

PO-CH/NL/0375
PART A

Part A.

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Begins: 23/1/89

Ends: 17/5/89



PO -CH /NL/0375



PART A

Chancellor's (Lawson) Papers:

JAPANESE CURRENT ACCOUNT
SURPLUS AND STRUCTURAL
REFORM

PO -CH /NL/0375

PART A

DD's: 25 Year

Phollos

6/12/95

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24/1

CH/EXCHEQUER	
REC.	24 JAN 1989
ACTION	Mr R. I. G. ALLEN
COPIES TO	Mr NICKS,
	Mr LANKESTER,
	Mr BROWN
	Mr SYMES.

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

23 January 1989

Dear Nigel,

PARIS ECONOMIC SUMMIT

We had a short talk with the Prime Minister this evening about the Paris Economic Summit from which I think three points emerged:

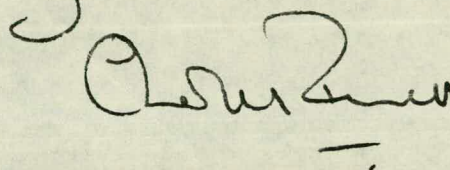
- the Prime Minister suspects that the French may launch an 'expensive' initiative on the environment at the Summit, drawing on the ideas put forward to a number of Heads of Government by Monsieur Rocard. She thinks that we should prepare for this by producing a paper of our own on the economics of environmental protection. This would examine the costs of commitments to deal with specific environmental problems such as car exhaust emissions, reducing dependence on coal and measures to preserve tropical forests. The paper should also look at the consequences for aid policy of additional commitments in these areas. You will want to set a study in train;
- the Prime Minister also wants the Summit to tackle again, and this time more effectively, the problem of persistent structural surpluses in countries like Japan and Germany. She would welcome ideas on how we can best go about this;
- in the same context, but also with an eye to the Anglo/German Summit in late February, she would like a note on our economic and trade relations with the Federal Republic of Germany, the reasons why we have such a substantial deficit in our trade with them and what we can do about it.

The Prime Minister also lamented the substantial deficit in our trade with the Community as a whole, the fact that our farmers seemed to fare worse last year in terms of farm incomes than any other farmers in the Community and the further rise expected in the current year in our net contribution to the Community. In the light of all these, it was hard to construct a case that membership was doing us much good. It might be useful if the Cabinet Office could put together a short factual note dealing with our comparative

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position in these three areas of our economic relations with the EC, illustrating the trends in each case.

I am copying this letter to Alex Allan (Treasury), Stephen Wall (Foreign and Commonwealth Office), Neil Thornton (Department of Trade and Industry), Roger Bright (Department of the Environment), Shirley Stagg (Ministry of Agriculture, Fisheries and Food), Carys Evans (Chief Secretary's Office) and Roger Lavelle (Cabinet Office).

Yours sincerely,


CHARLES POWELL

Nigel Wicks Esq., C.V.O., C.B.E.

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FROM: C MELLISS (IF2)
DATE: 4 April 1989
X 4700

CHANCELLOR

cc PS/EST
Sir T Burns
Mr Wicks o.r.
Mr Lankester
Mr Evans o.r.
Mr Odling-Smee
Mr Peretz
Mr Ilett
Mr Walsh
Mr Edmonds o.r.
Mr Molan
Mr Sharples
Mr Tyrie

VISIT OF GOVERNOR SUMITA

1. Governor Sumita of the Bank of Japan will be paying you a courtesy call at 4.00 pm on Thursday 6 April, at No. 11. He will be accompanied by Mr Ohta, the Deputy Governor for International Affairs at the Bank of Japan. I attach summary biographies of both men, who will have had extensive discussions with the Governor of the Bank of England earlier in the day. Governor Sumita will have attended the spring meetings in Washington. Sir Terence Burns will also be attending the meeting.

2. You will want to discuss with Governor Sumita some of the issues raised in Washington, such as the Brady debt plan, exchange rate intervention arrangements, and possibly the IMF quotas. No new briefing is provided on these topics. However there are two issues arising from the Spring Meetings which it would be useful for you to raise:

(i) the increase in the overall IMF quota that the Japanese think is appropriate;

(ii) the \$4.5bn increase in lending from the Japanese Export-Import Bank to be used in parallel with IMF funding under the Brady plan: What lies behind this and how significant is it?

3. This meeting will also give you an opportunity to find the Governor's views on likely developments in the Japanese economy

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and talk to him about trade and financial services issues. Attached at annex A is a note on the Japanese economy. At annex B is a copy of Governor Sumita's speech at the 1988 IMF/IBRD Berlin meeting, mostly about debt and development and the International Monetary System. At annex C is a note on current issues in financial relations with Japan.

Japanese Economy and Current Account Surplus

4. We, and the IMF, see some reduction from the exceptionally rapid rate of growth in 1988 of about $5\frac{1}{4}$ per cent. The latest WEP expects growth this year of nearly 5 per cent. A further rise in inflation to about 2 per cent, partly due to the introduction of a new sales tax, is expected.

5. The Japanese current account surplus was 2.8 per cent of GDP in 1988, a considerable adjustment from the figure of 4.4 per cent in 1986. But adjustment now seems to have stopped, and the Japanese monthly trade surplus has been rising since last June.

6. You may wish to raise with Governor Sumita:

- his Government's January forecast of real GNP growth of 4 per cent for FY 1989, i.e. year from 1 April 1989: is it now too low?

- how he sees prospects for a further reduction in the surplus.

Monetary and Exchange Rate Policy

7. The yen has appreciated in effective terms by more than 50 per cent since 1985Q2, but by less than 3 per cent since the beginning of 1988. The Bank of Japan intervened visibly earlier this week. Alone among G7 countries Japan has been able to avoid a significant rise in nominal short rates: they are now at 4.8 per cent compared with 4.4 per cent in March 1988. There has recently been a slight steepening of the yield curve, again a singular feature.

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8. There are two questions arising from this which you may wish to raise:

(i) Does the intervention mark a departure from the previous non-intervention stance and is it primarily designed to support the yen?

(ii) Is there now pressure for a rise in interest rates, particularly in view of recent rises in the dollar, the rise in inflation, and continued strong growth in Japan?

Structural Issues

9. A paper on the relation between the Japan current account surplus and structural reform is being prepared for the Paris Economic Summit. You may wish to ask the Governor about progress in structural reform in Japan e.g. in freeing the market in land and in deregulating the retail and financial services sectors. We hope to see a speedy resolution of outstanding applications for membership of the Tokyo Stock Exchange and investment trust licences granted to overseas firms in reasonable time as part of the deregulation of financial services, see also annex C.

Trade and International Investment

10. You may want to express the UK's continuing commitment to the free flow of goods, services, and capital between countries. Tokyo Telegram no. 289 of 23 March (attached at annex D) notes the Japanese perception of EC anti-dumping regulations, local content requirements and some countries' treatment of inward investment as protectionist. We agree with most of the comments in the telegram on the Japanese complaints, but we do not share the Embassy view, paragraph 6(i), that the anti-dumping rules are beyond reproach. (DTI and Treasury officials are currently lobbying the Commission on a private basis to modify their use of anti-dumping procedures.)

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11. The European heads of state have expressed their resolve that the Single Market should not turn in on itself. You may wish to reassure Governor Sumita of the government's determination to see that the level of EC protection does not increase and that there is no discrimination against Japanese products or firms - see paragraph 11 of telegram especially.

CHM

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Satoshi SUMITA

Governor, The Bank of Japan

Date of Birth: September 4, 1916

Education: 1940 LL.B., The University of Tokyo

1940	Joined the Ministry of Finance
1949 - 51	Director of Foreign Debts Division, Financial Bureau
1953 - 55	First Secretary, Embassy of Japan in Belgium
1955 - 56	First Secretary, Embassy of Japan in France
1956 - 57	Director of Fund Planning and Operation Division Financial Bureau
1957 - 60	Director of Co-ordination Division, Financial Bureau
1960 - 61	Regional Commissioner of Fukuoka Regional Taxation Bureau
1961 - 63	Councilor, Minister's Secretariat
1963 - 65	Deputy Director-General, Budget Bureau
1965 - 66	Deputy Vice Minister, Minister's Secretariat Economic Planning Agency
1966 - 69	Director-General, Banking Bureau
1969 - 71	Administrative Vice Minister of Finance
1972 - 78	President, The Export-Import Bank of Japan
1979 - 84	Deputy Governor, The Bank of Japan
1984, Dec.-	present position

Takeishi OHTA

Deputy Governor for International Relations
The Bank of Japan

Date of Birth: October 23, 1929

Education: 1952, LL.B., The University of Tokyo

1952	Joined The Bank of Japan
1960 - 63	Deputy Chief Representative in Hong Kong
1969 - 71	Deputy Chief Representative in Europe (London)
1975 - 76	Deputy Director, Foreign Department
1976 - 79	Chief Representative in Europe (London)
1979 - 80	Adviser to the Governor
1980 - 81	General Manager, Nagoya Branch
1981 - 84	Director, Foreign Department
1984 - 86	Executive Director
Dec. 1986 ~	present position

D. ob

Personal

THE JAPANESE ECONOMY

ANNEX A

Size and Structure

1. Japan's GDP is more than $2\frac{1}{4}$ times that of the UK and nearly 40 per cent of US GDP. Japanese GDP per capita is slightly higher than in the UK. Japan's large and efficient manufacturing sector produced 29 per cent of Japanese GDP in 1986, compared with 22 per cent in the UK. Japan's exports are nearly all manufactures. Manufactured imports are less than a third of manufactured exports.

Growth and Inflation

2. The Japanese economy grew exceptionally strongly in the first quarter of 1988, led by investment and exports, growth has since slowed but remains robust. Consumer price inflation has picked up since 1988Q2. It is still only 1.1 per cent, but is expected to rise further: wholesale prices are now rising rather than falling, and the gradual introduction of a sales tax during 1989 will also raise the inflation rate. The IMF forecast of 1.4 per cent is probably optimistic.

Table 1: Japanese Growth and Inflation

	Annual				Quarterly				
	1986	1987	1988	1989*	1988				1989
					Q1	Q2	Q3	Q4	Q1
Real GNP (per cent increase as previous year)	2.5	4.5	5.7	4.6	7.0	5.7	5.7	4.7	n.a
Domestic Demand	4.1	5.1	7.8	5.2	9.1	8.1	8.0	6.1	n.a
Consumer Price Inflation (per cent)	0.6	0.1	0.7	1.4	0.8	0.2	0.6	1.1	1.1 (Jan)

* IMF forecast

Japan's Account Surplus

3. Japan is both a high saving and a high investment economy. Net savings in Japan in 1987 were 18½ per cent of GDP and were about equal to net savings in the other G7 countries combined. The excess of savings over investment has been reflected in a Japanese current account surplus since the mid-1960s.

Table 2: Japan's Current Account Surplus (+) or deficit (-) as a percentage of GDP

1960-69 (average)	1970-79 (average)	1980-85 (average)	1986	1987	1988	1989*
0.1	0.9	1.8	4.4	3.6	2.8	2.6

* IMF forecast

The current account surplus has led to an increase in Japanese net overseas assets from 1 per cent of Japanese GDP in 1975 to 15 per cent (IMF estimate) by end-1988. This accumulation reflects direct investment in the NIEs, Europe and the US, and the acquisition of US Government debt. Japan has made a vital contribution to world saving during the 1980s.

