 25X1

FILE

Central Intelligence Agency

Washington, D.C. 20505

DATE 10/28/86 FILE

DOC NO EA M 86-20165

OIR 3

P & PD 1

DIRECTORATE OF INTELLIGENCE

27 October 1986

Japan: Is Tokyo Serious About Boosting Domestic Demand? 25X1

Summary

Prime Minister Nakasone has generated little support for reorienting economic policy in spite of his ringing endorsement six months ago of the Maekawa Commission's proposals for reducing the Japanese economy's dependence on exports. The momentum for turning growth inward, never large, slowed considerably over the summer as Nakasone focused on domestic politics and Tokyo's concern about imminent protectionist measures waned. The Maekawa package has triggered little enthusiasm in the ruling Liberal Democratic Party or the bureaucracy and will probably die a quiet death once Nakasone leaves office. Nonetheless, we expect the Japanese to continue to cite the Maekawa report at multilateral and bilateral gatherings as a sign of Tokyo's good faith, as well as to continue to emphasize that economic adjustment takes time. For example, the Japanese will probably claim progress on the Maekawa front at next week's economic sub-Cabinet talks with the United States, but the implementation timetable Nakasone plans to announce at next spring's economic summit will probably run well past 1990. 25X1

This memorandum was prepared by Office of East Asian Analysis. Information available as of 27 October 1986 was used in its preparation. 25X1
Comments and queries are welcome and may be directed to the Chief, Japan Branch, Northeast Asia Division, OEA, . 25X1

EA M-86-20165

25X1

[redacted] 25X1

Because the Japanese do not anticipate a severe and prolonged recession or across-the-board trade restrictions, Tokyo is unlikely to make a concerted effort to turn growth inward. Moreover, many Japanese strongly believe that economic growth cannot be maintained by a reliance on domestic demand. Japanese leaders who hold this view want to implement those Maekawa recommendations that enhance international competitiveness while channeling the proceeds of Japan's massive trade surpluses into programs, such as foreign aid, that can reap public relations benefits. [redacted] 25X1

The Maekawa Recommendations: A Rocky Start

Last spring Prime Minister Nakasone hailed the report of the Maekawa Commission--his blue ribbon panel on trade policy--as the first of many Japanese steps to reduce the economy's dependence on exports. Many of the panel's recommendations only replayed previous trade proposals (see table 1), but the report contained one novel element--a preamble suggesting Japan set as a goal the reduction of its current account surplus to an "internationally harmonious" level. Although stopping short of recommending Tokyo end its six-year campaign of fiscal austerity, the commission proposed reforms to increase domestic spending on goods and services, reducing the need for Japanese business to seek foreign markets. This feature of the Maekawa report gave it quick success on one level--from Tokyo's perspective--by muting US and EC criticism of Japan's trade practices before and during the Tokyo economic summit in May. [redacted] 25X1

The initial lack of enthusiasm for the Maekawa proposals, however, was evident in the Prime Minister's unsuccessful sales pitch at home. Instead of welcoming the report, leading politicians attacked Nakasone's premature advertising of the recommendations as government policy. And Nakasone himself has occasionally wavered. During the Diet election campaign this summer, he retracted two key planks--ending tax-free saving accounts and introducing an indirect tax that the Finance Ministry considers essential to any large tax cuts the commission proposed. With a landslide election victory behind him, Nakasone seems to be more resolved: he is chairing the committee planning for implementation and has staffed it with top officials from the government and the ruling party. [redacted] 25X1

Widespread backing for the shift away from export-led growth has not materialized. We see no evidence that the ruling party, key ministries, or leading businessmen have taken the basic message to heart--that Japan must adopt reforms that encourage a shift away from exports to the domestic market. As a case in point, Tokyo has still not adopted as official policy the recommendation that the current account surplus be reduced to "preserve international harmony," a phrase most often interpreted as the setting of a target for the current account. Recent Embassy Tokyo reporting suggests that a special advisory committee chaired by former Bank of Japan Governor Maekawa may recommend a surplus reduction target by yearend, but we doubt that Tokyo will officially adopt such a goal. The original Maekawa Commission

[redacted] 25X1

Table 1

Japan: Common Themes of Recent Trade Packages

Measures Proposed for Study or Implementation	May 1982	January 1983	October 1983	April 1984	December 1984	April 1985	July 1985	Maekawa Report
Tariff Cuts	x	x	x	x	x	x	x	
Standards and Certification Improvements	x	x	x	x		x	x	x
Low-cost Import Financing	x		x			x		
Financial Liberalization			x				x	x
Expand Agricultural Imports		x		x			x	x
Improve Distribution System	x							x
Increase Government Procurement of Foreign Goods		x					x	
Housing Incentives			x					x

