [redacted] 25X6

A supporting chorus is evident from some Japanese economists who question the government's traditional contention that a large deficit is a tax on future generations. They draw a sharp distinction between spending on government consumption and spending on public investment. Their argument points out that bond-financed increases in public investment, such as bridge and road construction, will benefit future generations, who should thus share some of the costs of these projects. Moreover, such investments--unlike consumption spending--earn a return that can be used to pay off the debt. [redacted] 25X1

Given the prospects that Japanese economic growth will continue to weaken in the months ahead, calls for fiscal stimulation will probably receive greater attention at senior political levels, where Finance Minister Miyazawa will be a key player. [redacted] 25X1 Miyazawa has publicly expressed interest in using an expansionary fiscal policy to offset the negative aspects of yen appreciation. If this in fact is Miyazawa's personal policy preference, and not just a political posture adopted to distance himself from the Prime Minister, then he could develop into an important voice in favor of increased spending. Moreover, Miyazawa has a compelling reason to become more active on the policy front in the months ahead; as one of the ruling party's three "new leaders," he is a potential candidate to succeed Nakasone as LDP president and thus as prime minister, but at this point more poorly positioned in the leadership race than some of his main competitors. Still, without support from elsewhere in the LDP for his policy views, Miyazawa will face an uphill battle to get the Finance Ministry to reverse field on a tight budget policy that has now been in place for nearly a decade. [redacted] 25X1

[redacted] 25X1

[redacted] 25X1

SUBJECT: The Effectiveness of Japanese Fiscal Policy: The View From Tokyo [redacted] 25X1

Distribution:

1 – Joseph Massey, USTR
[redacted] 25X1
1 – Donald Gregg, Office of the Vice President
1 – Thomas Hubbard, Department of State
1 – William Brooks, Department of State
1 – Chuck Kartman, Department of State
1 – Marshall Casse, Department of State
1 – Rea Brazeal, Department of State
1 – Nicholas Riegg, Department of State
1 – Allen Wallis, Department of State
1 – James Kelley, Staff Member NSC
1 – Cdr. (Ret.) James Auer, DOD/ISA/EAP
1 – [redacted] DIA/DB-2D
1 – [redacted] Defense Intelligence Agency 25X1
1 – [redacted] Defense Intelligence Agency
1 – Stephen Danzansky, National Security Council
1 – Louis Pugliariesi, National Security Council
1 – Bruce Smart, Department of Commerce
1 – H.P. Goldfield, Department of Commerce
1 – Byron Jackson, Department of Commerce
1 – Allen Lenz, Department of Commerce
1 – Mel Searles, Department of Commerce
1 – Maureen Smith, Department of Commerce
1 – David Mulford, Department of Treasury
1 – Robert Cornell, Department of Treasury
1 – Doug Mulholland, Department of Treasury
1 – Robert Fauver, Department of Treasury
1 – Richard Woodworth, Department of Treasury
1 – [redacted] National Security Agency 25X1
1 – David Germany, Council of Economic Advisers

Central Intelligence Agency
1 – Director, DCI/DDCI Executive Staff
1 – NIO/EA
1 – NIO/Economics
1 – C/EA [redacted] 25X1
1 – OGI/IIC/PI
1 – OEA/NEA/Korea Branch
1 – OEA/NEA/STI Branch
1 – OEA/NEA Division
1 – OEA/China Division
1 – OEA/SEA Division
1 – D/OEA
1 – C/Production/OEA
1 – FBIS Analysis Group

[redacted] 25X1

Sanitized Copy Approved for Release 2011/04/21 : CIA-RDP86T01017R000606740001-7

[redacted] 25X1

1 - DDI
1 - Senior Review Panel
1 - PDB Staff
1 - C/PES
1 - CPAS/ILS
5 - CPAS/IMC/CB
1 - Branch
1 - LDA
1 - NIC/AG
1 - DDO/EA Division
1 - DDO/EA [redacted] 25X1
2 - Author
1 - Chrono
DDI/OEA/NEA/Japan [redacted] 22 October 1986 25X1

[redacted] 25X1

Sanitized Copy Approved for Release 2011/04/21 : CIA-RDP86T01017R000606740001-7