Monetary and Fiscal Policy

4. Japanese monetary policy has been directed to the control of inflation but Japan is the only G7 country that has not had large rises in nominal interest rates since last May.

Table 3: Nominal and Real Short Term Interest Rates

(per cent)	1980-5 Average	1986	1987	1988	1989
Nominal	6.6	5.1	4.2	4.5	4.7 (Q1)
Real	3.9	4.5	4.1	3.8	3.4 (Jan)

5. The medium-term objective of Japanese fiscal policy is to need no new deficit-financing bonds by FY 1990. With strong growth in 1988, this should be achieved.

Table 4: Japanese Fiscal Surplus (+) or deficit (-) and Net Public Debt, as percentages of GDP

	1983	1984	1985	1986	1987	1988*	1989**
Central Government (FY)	-4.9	-4.1	-3.7	-3.1	-2.7	-2.4	-2.0
General Government	-3.7	-2.1	-0.8	-1.1	-0.3	-0.2	-0.2
Net Public Debt	26.2	26.9	26.6	26.6	25.9	24.6	23.5

Source OECD

* Estimate, partly forecast based on policies as at Autumn 1988

** Forecast

Exchange Rate and Competitiveness

6. The yen has appreciated in effective terms by approximately 50 per cent since the dollar's peak in February 1985.

Table 5: Japanese Exchange Rate

	1981	1982	1983	1984	1985	1986	1987	1988	1989 (29 March)
Effective exchange rate (1985 = 100)	87.5	83.0	91.8	97.9	100.0	124.4	133.2	147.4	146.8
Yen/dollar rate	219.5	248.8	237.4	237.5	238.3	168.3	144.7	130.4	132.8

7. Productivity growth in manufacturing has fallen below the G7 average during the 1980s.

JAPANESE EFFECTIVE EXCHANGE RATES (1985=100)

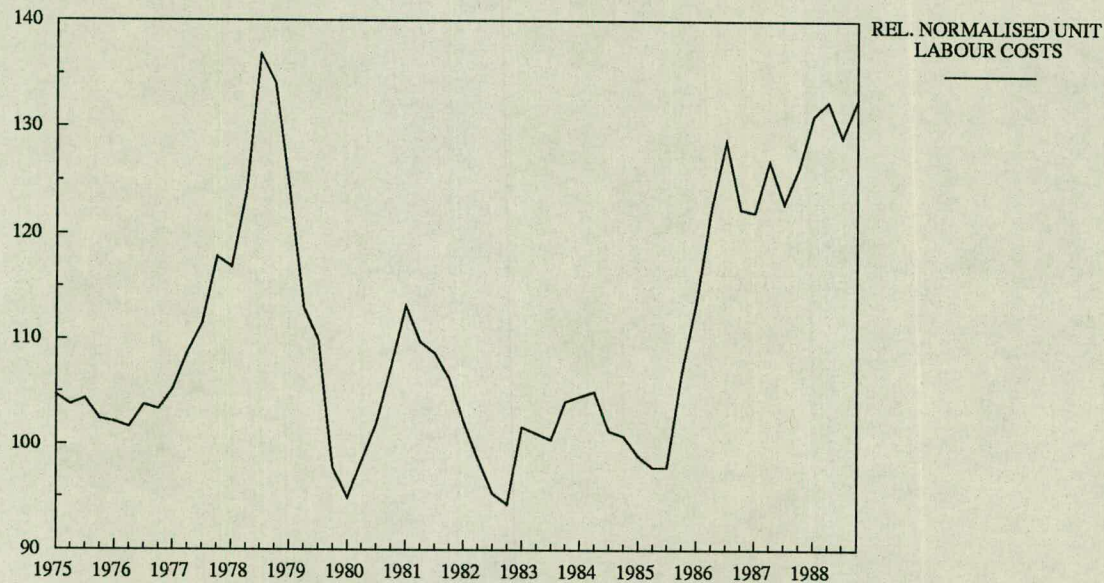


Table 6: Output per Employee in Manufacturing

	<u>Annual Average percentage change</u>		
	1960-70	1970-80	1980-1988
Japan	8.8	5.3	3.1
Major 7 Average	4.4	3.3	3.7

8. The chart below shows the sharp rise in Japanese relative unit labour costs since 1985.

Structural Reform

9. The Japanese economy has become much more open since 1980, and key sectors have been deregulated, especially financial markets. But further structural reform, which would improve the efficiency of the Japanese economy, could be undertaken in:

- Land. Regulations restrict building urban areas. The tax structure encourages holding on to land even if it is left idle: this adds to exorbitant housing costs;
- Agriculture. Japanese agriculture is inefficient and heavily subsidised and protected;
- Retailing and distributing. This sector is characterised by anti-competitive practices (eg. sole agency agreements, resale price maintained). The large Retail Stores Law prevents the building of larger and more efficient stores; and
- Financial services. Some interest rates are still regulated. Overseas companies find it difficult to obtain access to wholesale funds and rights to market certain kinds of assets (eg. investment trusts).

INTERNATIONAL MONETARY FUND
THE WORLD BANK GROUPINTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL FINANCE CORPORATION
INTERNATIONAL DEVELOPMENT ASSOCIATION
INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES
MULTILATERAL INVESTMENT GUARANTEE AGENCY

Press Release No. 12

September 27, 1988

HOLD FOR RELEASE
UNTIL DELIVERY

Statement by the Hon. SATOSHI SUMITA,
Governor, the Bank of Japan, and
Alternate Governor of the Fund and the Bank for JAPAN,
at the Joint Annual Discussion

There are a number of important issues before us, and I am grateful for this opportunity to state my views as Alternate Governor for Japan. Before that, however, I would like to express my very sincere admiration and appreciation to the Government of the Federal Republic of Germany for the impeccable arrangements that they have made for our meetings.

1. Present State of the World Economy and the Economic Issues Before Us.

(i) Present state of the world economy

In looking at the overall state of the world economy today, the first thing we notice is that it is achieving faster and better economic growth than expected. The industrial countries continue to enjoy strong expansion, and the developing countries as a whole are managing sustained though gradual economic growth.

The next feature of note is the progress that is being made in reducing external imbalances among the industrial countries, not only in volume terms but also in nominal value terms. The U.S. trade deficit and Japan's trade surplus in particular have been steadily reduced.

In addition, it is noteworthy that exchange rates, though having changed substantially at times, have been relatively stable of late.

Focusing more narrowly upon Japan, the economy has continued to expand, with the primary impetus from strong domestic demand, while prices have been very stable. Real GNP growth in fiscal 1987 was 4.9 percent--the highest it has been since fiscal 1984. In tandem with this,

the current account surplus is being steadfastly reduced, the surplus for fiscal 1987 being \$10 billion less than that for fiscal 1986--the first reduction since fiscal 1981.

Looking ahead, Japan, is determined to promote and consolidate the shift to domestic demand-led growth in line with the new five-year economic plan adopted this May. The tax reform now being discussed in the Diet is also expected to contribute to the attainment of this objective by creating a distortion-free tax structure and by instituting major tax reductions.

(ii) The economic issues before us

Yet while the outlook for the world economy appears bright, there are still three problems that remain before us.

The first is the continuing need to achieve noninflationary and sustained economic growth and to further reduce international imbalances among nations. This need clearly mandates a continued effort for economic policy coordination and for exchange rate stability.

Second is the need to resist the rising tide of protectionism. Here, I hope that the midterm review of the Uruguay Round will provide additional impetus for the promotion of multilateral free trade negotiations.

And third is the persistent problem of the developing countries' debts. According to IMF figures released recently, these countries' total accumulated debt is expected to be \$1.24 trillion by the end of this year. This is a truly staggering amount, and it is crucial that we make a serious effort to come to terms with this problem, not with idle armchair theories but with practical measures that will have tangible effects.

2. Policy Coordination and Improving the Functioning of the International Monetary System

(i) Policy coordination efforts

Meeting at the Plaza Hotel three years ago, the major industrial countries agreed to coordinate their policies to ensure that the dollar better reflects economic fundamentals. While steady progress has been made in reducing the imbalances among the major industrial countries in the months and years since then, this period has also seen very large and rapid changes in exchange rates. Bolstered by the Louvre Accord 19 months ago, policymakers have realized that they have to coordinate their economic policies and cooperate in exchange markets so as to reduce the external imbalances while promoting exchange stability and to achieve noninflationary economic growth, and all of them are working toward that end.

It was this concerted policy coordination effort by the countries concerned that enabled us to ride out the wave of market uncertainty following last October's Black Monday spasm, and it is this policy coordination that accounts for the progress we are making in achieving sound economic expansion and reducing the external imbalances.

It is important that these efforts for policy coordination be continued if we are to maintain these favorable trends: the surplus countries should sustain the momentum of domestic demand as long as possible, while the deficit countries should strengthen their efforts to reduce their fiscal deficits. At the same time, although the risk of global inflation is not an issue of urgent concern, it is important that we maintain vigilance against its resurgence.

(ii) Improving the functioning of the international monetary system

Many of our countries have deregulated exchange transactions and the international monetary system has undergone sweeping changes since the 1973 shift to floating exchange rates. Having gone through a number of tests and trials, including major exchange rate changes, the floating exchange rate system has gradually evolved and matured. This is thus an opportune time to step back and look at possible ways to improve the functioning of the international monetary system from the medium- to long-term perspective.

However, it should be noted that the introduction of a system establishing ranges, bands, or other binding means restricting the scope for exchange rate fluctuation would necessarily entail full consideration of asset settlement. Given this, I believe that it would be more realistic at this point to consider ways of diversifying reserve currencies to complement the dollar's key role, thereby facilitating the financing of resources for market intervention and dispersing the exchange risk of reserve currencies. Consistent with this, Japan has been steadily removing the barriers that would impede the use of the yen as an international currency.

(iii) The IMF's role

The IMF has an increasingly important role to play in the international monetary system. Not only, for example, does the IMF have a pivotal position in monitoring the sound operation of the exchange rate system, there are also a number of issues requiring the IMF's urgent attention in light of the present international liquidity situation.

The first of these issues is that of studying anew the concept of international liquidity. With the development of financial and capital markets worldwide, and with the enhancement of private sector holdings of foreign exchange, it is unrealistic to define international liquidity simply in terms of the reserve assets held by the monetary authorities. Some new definition needs to be found in better alignment with today's realities.

The second of the issues is posed by the question of whether or not each country actually has the level of liquidity that it needs. I believe that this problem mandates the additional supply of conditional liquidity from the IMF, which will in turn require a strengthening of the IMF's resources. I trust we are agreed that this strengthening should be effected not with borrowings but with a new quota increase. The Committee of the Whole of the IMF is currently studying specific modes for the Ninth General Review of Quotas, and I am hopeful that a substantial quota increase will be agreed upon soon.

In this connection, it should be noted that the quota shares are the basis for members' rights and responsibilities in the IMF, and it would be detrimental to the IMF's smooth functioning to leave these quota shares grossly out of line with economic reality. Japan fully intends to contribute to the international community through the IMF, and we hope that Japan will be allocated a quota share in line with its economic standing. It is with this in mind that I would like to take this opportunity to state that Japan intends to request a special quota increase in the context of the Ninth General Review of Quotas.