25X1

decided against such a move, after examining MITI forecasts showing the current account surplus would exceed 2.5 percent of GNP through 1990. It will probably top 4 percent of GNP this year. [redacted] 25X1

But Selective Implementation

Despite the report's poor reception at home, Tokyo is moving ahead on several of the Maekawa proposals for reasons having little to do with agreement on the need to spark domestic growth. Government bureaucrats and politicians, for example, have used the report's recommendations to argue for implementing items long on their agendas. For example:

- The Japanese plan to begin a wide-ranging reform of their tax code next year. The US Embassy in Tokyo notes that little consideration has been given to the relationship between tax reform and the Maekawa proposals. Moreover, the planned combination of income tax cuts and indirect tax increases will probably result in little net stimulus to the economy.

- MITI is engaged in an industrial restructuring program designed to phase out uncompetitive segments of the steel and textile industries and to shift the resources to more productive sectors. These moves are designed to enhance international competitiveness rather than to encourage firms to focus on the domestic market.

- Tokyo is drafting a new five-year plan for the coal industry, which will probably recommend sharp cutbacks in domestic production, to reduce high government subsidies. But imports of US coal will rise little.

- Japanese companies are increasingly setting up manufacturing plants overseas--a process accelerated by the strong yen, which makes producing abroad cheaper. MITI sees this as a counterpart of industrial restructuring as well as an outlet for funds generated by the trade surplus. It also suggests Japanese companies see weak domestic demand as continuing and therefore anticipate better profits elsewhere. [redacted] 25X1

On balance, these steps, except for direct investment, will probably do more to enhance Japan's international competitiveness than to reduce its trade surplus (see table 2). Measures more likely to expand domestic spending--such as reducing taxes, increasing public investment, providing tax incentives for housing, streamlining the costly distribution system, and liberalizing the now heavily subsidized agricultural sector to lower prices, increase imports, and free up land for housing--show little sign of being implemented soon. [redacted] 25X1

 25X1

Table 2

Key Maekawa Recommendations: A Report Card

Recommendation	Grade*	Comment
Expand Domestic Demand by		
-- Promoting housing construction -- Boosting public works	●---● ●---●	Current pump-priming plan contains a few minor housing incentives; FY87 budgets--both at the local and national levels--may contain modest increases in public works spending.
-- Stimulating private consumption by tax cuts, higher wages, shorter hours	●---●	Little sign yet of consumer-led recovery. Impact of lower oil prices and strong yen have not had major impact on consumer prices. Planned tax cuts may have little impact on consumer spending because people expect a comparable indirect tax to be implemented soon.
Transform the Industrial Structure		
-- Rationalize depressed industries, including textiles and coal	●---●	Political pressure and special interest groups slowing government plans to phase out uncompetitive industries like some textiles. MITI plans for cutting coal production in half by early 1990s also running into political opposition, but will proceed in some form. New industrial restructuring law likely to focus on enhancing competitiveness rather than encouraging firms to switch from the export to the domestic market.
-- Ease restrictions on agricultural imports, except rice and wheat	●---●	Most controversial Maekawa recommendation; Nakasone has expressed interest in reforming the price support system for wheat and rice but any change would be gradual and long-term. 25X6
-- Encourage outward foreign investment	●---●	Tokyo has provided a few tax and loan incentives [redacted] Outward investment will continue as long as the current account surplus remains large. 25X6
Improve Market Access		
-- Implement measures in the 1985 Action Program designed to ease import barriers	●---●	Sticking to action program timetable. Imports of manufactures--especially intermediate goods from Asian NICs--have risen briskly. 25X6
-- Streamline distribution system	●---●	No substantive action taken. Lack of competition within the multilayered distribution system has kept retail prices of imports from falling in line with yen appreciation.
Currency Stabilization and Financial Liberalization		
-- International cooperation to reduce exchange rate volatility	●---●	Japanese economic policymakers and major corporations have resigned themselves to a yen in the 150-to-160 per dollar range. Some businesses are planning for a 130 yen/dollar rate.
-- Further liberalize financial markets	●---●	The Finance Ministry has moved extensively in recent months to liberalize capital outflows--including allowing insurance companies and the huge postal pension fund to hold a larger share of their assets overseas. Continued foot-dragging on allowing overseas financial institutions into the Japanese market reflects Tokyo's concerns over the stability of