And the third of these issues requiring the IMF's attention is the need to study the role of the SDR in connection with international liquidity management. It is imperative that a study be made on improving the SDR's characteristics and making it an easily usable international reserve currency. This must include both analyzing the present situation and problems with regard to the SDR--currently perceived as a contingency safety net--and studying what modalities might be possible to expand the scope of SDR use, including use by the private sector.

3. Debt and Development

(i) Present situation and basic policy directions

Although the developing countries' debt service ratios have come down slightly, these countries continue to bear a staggering debt load and the situation remains serious. It is imperative that we overcome this situation in order to promote economic growth in the developing countries and to stabilize the international financial system.

It is my firm conviction that the menu approach proposed to cope with the tapering off of the flow of funds to the developing countries from commercial banks is valuable in broadening the range of options and promoting new financing participation.

Efforts to promote case-by-case solutions based upon full and accurate understanding of the situation in each of the developing countries are basic to any attempt to resolve these countries' debt problem. There is no general panacea for the debt problem. For the middle-income countries, it is essential to promote market-oriented

responses premised upon the self-help efforts of those countries with cooperation from the commercial banks, the governments of the industrial countries, and the multilateral financial institutions.

As noted in the Toronto summit's Economic Declaration, we must also recognize the plight of the poorest countries, and each of our countries should work within its legal framework to lighten their debt burden.

Both the IMF and the World Bank have an especially important role to play in dealing with the debt problem in that their financing serves as a critical catalyst for the flow of funds from other sources. I strongly hope that the IMF and the World Bank will continue to strengthen their policy advisory functions and will exercise cooperative leadership in resolving the debt problem.

(ii) Japan's response

Aware of the seriousness of these problems, Japan has made--and will continue to make--every effort to contribute to a solution to the debt and development problem.

We have, for example, instituted a major program designed to recycle at least \$30 billion over a three-year period, and nearly 80 percent of this \$30 billion has already been committed. Japan is active in contributing and subscribing to multilateral organizations as well as in cofinancing, with these organizations, by the Export-Import Bank of Japan, the Overseas Economic Cooperation Fund (OECF), and commercial banks. With specific reference to the importance of direct investment for alleviating the debt problem, it should be noted that the ASEAN-Japan Development Fund (AJDF) was established recently and is moving ahead steadily to implement its investment programs.

Looking to the plight of the poorest countries, Japan announced plans in Toronto to provide grants equivalent to the repayment amount of the principal and interest on yen credits committed to the least developed countries in the decade 1978 to 1987, thereby, in effect, waiving repayment on these credits.

On official development assistance (ODA) overall, Japan announced its Fourth Mid-Term Target this June for the five years from 1988 through 1992. Under this Target, Japan has pledged to raise the half-decade total of its ODA to at least \$50 billion--twice the total for the previous half-decade--and, for example, to respond positively to the need to provide strengthened resources for multilateral organizations, to work to enhance its grant aid to the least developed countries, and to make its yen loans generally untied. I assure you Japan is determined to achieve these goals.

Also in this same vein, I am pleased to announce, on behalf of Minister Miyazawa, that, as part of its contribution to promote growth in the developing countries and to help solve the debt problem, Japan is

prepared to extend additional financing in the form of untied loans in parallel with the Fund's extended or other arrangements. The loans will be extended by the Export-Import Bank of Japan, on a case-by-case basis, mainly to middle-income countries in support of medium-term structural adjustment.

(iii) The IMF's role in resolving the debt problem

With the successes being achieved by the case-by-case approach, I do not believe it would be either realistic or effective to seek a comprehensive, global solution to the debt problem. Reaffirming our support for the existing basic strategy, Japan would like to propose an additional menu item for the middle-income countries' debt strategies, as suggested by Minister Miyazawa in Toronto.

Under the proposed option, the debtor country would have to start by reaching agreement with the IMF on a medium-term program for economic structural adjustment. This is a prerequisite, and it is hoped that this structural adjustment program would be supported by bilateral funds from the industrial countries as well as multilateral funds from the international financial institutions. Once this program is agreed upon, the debtor country and the creditor banks would meet to agree on securitizing some of the debt outstanding and on rescheduling the rest of the debt under appropriate terms and conditions. In both cases, the certainty of repayment would be enhanced by the debtor country's special reserve accounts funded by their own resources and held in trust by the IMF. Of course, it goes without saying that this new scheme would have to be structured so that it meets three conditions: (a) that it is consistent with the case-by-case approach, (b) that it is market-oriented and the creditor banks are free to participate or not as they see fit, and (c) that it does not entail any transfer of risk from the commercial banks to the multilateral financial institutions or creditor country governments.

In addition to this, of course, there is much that the IMF can do within its traditional framework. I am thus encouraged by the fact that an effort is being made to revitalize the extended fund facility (EFF) by, for instance, allowing for one-year extensions of its programs when necessary and accepting some flexibility in its access limits on a case-by-case basis.

Likewise, I am glad to see that the compensatory financing facility (CFF)--created to provide temporary relief for countries that incur export shortfalls as a result of external factors--has been expanded and enhanced into the compensatory and contingency financing facility (CCFF) to deal with a wider range of external contingencies.

By the same token, I am delighted that the enhanced structural adjustment facility (ESAF) has gotten off the ground and lending has begun from this facility. The Export-Import Bank of Japan has supported

the ESAF with an agreement concluded this April to lend SDR 2.2 billion to the IMF, and the Japanese Government has pledged to contribute a grant of SDR 300 million to the ESAF, part of which has already been disbursed.

(iv) The role of the World Bank Group

The World Bank is a major player in international efforts to deal with the debt and development problem. Japan therefore actively supports the efforts to enhance and strengthen the World Bank and its affiliates.

There have recently been rising expectations regarding the World Bank's catalytic role in promoting and ensuring the flow of funds, particularly private funds, in support of the developing countries' efforts for growth-oriented and market-oriented adjustment. Cofinancing by the World Bank and private financial institutions has recently seen a diminishing flow of private funds. Given this, it is therefore all the more important that the World Bank needs to be even more flexible and positive about its catalytic functions--including cofinancing--in line with the specific circumstances of each case.

Among the many forms of private funds flowing to the developing countries, direct investment is especially important because it does not entail new indebtedness and because it is almost invariably accompanied by the transfer of technology and managerial know-how to the host country. It is, therefore, most encouraging that the Multilateral Investment Guarantee Agency (MIGA) has been established to promote such direct investment. I have the greatest expectations not only for its guarantee operations but also for its advisory functions, and I very much hope that more and more countries will become affiliated with MIGA and that MIGA will be able to fulfill the purposes for which it was established.

At the same time, the International Finance Corporation has a very important role to play in promoting debt-equity swaps and other modalities for enhancing the flow of private funds to the developing countries.

In light of the many features that distinguish the debt and development problem in each region and each country, it is important that there be cooperation between the World Bank and the regional development banks. We can all profit from having the World Bank and the regional development banks work together more closely and promote economic development more effectively.

It is indispensable that the World Bank's financial resources be enhanced if the Bank is to meet these expectations and to move meaningfully on the debt and development problem. Japan therefore welcomes the resolution by the Board of Governors on a general capital increase for the World Bank. At the same time, Japan supports the proposal to initiate discussions on IDA's Ninth Replenishment (IDA-9). Special consideration needs to be extended to the poorest countries in

negotiating IDA-9 resource allocations, and I very much hope that Asia-- said to be home to over half of the world's poverty--will be given special consideration along with sub-Saharan Africa.

Japan is determined to actively support the World Bank both in financial terms and in human resource terms. With the objective of recycling resources, over \$5.1 billion has already been committed to cofinancing with the World Bank by the Export-Import Bank of Japan, the OECF, and commercial banks. At the same time, Japan is moving ahead vigorously to provide grant contributions for the Japan Special Fund established within the World Bank last year as well as helping the World Bank raise additional funds from the Tokyo market. We intend to continue this vigorous support.

4. Conclusion

The world economy today presents an irrefutable picture of increasing interdependence. All of us are irrevocably affected by the way any one of us meets the challenges before it. The need for transnational approaches and transnational solutions is clear. And as we move forward to cooperate in solving our shared problems, I am confident that the IMF and the World Bank will provide the nucleus for this international coordination and will play an even more active role than they have so far.

It is widely recognized that Japan should play a more important role in the international community, and the Japanese people fully recognize their responsibilities and wish to rededicate themselves anew to making an even greater effort to contribute from a global perspective.

CURRENT ISSUES IN FINANCIAL RELATIONS WITH JAPAN

a. ECU Bill Market Makers

Background (not for use)

Bank of England is considering adding five new names to list of market makers in ECU Treasury Bills, including three Japanese firms. Announcement was originally planned at the end of March but has been delayed pending Lord Young's visit to Japan in May.

Line to take (if raised)

A matter for the Bank of England. Understand the question of any additions to the list of market makers is still under consideration.

b. Japanese Regional Banks in London

Background

The Hokuriku bank has pressed for a UK banking authorisation for some years, and the Japanese authorities gave the bank leave to apply for authorisation in 1985. The issue of regional banks has been raised regularly in bilaterals since then. The Bank of England has indicated privately in bilaterals that, given a generally receptive climate, the Bank would contemplate receiving a further application for authorisation from one institution early in 1989. The Hokuriku bank would be the first candidate for authorisation. The Japanese would then be asked for advice on the appropriate order for authorisation.

Line to take (if raised)

This is a matter for the Bank of England.

c. Tokyo Stock Exchange

UK still pressing for seats on Tokyo Stock Exchange for two UK firms: BZW and James Capel and subsequently for all suitably qualified applicants. At bilaterals last December Japanese indicated privately that a further opening of the TSE was likely in the middle of next year, following a review and nationalisation of the exchange. Nothing however could be said publicly at this stage.

Line to take (if raised)

UK still pressing strongly for seats on TSE for BZW and James Capel and then for all suitably qualified firms.

d. Investment Trust Licences

Background

No foreign firms currently hold licences to operate as investment trust companies (equivalent to UK Unit Trusts) in Japan. Japanese are currently reviewing these arrangements. UK pressing for licences for UK firms. Issue has been raised with Japanese in bilaterals and at Ministerial level by Mr Francis Maude. Mr Wicks recently wrote to Mr Gyohten pressing UK case.

Line to take

Want to see UK firms allowed to compete on equal terms with Japanese for investment trust business. Japanese firms have free access to UK Unit Trust market.

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PART ONE OF TWO PARTS

JAPANESE INVESTMENT IN EUROPE

SUMMARY

1. DANGER OF PROTECTIONISM CREEPING IN TO EUROPEAN POLICY ON JAPANESE INVESTMENT IN EUROPE. SOME AMONG OUR PARTNERS AND THE COMMISSION HAVE VERY DIFFERENT MOTIVES FROM OURSELVES. THE ATTRACTIVENESS OF THE UK ENVIRONMENT FOR INVESTMENT WOULD BE SERIOUSLY DIMINISHED IF RULES WERE SET COMMUNITY-WIDE. THE JAPANESE NEED TO BE KEPT UNDER SOME PRESSURE TO RAISE LOCAL CONTENT AND LOCALIZE THEIR EUROPEAN MANUFACTURING SUBSIDIARIES, BUT SETTING PERFORMANCE CRITERIA AND MAKING THE COMMISSION THE ARBITER (AS SOME JAPANESE NOW SEEM TO EXPECT WILL HAPPEN) WOULD BE BAD FOR THE UK AND FOR THE FREEDOM OF INVESTMENT WORLD WIDE. IMPORTANCE OF THE NISSAN CASE, AND OF SUPPORT FROM OTHER MEMBER STATES FOR THE UK ON THIS.

DETAIL

2. PARIS TELNO 263 TO FCO RECORDS M. FAUROUX AND LORD YOUNG'S AGREEMENT THAT THERE SHOULD BE A DISCUSSION OF JAPANESE INVESTMENT IN THE COMMUNITY. AS SEEN FROM HERE THERE ARE POSSIBLE ADVANTAGES AND OBVIOUS DANGERS IN THIS. SOME DEFINITION OF WHAT THE PROBLEMS ARE, WHAT ARE THE COMMON INTERESTS OF THE COMMUNITY AND HOW BEST TO ACHIEVE THEM (SEE PARAS 9-10 BELOW) COULD BE USEFUL. THIS APPEARS TO BE LACKING AT PRESENT, AND COMMUNITY POLICY IS IN DANGER OF BEING MADE PIECEMEAL OR BY BY STEALTH, .8, - 2-6 2#8:# :97)^ '3 04953:TIONIST AND COUNTER TO UK INTERESTS. HOWEVER WE NEED TO BE PREPARED TO RESIST THE PREJUDICES OF THE COMMISSION AND CERTAIN MEMBER STATES FOR A MORE PRESCRIPTIVE EC-WIDE REGIME WHICH WOULD ALMOST CERTAINLY DAMAGE THE UK'S INTEREST.

3. THE UK INTEREST SEEMS TO LIE IN KEEPING THE FIELD AS CLEAR AS POSSIBLE OF FORMAL RULES AND PERFORMANCE CRITERIA.

THE ESSENCE OF THE UK'S ATTRACTION AND SUCCESS IS THAT IT OFFERS A VERY FREE ENVIRONMENT FOR INVESTORS. EXCEPT IN CASES AFFECTED BY STATE AIDS OR ANTI-DUMPING REGULATIONS, JAPANESE COMPANIES COMING TO THE UK FACE NO MAJOR EUROPEAN HURDLES, NO RESTRICTIONS FROM HMG, AND NO PRESSURE TO INVEST IN ANY PARTICULAR FORM OR LOCATION. LOCAL CONTENT AGREEMENTS WHERE THEY EXIST ARE VOLUNTARY AND TAKE INTO ACCOUNT THE CIRCUMSTANCES OF THE CASE. TO THE EXTENT THAT COMPANIES IN FUTURE HAD TO MEET NEW EC-WIDE CRITERIA, THE UK WOULD LOSE ITS ATTRACTIVENESS RELATIVE TO OTHER LOCATIONS AND THE POLITICAL WELCOME IN THE UK WOULD COUNT FOR MUCH LESS IF INVESTMENT PLANS HAD TO BE CLEARED THROUGH BRUSSELS.

4. AS SEEN FROM HERE, SOME OF OUR PARTNERS HAVE VERY DIFFERENT MOTIVES. IN SOME MEMBER STATES THERE IS STILL A STRONGLY PROTECTIONIST SLANT, PARTICULARLY TOWARDS POLITICALLY SENSITIVE DOMESTIC INDUSTRIES. THE FRENCH HAVE BEEN VERY SELECTIVE ALL ALONG IN THEIR INVITATIONS TO JAPANESE INVESTMENT AND HAVE PLAYED ON THE JAPANESE WEAKNESS AGAINST COMMERCIAL BULLYING. THEY NOW SEEM TO BE TAKING A MORE OUTWARDLY WELCOMING ATTITUDE, BUT WE WOULD BE SURPRISED IF THEY DID NOT CONTINUE TO USE THE VARIOUS CONTROLS THEY HAVE OVER MARKETING IN FRANCE AS A LEVER TO ENTICE COMPANIES TO INVEST IN FRANCE. WITHIN THE COMMISSION THERE ARE CLEARLY MANY WHO WOULD SEE THE ELABORATION OF EC-WIDE RULES ON INWARD INVESTMENT AS A MEANS OF BRINGING MATTERS EFFECTIVELY WITHIN THEIR CONTROL AND COMPETENCE. THIRDLY, TOYOTA'S UNEXPECTED DECISION TO ASSEMBLE IN THE UK (AND THE MISGUIDED PERCEPTION THAT WE HAVE PURSUED IT WITH FINANCIAL ASSISTANCE) HAS AROUSED THOSE WITH PROTECTED AUTOMOBILE INDUSTRIES, AND WHO MORE GENERALLY RESENT UK SUCCESS IN ATTRACTING JAPANESE INVESTMENT. THE NISSAN CASE AND RUGGIERO'S PITCH IN TOKYO (MY TELNOS 207 AND 253) ARE ATTEMPTS THROUGH REAL POLITIK TO FORCE THE JAPANESE TO PLACE MORE INVESTMENT IN THEIR COUNTRIES. ALTHOUGH THE JAPANESE HAVE OFFICIALLY REPUDIATED IT, THE ARGUMENT THAT JAPANESE INVESTMENT SHOULD BE MORE EVENLY DISTRIBUTED WITHIN THE COMMUNITY IS HAVING SOME IMPACT HERE, AND WE HAVE REPORTS THAT COMMISSION OFFICIALS ARE PEDDLING THIS LINE.

5. THE JAPANESE CITE THE TREATMENT OF JAPANESE INWARD INVESTMENT AS PART OF THE EVIDENCE FOR THEIR FEARS THAT EUROPE POST 1992 WILL BECOME MORE PROTECTIONIST. THERE IS A GREAT DEAL OF CONFUSION ABOUT THE DISTINCTION BETWEEN ANTI-DUMPING MECHANISMS, LOCAL CONTENT AGREEMENTS AND RULES OF

ORIGIN, BUT THERE IS A FAIRLY WIDELY HELD BELIEF THAT, EVEN FOR EXISTING INVESTORS THE SANDS ARE SHIFTING UNDERNEATH THEM, AND THAT THE RULES ARE BEING REINTERPRETED IN A PROTECTIONIST AND DISCRIMINATORY DIRECTION.

6. NOT ALL THE JAPANESE COMPLAINTS ARE JUSTIFIED BUT IT MAY BE USEFUL TO COMMENT ON THEM.

- I) ANTI-DUMPING: THE JAPANESE ALLEGE ABUSE OF THE METHOD OF CALCULATION OF DUMPING MARGINS AND BIAS IN THE EUROPEAN COURT AGAINST THEIR CHALLENGES. THEY ALSO CLAIM THAT THIS COVERT PROTECTIONISM IS CARRIED THROUGH AGAINST THEIR SUBSEQUENT INVESTMENT IN THE COMMUNITY THROUGH THE DISCRIMINATORY ANTI-CIRCUMVENTION REGULATION WHICH ENABLES THE COMMISSION TO IMPOSE UNREALISTIC LOCAL CONTENT CRITERIA.

COMMENT

IN PRINCIPLE, THERE IS NO REASON FOR THE COMMUNITY TO BE DEFENSIVE IN THIS AREA. ALTHOUGH THE JAPANESE GOVERNMENT HAVE TAKEN THE REGULATION TO THE GATT, INDUSTRY STILL SENSES THAT IT IS ON WEAK GROUND IN COMPLAINING ABOUT ANTI-DUMPING REMEDIES. THOSE WHO DO NOT DUMP WILL NOT BE AFFECTED. TO THOSE WHO HAVE BEEN, THE REGULATION HAS OFTEN ACTED AS A SPUR TO INCREASING THEIR LOCAL CONTENT LEVELS. THE 40% LEVEL THOUGH CRITICISED AS ARBITRARY, IS NOT EXCESSIVE, PROVIDED THE COMMISSION TAKE ADEQUATE ACCOUNT OF THE CIRCUMSTANCES OF INDIVIDUAL CASES, WHICH THEY HAVE LARGELY DONE. WE CANNOT COMMENT ON THE COMPLAINTS ABOUT DUMPING MARGIN CALCULATIONS, BUT THE CREDIBILITY OF THE PROCEDURE IS OBVIOUSLY VERY IMPORTANT.

II) LOCAL CONTENT REQUIREMENTS

APART FROM THOSE CASES UNDER (I) ABOVE, THE JAPANESE ARE ALARMED BY TALK OF DEMANDING COMPULSORY LOCAL CONTENT AGREEMENTS AS A CONDITION OF INVESTMENT IN CERTAIN SECTORS. THEY CLAIM SUCH CONDITIONS, IF SET AT UNREALISTICALLY HIGH LEVELS WOULD DETER THEIR INVESTMENT. THEY WOULD ALSO PUT THEIR EUROPEAN SUBSIDIARIES UNDER A HANDICAP NOT FACED BY LOCAL OR OTHER FOREIGN COMPANIES ALREADY ESTABLISHED IN THE COMMUNITY WHO COULD UNDERCUT THEM BY PROCURING MORE OUTSIDE THE EC.

COMMENT: AS SEEN FROM HERE OUR VOLUNTARY AGREEMENTS WITH COMPANIES LIKE NISSAN AND KOMATSU HAVE ACTED AS A NECESSARY STIMULUS TO PUT REAL EFFORT INTO DEVELOPING LOCAL SUPPLIERS. BUT WHEREAS THESE ARE NON-BINDING AND CAN BE OPERATED FLEXIBLY IN THE UK IF CIRCUMSTANCES WARRANT, THE INTRODUCTION OF MORE RIGID EC-WIDE CONDITIONS WOULD BE A MORE SERIOUS DETERRENT TO INVESTMENT.

III) RULES OF ORIGIN: THE MOST SERIOUS THREAT TO THE JAPANESE IS LOSS OF THE MARKET DUE TO CHANGES IN THE RULES WHICH ALLOW JAPANESE PRODUCTS SUBSTANTIALLY MANUFACTURED IN THE EC FREE CIRCULATION WITHIN THE COMMUNITY. NISSAN UK'S PROBLEMS IN FRANCE HAVE A VERY HIGH PROFILE HERE, AND ARE VIEWED BY MANY AS THE SHAPE OF THINGS TO COME. IF THE COMMISSION FAIL TO ENFORCE THE RIGHT OF THESE CARS TO FREE CIRCULATION ON THE BASIS OF THE EXISTING RULES OF ORIGIN, AND THE FRENCH GET AWAY WITH IMPOSING A DE FACTO 80% LOCAL CONTENT CONDITION, THE JAPANESE FEAR THAT SIMILAR CONDITIONS WILL BECOME THE NORM FOR OTHER JAPANESE PRODUCTS MANUFACTURED WITHIN THE COMMUNITY. ALTHOUGH THE EC IS SIGNATORY TO THE KYOTO CONVENTION WHICH DEFINES THE ORIGIN AS THE PLACE OF THE LAST SUBSTANTIAL MANUFACTURING PROCESS, AS PROCESSES BECOME MORE COMPLEX AND PRODUCTS MORE INTERNATIONAL, THERE IS STILL MUCH SCOPE APPARENTLY FOR INTERPRETATION OR CLARIFICATION OF THIS DEFINITION BY CUSTOMS SERVICES. KINGSTON, ADVISER TO THE COMMISSION AS WELL AS SEVERAL JAPANESE COMPANIES IN THE UK, TOLD US THAT HE SAW DANGER IN AN ALLIANCE BETWEEN MME SCRIVENER AND THE FRENCH OFFICIALS IN DG III. THERE IS ALREADY A PROPOSAL TO EXTEND THE CURRENT RULING ON ORIGIN OF TV'S ETC TO VTR'S AND OTHER PRODUCTS: ALSO, OF MORE STRICT 'QUALITATIVE' DEFINITIONS BASED ON CONTENT BY PARTS VALUE, KEY PARTS, ETC. (MADRID TELNO 272 IS REASSURING UP TO A POINT ON THIS ISSUE.