25X1

Key Maekawa Recommendations: A Report Card

Recommendation	Grade*	Comment
Increase International Cooperation		
-- Expand imports from LDCs	●---●	Yen appreciation has boosted imports of intermediate goods such as steel from Korea and Brazil. However, progress in raising imports of commodities or final manufactured goods from LDCs has been minimal.
-- Expand foreign aid	●---●	Tokyo has adopted goal of doubling overseas development assistance in the next seven years--in dollar terms. If the yen remains strong, Tokyo should have little trouble meeting this goal. At the same time the strong yen increases the burden LDCs must bear to repay debt denominated in yen. 25X6
-- Promote a new GATT round	●---●	Tokyo supports most US positions but is wary of multilateral agricultural negotiations. 25X6
Fiscal and Monetary Management		25X6
-- Implement fiscal policy flexibly	●---●	Economic slowdown has generated calls for temporary stimulus from politicians and businessmen. Nonetheless, little shift in government or big business desire for shrinking role of public sector in the long term.
-- Abolish tax-free interest for small savers accounts	●---●	Tokyo's Tax System Advisory Council will probably recommend introduction of low tax on interest income as part of 1987 tax reform package. Even with bulk of small savers accounts "grandfathered," the proposal will face tough political opposition.
-- Use monetary policy to support domestic demand expansion	●---●	Three cuts in discount rate in 1986 are "enough," according to Bank of Japan Governor Sumita. Nonetheless, another cut is possible if yen strengthens further.

*Grades

●---O indicates Tokyo is likely to move ahead with reform in a meaningful way in the next few years.
●---O indicates Tokyo will probably stonewall.
O---● indicates that we believe that proposal, if implemented, would reduce Japan's trade surplus.
O---● indicates that we believe trade impact--at least in short run--might be negative.
O---● indicates that we are uncertain of the effect on trade flows.

25X1

[redacted] 25X1

Maekawa Over the Long Haul

After Nakasone steps down as prime minister--his current term expires in October 1987--the overall Maekawa package will probably fade away, as have many other reports by Japanese study groups. In fact, the bias in favor of other, more widely supported policies that would contribute to the demise of the Maekawa approach is striking. In particular, the underpinnings of Japan's current economic policy--marked by a focus on budget austerity and small government--remain strong.

- Keidanren--Japan's most prestigious big business organization--continues to hold that the private sector would not be able to generate an acceptable level of economic growth in the face of the higher taxes needed eventually to pay for deficit financing.

- Japanese bureaucrats and politicians believe Tokyo must slow the growth of the national debt now to prepare for the onslaught of additional payments necessary because of the rapid aging of the population beginning in the 1990s. These views were strongly represented this summer in the final report of the Administrative Reform Council--the group largely responsible for "selling budget austerity." [redacted] 25X1

Moreover, there is a school of thought that argues Japan cannot afford to rely largely on its domestic market to generate growth as it approaches a critical demographic and economic juncture created by the "graying" of the population. Saburo Okita, former Foreign Minister and a respected economics authority in Japan, is the most prominent advocate of this view. Okita argues that institutional and cultural factors, such as the high saving rate, keep domestic spending well below the level needed both to approach full employment and to support productivity-enhancing investment. In his view, growing exports represent the only alternative to slow growth and rising unemployment. To fend off criticism from Japan's trading partners, Okita argues that Japan must recycle its trade surpluses as increased foreign aid and overseas investment. [redacted] 25X1

If we and the Japanese who expect the economy to pick up by mid-1987 have underestimated the negative impact of yen appreciation, a reorientation of economic policy toward domestic growth could occur. Under tougher circumstances, the departure of Nakasone--a staunch supporter of budget austeriry--may make it easier for others to advocate policies, including fiscal stimulus, to offset the loss in export markets. Nakasone's probable successors, with the possible exception of former Finance Minister Takeshita, are not as philosophically wedded to fiscal conservatism. If gloomy economic prospects coincide with a sharp upsurge in protectionism, the move to foster domestic growth would gain considerable ground. [redacted] 25X1

[redacted] 25X1

[redacted] 25X1

An Alternative Outcome

Notwithstanding the factors that appear to call into question the staying power of the Maekawa approach, we can envision a scenario--although we believe it unlikely--that would generate a real shift in Japan's export orientation. In particular, the combined threats of a prolonged recession and substantial new overseas barriers to Japanese exports could produce a consensus that the country's export markets were no longer reliable. Some economists argue that the recent appreciation of the yen--up roughly 50 percent against the dollar over the past year--sets the stage for a policy shift, although we disagree. Despite the fact that yen appreciation is clearly hurting the economy today, Japan--in our view and that of most observers--can adjust as effectively to the strong yen as it did to the energy shocks of the 1970s (see the appendix). [redacted] 25X1
[redacted] 25X1