IF THIS WERE TO HAPPEN THE INCENTIVE FOR NEW INVESTMENT IN THE EC WOULD BE SEVERELY DIMINISHED. JAPANESE COMPANIES MIGHT DO BETTER (AS THEY HAVE ARGUED) TO SET UP IN EFTA COUNTRIES. OR THEY COULD CONTINUE EXPORTING FROM ASIA OR JAPAN. FOR PROFITABLE HIGH-TECH PRODUCTS

WHERE THERE IS LITTLE EUROPEAN COMPETITION THIS COULD BE QUITE A SAFE ALTERNATIVE. CHANGES IN THE RULES AFFECTING COMPANIES WHO HAVE ALREADY INVESTED WOULD SEVERELY DAMAGE TRUST IN THE COMMUNITY. ANY RAISING OF THE THRESHOLD OF QUALIFICATION FOR COMMUNITY ORIGIN WOULD ALSO PUT JAPANESE COMPANIES IN THE EC UNDER A COMPETITIVE DISADVANTAGE AGAINST EUROPEAN AND POSSIBLY AMERICAN COMPANIES TO WHOM THE RULES WERE NOT APPLIED.

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PART TWO OF TWO PARTS

7. AT THIS STAGE IT IS CERTAINLY NOT POSSIBLE TO ARGUE THAT THE FLOW OF INVESTMENT IS DIMINISHING - RATHER THE REVERSE. THE DANGER IS MUCH MORE THAT ITS LOCATION WILL BE INCREASINGLY INFLUENCED BY POLITICAL FACTORS, TO THE UK'S DISADVANTAGE, AND THAT JAPAN, SEEING THE EC AS A CLOSED BLOC, WILL USE THAT FACT TO JUSTIFY ITS OWN RESORT TO REGIONAL OR BILATERAL PREFERENCE.

8. IN ANY GENERAL DISCUSSION ABOUT JAPANESE INVESTMENT THEREFORE IT SEEMS ESSENTIAL FIRST TO DEFINE THE BASIC ISSUES SUCH AS:-

- WHETHER THERE IS A NEED FOR SPECIAL RULES TO COVER JAPANESE (AND POSSIBLY OTHER FAR EASTERN) BUT NOT OTHER FOREIGN COUNTRIES' INVESTMENT IN THE EC:
- WHAT IT IS ABOUT JAPANESE INVESTMENT WHICH MAKES IT DESIRABLE TO IMPOSE SUCH RULES: AND,
- WHETHER IT IS IN THE COMMUNITY'S INTEREST IN THE URUGUAY ROUND AND AS AN INVESTOR IN OTHER PARTS OF THE WORLD TO DO SO.

9. THERE ARE A NUMBER OF AREAS OF LEGITIMATE COMMON CONCERN FOR EC MEMBER STATES IN THE SPECIFIC CASE OF JAPANESE INVESTMENT. FIRST AND FOREMOST IS THE LEGACY OF DUMPING AND CIRCUMVENTION OF ANTI-DUMPING DUTIES. ON THIS THERE SEEMS NO NEED (SUBJECT TO THE GATT CASE) TO CHANGE THE PRESENT RULES. A SECOND IS THE AVOIDANCE OF WASTEFUL COMPETITIVE SUBSIDIES ON JAPANESE COMPANIES WHO COULD DO WITHOUT THEM. ARGUABLY WE SHOULD BE AMONG THE GAINERS FROM A TOTAL BAN ON SUCH INCENTIVES, IF IT WERE THOROUGHLY OBSERVED, SINCE OUR ATTRACTIVENESS FOR MOST COMPANIES IS NOT LARGELY DETERMINED BY THE INCENTIVES WE CAN OFFER. IF HOWEVER THEY ARE RETAINED BY OTHER COUNTRIES EITHER FOR COMPETITIVE PURPOSES OR ON REGIONAL POLICY GROUNDS,

THE ABILITY OF THE DESIGNATED REGIONS OF THE UK TO COMPETE INTERNATIONALLY NEEDS TO BE SAFEGUARDED. THIRD IS THE DESIRE TO AVOID 'SCREWDRIVER ASSEMBLY' OPERATIONS, AND TO ACHIEVE THE HIGHEST POSSIBLE DEGREE OF LOCALLY ADDED VALUE EVEN IN PURE ASSEMBLY OPERATIONS. IN CERTAIN CASES, GIVEN THE STRONG LINKS BETWEEN JAPANESE COMPANIES AND THEIR JAPANESE SUPPLIERS, AND ALSO THE UNCOMPETITIVENESS ON PRICE GROUNDS OF MANY EC COMPONENT SUPPLIERS IN COMPARISON TO FAR EASTERN SOURCES, THERE MAY BE A STRONG CASE FOR VOLUNTARY LOCAL CONTENT AGREEMENTS IN PARTICULAR SECTORS, THOUGH NOT NECESSARILY AS A NORM. FOURTH IS THE DESIRE TO SEE OTHER CORPORATE FUNCTIONS SUCH AS DESIGN, R AND D, PURCHASING AUTHORITY ETC., PROGRESSIVELY TRANSFERRED FROM JAPAN SO THAT EUROPEAN SUBSIDIARIES BECOME INCREASINGLY INDEPENDENT AND MANAGED BY LOCAL STAFF. IN THIS AREA TOO, ONE HAS TO STRIKE A BALANCE BETWEEN OVERCOMING THE ETHNOCENTRICITY OF SOME JAPANESE COMPANIES WITH WHAT IT IS REASONABLE TO EXPECT IN A SHORT PERIOD OF TIME.

10. A CERTAIN AMOUNT OF MORAL AND OTHER PRESSURE UPON JAPANESE COMPANIES TO RAISE THEIR LOCAL CONTENT AND PROGRESSIVELY LOCALIZE THEIR EC OPERATIONS IS NECESSARY AND EVEN EXPECTED BY THE JAPANESE. IF THEY ARGUE THAT THEY SHOULD NOT BE PUSHED TOO FAR, IT IS NOT NORMALLY ON THE PRINCIPLE OF THEIR COMMERCIAL INDEPENDENCE OR NON-DISCRIMINATION, BUT ON THE GROUNDS OF DIFFICULTY IN OBTAINING ADEQUATE OR COMPETITIVELY PRICED COMPONENTS (IN WHICH THERE IS SOME TRUTH). RIGOROUS ATTENTION TO QUALITY AND RISK-AVERSE MANAGEMENT ARE AMONG THE REASONS WHY JAPANESE COMPANIES ARE STABLE AND SUCCESSFUL IN THE LONG TERM. TO IMPOSE UNIFORM AND DIFFICULT ENTRY CONDITIONS UPON NEWCOMERS WOULD DOUBTLESS SCARE MANY COMPANIES AWAY FROM THE EC. MORE IMPORTANTLY, COMPANIES DIFFER CONSIDERABLY IN THEIR PHILOSOPHY. SOME ARE ON THE WAY TO BECOMING GENUINE MULTINATIONALS IN SOMETHING LIKE THE SENSE THAT WE WOULD RECOGNISE. OTHERS ARE STILL RUN ON A FAMILY BASIS. THE OPPORTUNITIES FOR THEM TO FIND LOCAL COMPONENTS AND SKILLS ALSO VARY. THEY NEED TO BE DEALT WITH CASE BY CASE ACCORDING TO THEIR CIRCUMSTANCES, AND IT IS DIFFICULT TO ENVISAGE A CENTRAL AUTHORITY IN BRUSSELS DOING THIS WITH THE LONG TERM INTERESTS OF THAT COMPANY IN MIND. ON THE OTHER HAND JAPANESE COMPANIES WILL PROBABLY BE AMENABLE TO GUIDANCE FROM HOST GOVERNMENTS WITH AN INTEREST BOTH IN THE INVESTOR AND IN THEIR DOMESTIC SUPPORT INDUSTRIES SEEM MORE LIKELY TO TAKE A BALANCED AND RESPONSIBLE VIEW.

11. AS SEEN FROM HERE THEREFORE WE NEED TO DISCOURAGE AS STRONGLY AS POSSIBLE THE EMERGENCE OF NEW COMMUNITY PERFORMANCE CRITERIA, OR REDEFINITION OF THE RULES OF ORIGIN IN SUCH A WAY AS WOULD HAVE A SIMILAR PROTECTIVE EFFECT. WE ALSO NEED TO CORRECT URGENTLY THE IMPRESSION CURRENT IN JAPAN THAT SUCH AN EVOLUTION IS ALREADY IN TRAIN AND THAT THE COMMISSION WILL INCREASINGLY PLAY A DECIDING ROLE IN THE TERMS AND ALLOCATIONS OF INVESTMENT. THE RESOLUTION OF THE NISSAN DISPUTE IN OUR FAVOUR IS CRITICAL IN THIS REGARD. ALTHOUGH THE JAPANESE SEE US AS FIGHTING STRONGLY AGAINST INVESTMENT PROTECTIONISM, THEY ALSO SEE US AS A SOMEWHAT ISOLATED VOICE WITHIN THE COMMUNITY ON THIS ISSUE. IF THIS IMPRESSION WERE BORNE OUT IN FACT, IT COULD BE VERY BAD FOR NEW INVESTMENT IN THE UK. WE NEED TO ENSURE THAT IN ANY BRUSSELS DISCUSSION OUR ALIES SPEAK UP ON THE PRINCIPLES AND VOICE THEIR OWN OPPOSITION TO NEW PROTECTIONIST MEASURES. IT WOULD ALSO BE HELPFUL IF THEY - PARTICULARLY THE GERMANS, COULD MAKE THEIR CONCERN ABOUT THE NISSAN CASE PLAIN TO THE COMMISSION AND THE FRENCH.

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JAPAN POLITICAL AND ECONOMIC

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PAGE 4
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FROM: P EDMONDS (IF2)
 DATE: 28 April 1989
 EXT: 5546

1. MR EVANS

2. CHANCELLOR

cc Economic Secretary
 Sir P Middleton
 Sir T Burns
 Mr Wicks
 Mr Lankester
 Mr Odling-Smee
 Mr Peretz
 Mr Ilett
 Mr Melliss
 Mr Gibbs

JAPANESE CURRENT ACCOUNT SURPLUS AND STRUCTURAL REFORM

I attach a paper on Japan as requested in Charles Powell's letter to Nigel Wicks of 23 January. This paper includes comments by other departments on an earlier draft. If you are content with the paper, I attach a draft private secretary letter to Mr Powell.

2. Bilateral trade balances are, as we know, a particularly bad basis for policy making. And worries about the persistent trade surpluses of the Japanese and Germans are easily overdone, especially at a time when the US is continuing to run a large external deficit. Nevertheless, over time, some gradual reduction in the overall surpluses is probably desirable.

3. There are forces already pushing in this direction, as your Berlin speech made clear. But there are also some impediments in the structure of these economies, and it is these which are the main concerns of this paper.

4. The draft is somewhat agnostic (see paragraph 2vi) about the effects of further Japanese structural reform on the current account surplus. I think this is inevitable. If a stronger line is wanted on ways of reducing the Japanese trade surplus, then further yen appreciation is bound to be on the agenda. You will want to consider closely the arguments in paragraph 6.

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*but these must be
equal & opposite!*

5. For financial services, one of the four areas considered, we think that further reform is unlikely to have much effect on the current account position (the capital account could well be much more affected). The draft lists further reforms of financial services that could be undertaken, but it is not clear that these would be in the UK's best interests. Financial liberalisation may tend to drive business which is currently offshore in centres such as London back to Japan. This is the reason why no mention is made in this section of removing the Article 65 barriers. However, the paper welcomes further reform of financial services since not to do so would be inconsistent with the overall argument that structural reform is beneficial to the Japanese economy.

6. The paper has a similar structure - and argument - to that on Germany sent to No.10 under Jonathan Taylor's letter of 17 February. But there are obvious differences between the two cases spelt out in the draft PS letter.

7. The draft letter to number 10 suggests how best to put the arguments to the Japanese. Our judgement is that a multilateral, not bilateral, approach is needed and that the argument is best cast in terms of the benefits to the Japanese people/consumers that would follow from further and more effective structural reforms, especially in the areas of land and agriculture and distribution. The potential improvements to the standard and quality of life in Japan are large. In addition, these reforms may help bring about a gradual reduction in the external surplus, and so contribute to the policy coordination process.

P. Edmonds

P EDMONDS

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DRAFT LETTER

Charles Powell Esq
No 10 Downing Street
LONDON SW1

April 1989

1. In your letter of 23 January to Nigel Wicks about the Paris Economic Summit, you asked if we could let you have a note on our economic and trade relations with Japan and on what we might do to reduce the trade imbalance between the UK and Japan.

2. I enclose a paper covering the Japanese current account surplus and the Japanese bilateral surplus with the UK. Our conclusion is that Japan would be well advised to adopt structural reforms in a number of areas which would improve the growth potential of the Japanese economy, and which may over time reduce the current account surplus. We have picked out four areas of reform: land and agriculture, distribution, financial services, and air transport services. However, it would be a bad mistake to follow the US line in pressing the Japanese to expand their domestic demand any further since, first, the world at the present time positively needs the high savings which Japan is generating; and, second, the Japanese economy is already operating close to full capacity so that additional demand would carry inflationary risks.

*Met by
imports?
(Depend on
nature of
demand?)*

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3. This general line of argument is very similar to the earlier paper on Germany I sent to you on 17 February. But the Japanese case is different in several important respects:

- the smaller Japanese weight in the UK's effective exchange rate index (8.8 per cent compared with 20.0 per cent for Germany and more than 50 per cent for the countries in the ERM) makes the inflationary consequences for the UK of a yen appreciation ^{much} less than for a DM appreciation;
- the adjustment that has already taken place in the Japanese surplus since 1986, which has reflected constructive action not matched in Germany;
- the chances of Japan triggering US protectionist action are ^{much} greater than with Germany; and
- the German surplus, which is bigger as a share of GDP, is ^{also} more of a European problem than the Japanese surplus ^{is,} and is of greater direct importance to the UK.

Further adjustment in Japan may well entail a further yen appreciation. The Chancellor has endorsed the paper and will be ready to discuss with the Japanese the four areas of reform suggested in the paper.

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4. In drawing on the material in the paper in discussion with Japanese ministers, the Prime Minister and ministerial colleagues will be able to argue that the further structural reforms we are proposing will be of direct benefit to the Japanese people as a whole, despite the short term costs to some sections of the population. Reform of land taxation and agricultural support will reduce food prices and make much-needed urban land available for housing, while reform of the Japanese distribution system will lead to lower prices and greater consumer choice. Our interest in these reforms is multilateral: a more open and efficient Japanese economy will contribute to sustained non-inflationary growth in the world economy. This ^{may be} ~~is~~ not the best time to be arguing for these reforms, with the Japanese preoccupied as their domestic political problems, but ^{on any scale or in bound to} ~~it would be wrong to give up on what~~ will be a long-term process.

5. I am sending copies of this letter to Stephen Wall (Foreign and Commonwealth Office), Neil Thornton (Department of Trade and Industry), Roger Bright (Department of Environment), Shirley Stagg (Ministry of Agriculture, Fisheries and Food), Carys Evans (Chief Secretary's Office) and Roger Lavelle (Cabinet Office).

J M G TAYLOR

Private Secretary

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PARIS ECONOMIC SUMMIT: NOTE ON JAPANESE CURRENT ACCOUNT SURPLUS
AND STRUCTURAL REFORM

Introduction

1. This paper notes the record of the Japanese economy in the 1980s, with rapid growth and an impressive trading performance. The current account surplus, which has shown considerable adjustment since 1986, is the counterpart of the excess of net savings over net investment. ^{domestic} ~~The surplus~~ ^{domestic} has made an important contribution to world savings. There is at present ^{little} ~~no~~ scope for expansionary fiscal or monetary policy in Japan. The paper then sets out further structural reforms Japan could follow which may, on balance, tend to bring about a lower current account surplus.

Summary of Line to Take

2. i. Current account surplus equals the surplus of net savings over net investment.
- ii. Japan is making a major contribution to global savings.
- ~~iii. The current account surplus should come down as and when the US current account deficit is reduced.~~
- iv. There is ^{little} ~~no~~ current scope for expansionary Japanese macroeconomic policy.
- v. Some further yen appreciation would promote external adjustment and curtail inflationary pressures in Japan.
- vi. Further structural reforms would promote efficiency in the Japanese economy and may, on balance, tend to reduce the current account surplus.
- vii. Japan should free the market for land by changes in taxation, and reduce the support and protection given to agriculture.
- viii. Japan should adopt pro-competitive policies in its distribution sector.

ix. Access to Japanese financial markets for overseas firms should be further improved.

x. Japan should move to more liberal air service arrangements.

The Japanese Economy

3. Japan is the second largest OECD economy, with a GDP less than half that of the US but twice that of Germany, the next largest. With high levels of investment and a high standard of education Japan will probably continue to grow more rapidly than any of the other major economies. The Japanese economy has adapted ^{well} to the changing circumstances of the 1970s and 1980s, particularly to the second oil price shock and, more recently, to the large appreciation of the yen. The size of Japan's economy, and its physical separation from its main ^{markets} mean that trade is a low proportion of Japanese GDP, as ^{it is} for ^{the} US and the EC (excluding intra-EC trade). Imports of goods and services were 8 per cent of Japanese GDP in 1987. Imports ~~in~~ to Japan are not, in general, restricted by overt trade barriers.

4. The Japanese are ^{high} savers. In 1987, net national savings were a higher proportion of GDP than in any other G7 country. They were approximately equal to net savings in ^{all} the other G7 countries combined. Reasons for the particularly high personal sector savings include the influence of past poor provision for old age and limited other social security benefits, the rapid ageing of the population expected in the next thirty years, and ~~possibly the effects of high land and property prices.~~ ^(Perhaps more important of all) is Japanese culture. High land prices.) Net investment ^{is} also a higher proportion of GDP than in any other G7 country, resulting in rapid growth of the capital stock. The excess of savings over investment ^{is} the direct counterpart of the current account surplus. High savings and the current account surplus may be partly sustained by structural rigidities - especially outside manufacturing.

normal
gross output

5. In the ^{res of the} industrialised world - most notably the US - there is a shortage of savings. As long as this persists, then a sizeable Japanese current account surplus will make an important contribution to global savings. Japanese action to reduce their external surplus by a large amount in the near future would put further upward pressure on world interest rates. But as and when the US current account deficit comes down a reduction in the Japanese surplus will be appropriate. Otherwise the continued current account surplus and the build up of Japanese net overseas assets may further fuel protectionist pressures.

6. There has already been a considerable fall in the Japanese current account surplus, from 4.3 per cent of Japanese GDP in 1986 to 2.8 per cent in 1988. The nominal value of the yen, in effective terms, has increased by 50 per cent since its 1985 low, with a real appreciation of 40 per cent. This appreciation has contributed to the external adjustment by changing the relative prices of traded goods and by adding to the rapid growth of domestic demand. On the other hand, it has also led to increased efficiency on the part of Japanese exporters. Continuing current account adjustment may well involve some further yen appreciation. A sharp appreciation of the yen in the near future could ^{conceivably} have unwelcome inflationary effects on other economies, but a ten per cent yen appreciation would represent a fall of under one per cent in the UK's effective exchange rate index. Some further rise in the yen may well have a useful role to play in both reducing the Japanese trade surplus and curtailing inflationary pressure in Japan.

7. The UK had a deficit on visible trade with Japan of £1.6 billion in 1981 (0.5 per cent of UK GDP). By 1988 this had increased to £4.8 billion (1 per cent of UK GDP). With domestic demand now growing more slowly in the UK the growth of this deficit should slow down and may be reversed. The FSBR forecasts a slowdown in UK domestic demand growth from 6½ per cent in 1988 to 2½ per cent in 1989, which is the same as forecast GDP growth. In Japan, domestic demand is expected to grow at over 5 per cent, which is faster than GDP.

Macroeconomic Policies

mix | 8. Discussions at the Summit will touch on the possible macroeconomic policy measures Japan could take to promote external adjustment. There is ~~no~~ ^{little} current scope for the Japanese Government to act to stimulate the economy by fiscal policy at a time when the Japanese economy is already expanding rapidly. For monetary policy the prime task must be the control of inflation. Japanese inflation remains lower than in any other G7 country, but has already risen from 0.2 per cent in June 1988 to 1 per cent, and will be temporarily higher in 1989 due to the introduction of a new sales tax. The main scope for Japanese policy action is in the area of structural reform.

Structural Policies

9. The structural reforms set out in this note would promote the more efficient use of resources in Japan, and increase the potential for growth of the Japanese economy, by reducing distortions and opening up markets. In some specific areas, for example stock exchange seats, there are clear UK interests to be served in opening up the Japanese market. Such cases are now rare, although where they arise we will need to press the Japanese vigorously in bilateral contexts.

10. The more general case for structural reform in Japan is that an economy which is more open and less regulated and has a more efficient service sector will have higher domestic demand and imports: this is in the interests both of Japanese consumers and of exporters (including the UK) to Japan. A more efficient Japanese economy will also respond to external shocks and changes in macro economic policies more readily. It may also show faster growth of exports, so the net effect on the current account balance is unclear. Over time, however, further structural reforms in the areas singled out in this paper may tend to bring about a lower current account surplus. It would be wrong to expect the effects to be either quick or substantial.

11. Our interest in the more efficient operation of the Japanese economy is essentially multilateral, and not bilateral. It is best pursued in the context of the Summit, of G7 Finance Ministers, and of OECD.