Outlook

Some additional fiscal stimulus is probable in the attempt to ease the impact of the strong yen, but the overall approach in Tokyo will probably remain "business as usual." We expect additional spending to be temporary and to concentrate on public works--such as roads and bridges--that would minimize the long-term costs associated with pump priming. Depending on the tactics of the opposition, the ruling party and Finance Ministry might agree to accelerate planned income tax cuts and perhaps delay the introduction of a revenue-enhancing indirect tax, hoping the net effect would encourage consumer spending. The impact on the economy of such moves would be minor, in our view. [redacted] 25X1

[redacted] 25X6

[redacted] 25X1

Declassified in Part - Sanitized Copy Approved for Release 2011/12/01 : CIA-RDP86T01017R000706770001-3

[redacted] 25X1

APPENDIX

Japanese Economic Prospects: How Bad Are They?

The yen's strength is conditioning Japanese economic prospects for 1986, making it unlikely Japan could achieve the government's official forecast of 4-percent real GNP growth, much less rival the 4.6 percent achieved last year (see figures 1-3). Indeed, we expect economic growth to slow to approximately 2 percent this year, the worst performance since 1975. Our pessimism is widely shared by private forecasters in Japan and reflects the toll the strong yen is taking on the foreign sector's contribution to growth, which in recent years has amounted to over half of the total.

- Despite Japanese manufacturers' willingness to lower the yen prices of their goods to maintain overseas sales, Japanese export volumes have been declining gradually for over six months. Price and quantity decreases are cutting manufacturers' earnings and production. This in turn is forcing export-related manufacturing firms--such as auto and electrical appliance manufactures--to trim investment spending considerably.

- In addition, lower import prices are drawing in intermediate goods such as steel from the Asian NICs, which also hurt Japanese manufacturing. Imports of US manufactures have not increased much, however.

Domestic demand, moreover, has not risen to compensate for the yen's deflationary impact on trade and growth. Low wage settlements have dampened private consumption and Tokyo's austere fiscal policies have limited the stimulus provided by the public sector. [redacted] 25X1

The major question is whether over the next year or two the Japanese economy will adjust sufficiently to a 150-yen-to-dollar exchange rate to allow growth to return to the more politically palatable 3-percent level. At present, most observers expect it will, a judgment with which we concur. Although weak exports will continue to restrain growth in 1987, we anticipate domestic demand will rebound somewhat. Simulations done using our econometric model of Japan suggest that real GNP will increase about 3 percent next year. [redacted] 25X6
25X6
Underlying the relatively upbeat forecasts are assumptions that real incomes will rise as a result of yen appreciation and that investment in nonexport-related industries--such as services and gas and electric utilities--also will steadily increase. [redacted] 25X1

Despite general agreement that Japan will probably--given time--be able to digest a strong yen, some private forecasters are bearish about prospects for next year. Mitsubishi Research Institute, for example, recently lowered its 1987 forecast to 1.7 percent, or 0.5 percentage point below its prediction for this year. If Mitsubishi is