12. The rest of this paper describes four areas of structural reform - land and agriculture, distribution system, financial services and air transport - which we can emphasise in putting the case for a faster pace of structural reform in Japan. Of these four areas the first two, land and agriculture and the distribution system, will require major reforms that will affect powerful interest groups in Japanese society, so progress will be slow. Separate Annexes A-D give further details of these four subjects; Annex E compares the UK and Japanese economies and describes their economic and trade relations; and Annex F sets out in more detail the links between savings, structural rigidities, and the current account surplus.

a. Land and Agriculture

*What has
the high
land price
got to do
with the
current
account?*

13. The average price of Japanese land is about forty times higher than in the US. There is a strong presumption that this is partly due to government policies, and there is evidence of a serious misallocation of resources because of these policies. It is possible that the high price of land leads to reduced consumption and tends to increase the current account surplus, as residents in Tokyo, for example, have to save about three times their annual salary to put down as a deposit on a house. But a fall in land prices would reduce wealth and many households could be expected to respond by saving more to rebuild their stocks of wealth, and increasing their stocks of overseas assets. The net effects of a fall in the price of land on consumption and the current account surplus are therefore uncertain.

14. Part of the explanation for the high price of land lies in its scarcity. Japan has a small useable area for a country with a population of over 120 million and a large and powerful economy. But government policy also makes a major contribution to the

problem. The taxation structure encourages land holding, even if it is left idle. For example, there is a high capital gains tax on land sales. Tight restrictions on the height of buildings limit the use of available land ^{for} urban housing. Land prices are also kept high by the support and protection against imports given to Japanese agriculture.

15. Massive government support for agriculture leads to an unusually high proportion of land in urban areas being used for agriculture; 16 per cent of land in 3 major urban areas. According to the OECD, government support accounted for 76 per cent of farming income in Japan in 1987, compared with 51 per cent in the EC and 41 per cent in the US. Many households derive part of their income from farming, but Japanese agriculture accounted for only 3 per cent of GDP in 1986. Some studies have concluded that the value added in Japanese agriculture is less than the value of government support, implying that resources used in agriculture could be better used elsewhere. The combination of high domestic support prices and restrictions on imports keeps an excessive amount of Japanese land and labour in farming and causes high food prices for Japanese consumers. Major liberalisation of Japanese agriculture would increase food imports and lower food prices and so allow increased spending on other consumer goods. But some of the resources freed from agriculture would move to Japan's manufacturing sector, and the net exports of that sector could be expected to increase. The net effect on the current account is therefore uncertain.

Line to take: Japan should alter its taxation structure to free the market for land, to reduce tax distortions that keep land in agricultural use, and to reduce ^{restrictions} ~~regulations~~ on urban development and construction. Support prices for agricultural products and restrictions on food imports should both be reduced. Japan will need to move in these directions as part of its response to the GATT agreement in April.

b. Distribution System

16. The complex Japanese distribution system is inefficient and tends to work as a barrier to imports. It has not been deliberately designed as a barrier to imports, but the proliferation of small retailers, long distribution chains, retail

What stops
retailers from
importing?
(US firms)
[1980-1987]
2/19

price maintenance, and established links between manufacturers, wholesalers and retailers make it harder for new entrants to compete in Japanese market. This affects imports in particular. The need for reform was accepted by the Japanese at the Toronto Economic Summit.

17. There are indications of inefficiency in the Japanese distribution system compared to that of other major economies.

- The number of retail stores per 1000 people in Japan is twice as great as in the UK or the US, and 80 per cent of the 1.6 million stores in Japan have under 100 square metres of floor space.

- The ratio of wholesale sales to retail sales of consumer goods in Japan is around 2, compared to a ratio of less than one in other major economies: goods are being re-sold more often before they reach the consumer.

In response, the Japanese emphasise the value they place on local shopping and on the quality of service, and point to the rapid growth of imports in the 1980s as showing that the distribution system does not prevent imports.

18. The distribution sector contains many commercially - inspired anti-competitive practices. The clearest regulatory restriction is the Large Retail Stores Law, which protects small shopkeepers by allowing them to prevent or delay the establishment of large retail outlets: only $\frac{1}{2}$ per cent of Japanese stores have a floorspace of more than 500 square metres.

19. Widespread retail price maintenance prevents price competition between stores, and distribution chains. Sole agency agreements and secret rebates to retailers make it hard to break into established relationships. Established UK exporters gain from sole agency agreements that keep out parallel imports from SE Asian countries; other UK firms lose out. There are pressures for reform from within Japan, but small retailers have traditionally

Has
any party
or consumer
group?

been strong supporters of the ruling LDP, and reform has been very slow so far with only minor amendments to the Large Retail Stores Law.

Line to take

Japanese Government should pursue more competitive policies with regard to manufacturer/wholesaler/retailer relationships, with the emphasis on deregulation. Welcome existing plans to improve working of the Large Retail Stores Law: we hope they will soon be fully effective and that further reforms will be proposed.

c. Financial Services

20. Japanese financial markets have been greatly liberalised since 1980: holdings of yen assets are much less restricted; there is now an offshore banking market with no withholding tax applied to deposits; and a market has developed in Government Bonds.

21. However there is still some way to go in establishing fully liberalised markets. Measures which would contribute to the development of Tokyo as an international financial centre, and would in many cases help foreign companies in Tokyo, include:

- full deregulation of interest rates;
- more issues of short-term Government debt to sustain a secondary market;
- allowing overseas firms to manage corporate and government pension fund
- opening membership of the Tokyo Stock Exchange to all suitably qualified applicants

Is this really one of our objectives?

*not also
capital flows*

These financial market reforms would not have any large effects on the Japanese current account surplus, but reforms that increased the volume of business taking place in Tokyo may lead over time to an increased current account surplus.

Line to take

Welcome liberalisation of Japanese financial markets since 1980. But still more needs to be done (see list of measures above) in particular to ensure free access for foreign financial institutions.

d. Air Transport Services

22. Air Services have traditionally been closely regulated in Japan, with the Japanese government adopting interventionist policies on routes, capacity and fares. Restrictions on capacity partly explain why fares, expressed in cost per mile, are higher between London and Tokyo than on other long-haul flights to and from the UK. Non-stop services between the UK and Japan were introduced in 1987 and the number of journeys has increased by about 50 per cent since the mid-1980s. The number of operators permitted to operate services will rise from 2 to 4 this summer. We are now looking for more liberal air service arrangements with Japan and in particular reduced Government intervention in the airlines' business.

23. We will be pressing the Japanese Government to agree to:

- removal of restrictions on the number of services that can be operated, allowing the airlines more flexibility to respond to change in market demand.
- simplified arrangements for the approval of fare levels, allowing airlines to introduce more competitive fares.
- flexible arrangements for routeings. Ideally there should be no restrictions, but as a minimum we seek access to

*not also
V impulse
transfer back
(Saps
[see 24])*

Osaka of growing importance for business travel) for UK operators over the tenter Siberian routing, so far denied by the Japanese authorities.

24. The net deficit on tourism grew from \$8.7 billion in 1987 to \$15.7 billion in 1988. Liberalisation of air services will encourage tourism in both directions, but on balance is likely to encourage Japanese tourism more and so reduce the current account surplus.

Line to take

Welcome liberalisation that has taken place. Further liberalisation (see above) would increase competition, increase consumer choice, and reduce prices.

HM Treasury

ANNEX A

LAND AND AGRICULTURE

Land Value and use

1. The price of land in Japan is very high. Land in Japan is forty times more expensive than in the US. Even when adjustments are made for the density of population and for the intensity of economic activity, Japanese land prices are 3 or 4 times those in the US and Canada. So the relative scarcity of land in Japan cannot be the full explanation. As in most countries, land prices are higher and have risen faster in the capital city and other urban areas, but the level of prices is relatively high everywhere.

2. Land is not efficiently allocated. Average floor space in Japanese houses is small and park land per person in Tokyo is only a fraction of that of London and New York. It is much more expensive to buy a home in Tokyo (six times annual income in 1986) than in New York (three times) and Japanese housing is notoriously cramped. Yet the population density of Tokyo is relatively low, and a large amount of urban land is used for agriculture. In 1983 16 per cent of land in three major metropolitan areas was designated as farmland. In 1985 the average size of an 'urban farm' in metropolitan Tokyo was only 600 m², and these tiny farms are unlikely to be efficient: small farms are only half as efficient as large farms in the production of rice.

Causes

3. The reasons given below for high Japanese land prices support the belief that there is a misallocation of land in Japan.

i. Regulations on development

4. There are strict regulations controlling the development of urban land. Most notable are the tight restrictions on the

height of buildings, which restricts the available volume of housing in urban areas. Also the process of approving a change of use of urban land for construction is slow and difficult.

ii. The Tax System

5. The tax system in Japan encourages land holding in general and agricultural use in particular. Urban agricultural land is often left uncultivated and unmaintained. Tax distortions include preferential tax rates applied to agricultural land, differential land valuation according to usage, high capital gains tax on land sales, and exemption from inheritance tax on land maintained in agricultural use for more than 20 years.

iii. Agricultural Policy

6. The agricultural sector in Japan is heavily protected, and high prices for agricultural output raise land prices. One study estimated the central value of agricultural land to be 68 per cent higher due to this protection.

7. The proportion of farm income due to all forms of government support (the producer subsidy equivalent or PSE) in Japan was 76% in 1987 compared with 51% for EC and 41% for US. High internal support prices are maintained by import quotas and licenses. It is estimated that value added was 54% of the agricultural sector's gross output in 1980-83. This was less than the proportion of farming income given by government support (59 per cent) implying that Japan would be better off if all agricultural resources were simply left idle.

Effects of Reform

8. These are not straightforward, but the main effects of reducing restrictions on construction, reducing the incentives given by the tax system to hold land, and reducing the support and protection to agriculture would probably be:

- a fall in land prices (tending to reduce the total value of land);

- a shift in land use from agriculture to dwellings and plant (tending to increase the total value of land);
- a reduction in the wealth of many landowners (including homeowners) who may save more to rebuild their stocks of wealth, and therefore reduce their consumption and imports. This group may plan to acquire more overseas assets, which would imply an increase in the current account surplus during the transition;
- an increase in the purchasing power of non-landholders' wealth, leading them to save less and consume more, leading to increased imports;
- an increase in imports of agricultural products;
- lower food prices and a reduction in the taxation needed to provide support for the farming sector;
- shifting of resources to manufacturing, which would face lower costs of land and possibly labour, and possibly also a lower exchange rate. This could be expected to lead to an increased trade surplus in manufactured goods.

9. The net effect on the current account of reforms in land and agriculture on consumption and imports is uncertain. Simulations of the effects of agricultural liberalisation have shown contrasting results on different models. Japanese data on the motivation for saving suggests that saving for sickness, accident and old age are probably more important motives than plans for house purchase, so the main effect of reform that reduces the prices of land and housing may be of households rebuilding stocks of wealth by purchase of other assets - including overseas assets.

DISTRIBUTION AND RETAIL BUSINESS IN JAPAN

1. The Japanese distribution system is widely considered to be both inefficient and a barrier to imported goods. It is difficult to identify any areas which could be thought of as deliberate discrimination against imports. It is long-standing business practices, rather than government policy or regulation, that makes it difficult for domestic and overseas companies to break into new markets. In particular, the proliferation of small retailers; long distribution chains, and established links between manufacturers, wholesalers and retailers make it more difficult than it might otherwise be for imports to establish themselves in the Japanese market.