[redacted] 25X1

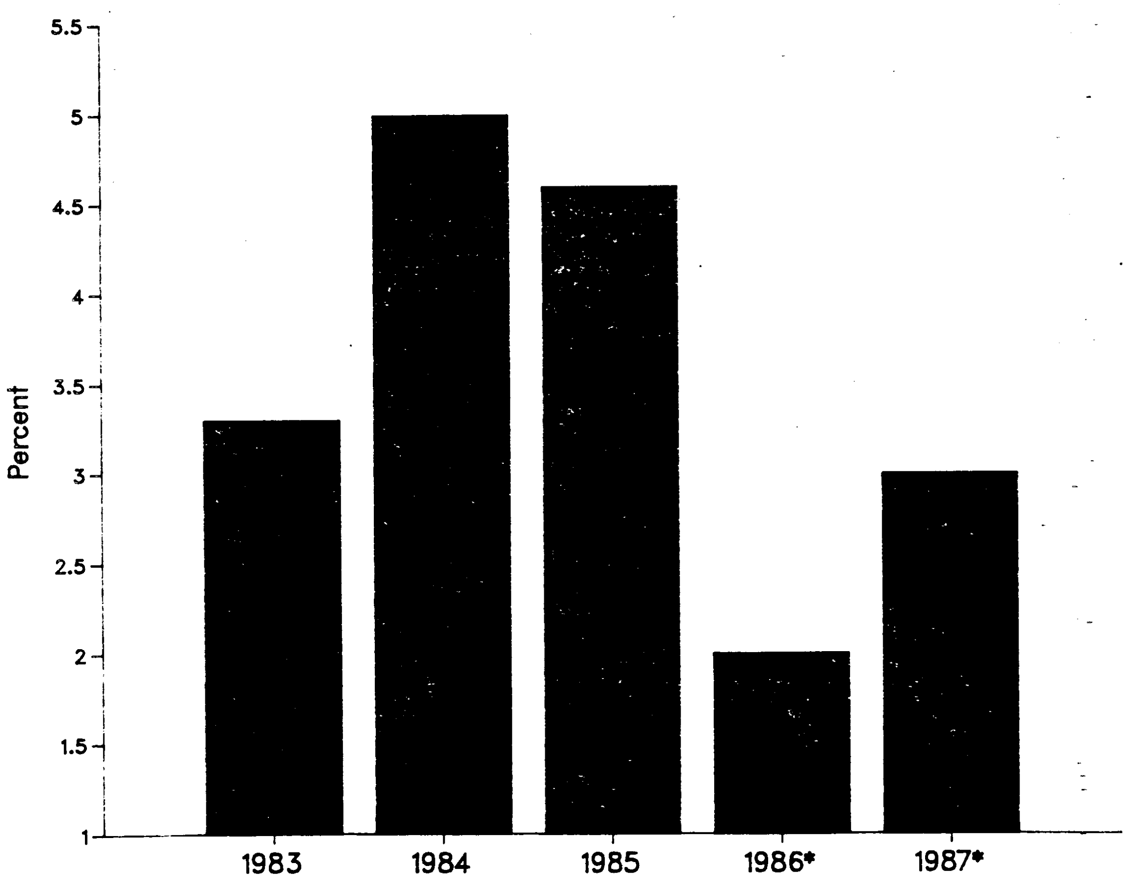
25X1

correct in its assessment that 1987 will be worse, Tokyo will face some tough macroeconomic policy decisions. 25X1

25X1

Figure 1

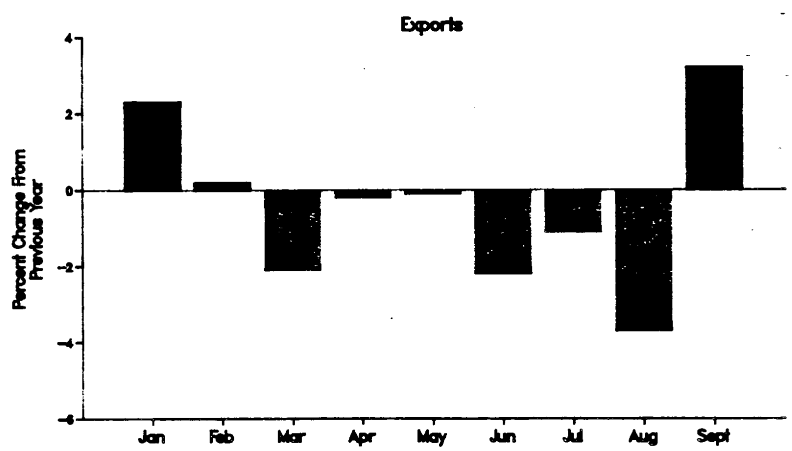
Japan: Growth in Real GNP



*CIA projection.

25X1

Figure 2
Japan: Export and Import Volumes, 1986



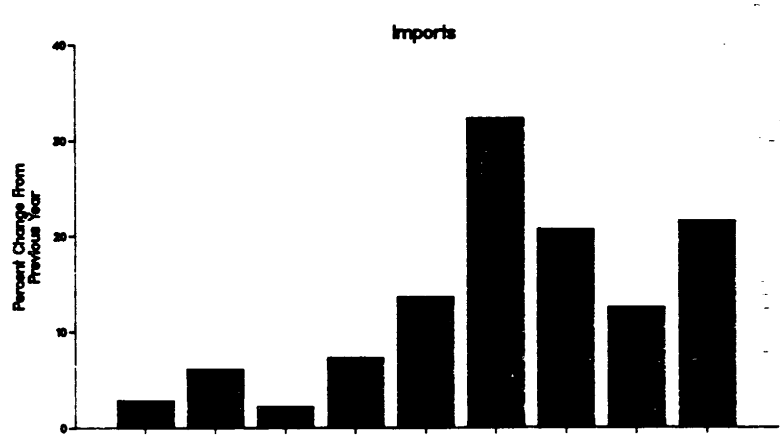
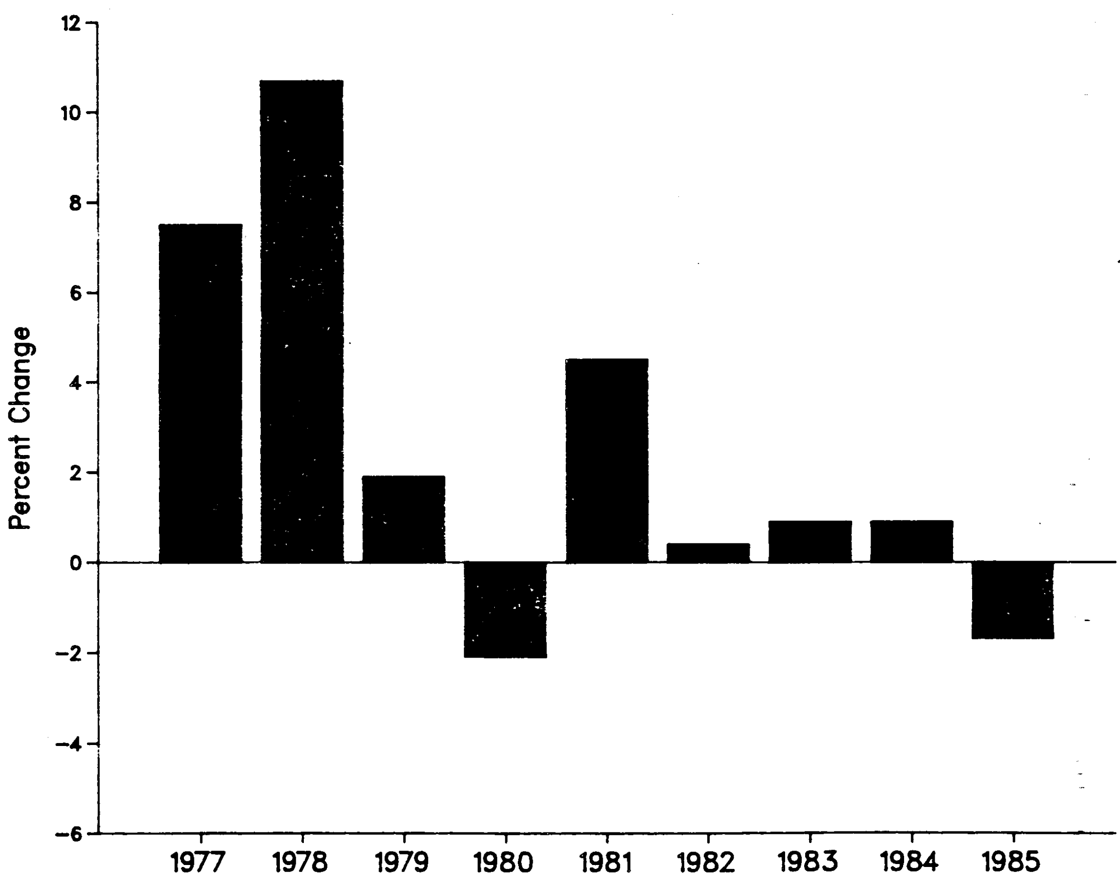


Figure 3

Japan: Growth in Real Government Spending



25X1

[redacted] 25X1

SUBJECT: Japan: Is Tokyo Serious About Turning Growth Inward? [redacted] 25X1
Distribution:
1 – Joseph Massey, USTR
1 – Bob Park, Intelligence Liaison, USTR
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 – Robert Reis, Department of State
1 – Nicholas Riegg, Department of State
1 – Allen Wallis, Department of State
1 – James Kelly, Special Assistant to the President, NSC
1 – Cdr. (Ret.) James Auer, DOD/ISA/EAP
1 – [redacted] 25X1
1 –
1 –
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] 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
1 – DDI
1 – Senior Review Panel

[redacted] 25X1

[redacted] 25X1

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
[redacted]
2 - Author 25X1
1 - Chrono
DDI/OEA/NEA/Japan/[redacted] 27 October 1986 25X1

[redacted] 25X1