2. This applies in particular in the area of consumer goods. Sole agency agreements and retail price maintenance restrict competition and make it hard for overseas firms, or indeed new Japanese firms, to build up retail sales. The Large Retail Stores Law protects small shopkeepers from larger, more competitive retailers by allowing them to prevent the establishment of new stores. This restriction on the size and number of large retail outlets not only inhibits the growth of imports, which have mainly been sold through large stores, but also checks the trend towards mass-merchandising seen in the USA and Western Europe.

3. The small, one or two employee, family stores ("mom and pop" stores), which stand to lose from a reform of the Large Retail Stores Law, still dominate Japanese retailing. 80 per cent of the 1.6 million stores in Japan have less than 100 sq metres of sales floor space. Department stores and supermarkets (sales space of over 500 sq metres) are only 0.5 per cent of all stores. Consumers are demanding more choice and variety, in line with their increasing affluence, and younger people prefer large stores because of their parking facilities and wider range of merchandise. Small retailers have traditionally been strong

supporters of the ruling LDP and this has probably contributed to the government's reluctance to introduce any early, structural reform of the Large Retail Stores Law, but the domestic pressure for reform will not go away.

4. Early action to reform the Large Stores Law should be encouraged, as part of a pro-competitive government policy. Japan would benefit from wider reforms including action against restrictive practices, such as retail price maintenance and secret rebates to retailers. Action against sole agency agreements, while desirable in principle, would probably be opposed by existing UK exporters to Japan.

5. The table below gives comparative figures for the UK and Japanese distribution sectors. This shows that there are more than twice as many retailers per population in Japan and that the ratio of wholesale to retail sales in Japan is twice that in the UK (ie goods are sold more often before they reach the consumer).

THE JAPANESE AND BRITISH DISTRIBUTION SECTORS

	<u>UK</u>	<u>Japan</u>	<u>US</u>
Number of retail outlets (1000's)	343,(1986)	1,628,(1988)	1,920(1982)
Number of retail stores per 1000 population (1982)	6.3	14.5	8.3
Ratio of wholesale to retail sector in 1982 (by value of sales)	2.0	4.2	1.9

Source: OECD, DTI

JAPAN: FINANCIAL SERVICES: LIBERALISATION AND DEREGULATION

1. Japan's markets have been greatly liberalised in recent years, and barriers to inflows into yen have been reduced. Funds can now flow into and out of yen relatively freely. This process started in Spring 1980 when Japan adopted a broadly permissive stance to inward and outward capital flows. There is now a well established yen eurobond market, and euroyen CDs and commercial paper are traded without major restrictions. An offshore banking market has been established with no withholding tax applied to deposits. Yen eurobonds, euroyen deposits, and Samurai bonds are free of the Japanese withholding tax for non-residents. In Tokyo there is now a large Government bond market, and foreign management access to this market has recently been improved. There is also a thriving yen Government bond futures market, with further expansion of futures markets planned. The yen commercial paper market has grown rapidly.

2. Foreign financial institutions are established in commercial banking, trust banking, securities business (including 22 members of the Tokyo Stock Exchange) and in investment management. The growing presence of Japanese financial institutions in Europe, and in particular in London, and the USA also offers channels for financial flows between international markets.

Remaining obstacles

3. However there is still some way to go in establishing fully liberalised markets. Measures which would contribute to the development of Tokyo as an international financial centre, and would in many cases help foreign companies in Tokyo, includes:

(i) Full deregulation of interest rates For foreign banks the main problem is one of access to funding on reasonably competitive terms. Deregulation of interest rates would help foreign banks by removing the competitive advantage Japanese banks gain from their retail networks providing regulated (ie lower interest rates) deposits. Progress so far, even including future changes announced, does not yet amount to full deregulation of interest rates.

(ii) Development of a fully fledged short term Government debt market. As well as helping provide an additional means of control of domestic monetary conditions for the authorities this would offer a potentially attractive investment outlet for foreign holders of the yen.

(iii) Reform of cumbersome issuing procedures for Samurai bonds, and abolition of the withholding tax overseas residents pay as domestic bond issues, would add depth to bond market trading.

(iv) The planned legislation to permit overseas firms to enter corporate pension fund management could be accelerated and further steps taken to place Government pension funds with foreign investment managers.

(v) Membership of Tokyo Stock Exchange could be granted to those candidates still waiting (from the UK, BZW and James Capel) and to all further qualified applicants.

(vi) Investment trust licences could be granted to foreign firms after the Study Group examining the question reports in the middle of this year.

UNITED KINGDOM/JAPAN AIR SERVICES

1. Further development of air links between the UK and Japan is needed to meet the increasing demand for business and leisure travel on the route (see Table 1, over). The introduction of non-stop services in 1987 has encouraged many more people to travel. Market growth is expected to remain buoyant in the future. The proposed introduction of services by All Nippon Airways and Virgin Atlantic Airways during 1989 to operate on the route alongside Japan Airlines and British Airways will be a further important milestone in our air services relations which we welcome.

2. One important effect of greater competition will probably be lower fares. At present, flights between Tokyo and London are more expensive, in cost per mile, than other long haul flights to or from London, (see Table 2 over). The Japanese have recently approved some reductions in fare levels between Japan and Europe. The Japanese authorities have traditionally adopted a highly regulatory approach to fare levels, partly to give a measure of protection to JAL who are a high cost operator with a poor industrial relations record. There are signs that this protectionist policy is beginning to change with the emergence of ANA as a second Japanese carrier on international routes.

3. We hope that further progress can now be made towards the introduction of more liberal air services arrangements at the Government level in order to allow the airlines maximum flexibility to respond swiftly to changes in market demands. Generally, we look for arrangements with Japan which reduce Government intervention in the airlines' business to the minimum possible.

4. In particular, this suggests:

i) the removal of restrictions on the number of frequencies that can be operated by the airlines of both countries. This will allow capacity to rise to meet increasing demand, and competition will lead to lower fares.

ii) simplified arrangements on the approval of fare levels for journeys between our two countries allowing airlines greater opportunity to introduce lower fares in accordance with market requirements;

iii) flexible arrangements on routeings - for example UK airlines should be given the opportunity to operate over the new - Siberian route to Osaka which at present is denied to them by the Japanese authorities;

Table 1: United Kingdom/Japan Air Services
Traffic Statistics 1984-1988

NUMBER OF ONE WAY JOURNEYS BETWEEN UK AND JAPAN,
(thousands)

	Summer	Winter
1984	179	127
1985	202	131
1986	210	159
1987	282	198

Table 2: Comparative Air Fares (cheapest on demand fares)

	Category	Cost (£)	Distance (mile)	Cost (pence per mile)
London-Tokyo*	Y2 (Economy)	560		9.4
London-Tokyo*	Y1 (Full Economy)	1070	5956	18.0
Tokyo-London**	Y1 (Full Economy)	1612		27.0
London-Sydney	Y2	675	10565	6.4
Sydney-London	Y2	n/a		
London-San Francisco	Y2	409	5358	7.6
San-Francisco-London	Y2	376		7.0

* The Civil Aviation Authority has recently approved a 5 per cent increase

** The Japanese authorities have not yet approved any $\frac{1}{2}$ fare from Tokyo to London

THE UK's ECONOMIC AND TRADE RELATIONS WITH JAPAN

Introduction

1. This Annex compares the economies of Japan and the UK and sets out the UK's bilateral economic reactions with Japan. The main data source is the OECD.

Size and Composition

2. When converted into a common currency using the OECD's Purchasing Power Parities, Japanese GDP is $2\frac{1}{4}$ - $2\frac{1}{2}$ times that of the UK. Per capita GDP is slightly higher than in the UK.

Table 1: Size of UK and Japanese Economies in 1987

	Japan	UK
GDP (\$ billion converted at OECD PPPs)	1609	703
Population (million)	122.1	56.9
GDP per capita (\$ thousand)	13.2	12.4

Table 2: Japanese GDP as percentage of UK GDP

	1970	1980	1987	1988	1989*
Japan	160	208	229	233	237

Based on PPPs

* Based on FSBR forecast of UK growth in 1989 and IMF forecast of Japanese growth

3. Manufacturing produces a higher proportion of GDP in Japan than in the UK, and employs a higher proportion of those in work. The Japanese manufacturing sector is highly efficient, but the agricultural and service sectors are comparatively inefficient.

Table 3: Output Structure (1986)

Percentage of GDP

	Japan	UK
Agriculture	3	2
Industry	41	33
of <u>which</u> manufacturing	(29)	(22)
services (including Government sector)	56	65
	<u>100</u>	<u>100</u>

Table 4: Employment Structure (1986)

Percentage of all active persons

	Japan	UK
Agriculture	11	3
Industry	34	30
of <u>which</u> manufacturing	(24)	(22)
services (including Government sector)	55	67
	<u>100</u>	<u>100</u>

4. Investment is a higher proportion of GDP in Japan than it is in the UK, and consumption a lower proportion. Both exports and imports are much smaller relative to GDP in Japan: in 1987 net exports were more than 3 per cent of Japanese GDP.

Table 5: Comparison of Expenditure in 1987

Per cent of GDP

	Japan	UK
Private Consumption	57.8	62.6
Government consumption	9.6	20.9
Gross investment	29.1	17.4
Exports	11.1	26.4
<u>Less</u> Imports	7.8	27.4

5. Throughout the 1980s, net savings have been a higher proportion of GDP in Japan than in the UK or, in fact, of any other G7 country. Net national savings in 1987 in Japan were roughly equal to net savings in the other G7 countries combined. In 1986, household net savings alone were 11 per cent of GDP. Net investment has also been a higher proportion of GDP in Japan than in any of the other major seven countries.

Table 6: Net national savings and investment as percentages of GDP

	Savings		Investment	
	1987	1981-7 Average	1987	1981-7 Average
Japan	18.4	17.5	15.1	15.9
UK	5.4	5.8	5.6	4.7
G7 Average	7.6	7.8	8.3	8.3

6. With this high level of net national investment there has been a more rapid increase in the capital stock per person employed, which rose by 54 per cent in Japan over 1980-86 compared to a 16 per cent rise in the UK.

7. Japan's current account surplus is based on its position as a massive net exporter of manufacturing goods, especially capital goods. Manufacturing exports in 1987 were \$225 billion, compared with manufacturing imports of only \$66 billion.

Table 7: Composition of Trade, Japan and UK 1987

US \$ Billion

	Exports		Imports		Balance	
	Japan	UK	Japan	UK	Japan	UK
Total Goods	229	131	149	154	80	- 23
of which						
manufactures	(225)	(104)	(66)	(118)	(159)	(- 14)
(SITC 5-9)						
raw materials	(4)	(27)	(83)	(36)	(-79)	(- 9)
(SITC 0-4)						
Services	37	46	35	30	2	16
Total	266	177	184	184	82	- 7

Shares in World Markets of Goods

8. The Japanese share of world exports is now about nine per cent compared to the UK's 5 or 6 per cent.

Table 8: Share of World Exports of Goods

percentage

	1970	1979	1987
Japan	6.5	6.5	9.3
UK	6.6	5.5	5.4

Current Account Position

9. Japan has had a current account deficit in only four years since 1965. Table 9 shows Japanese and UK current accounts as percentages of GDP.

Table 9: Current Account Position

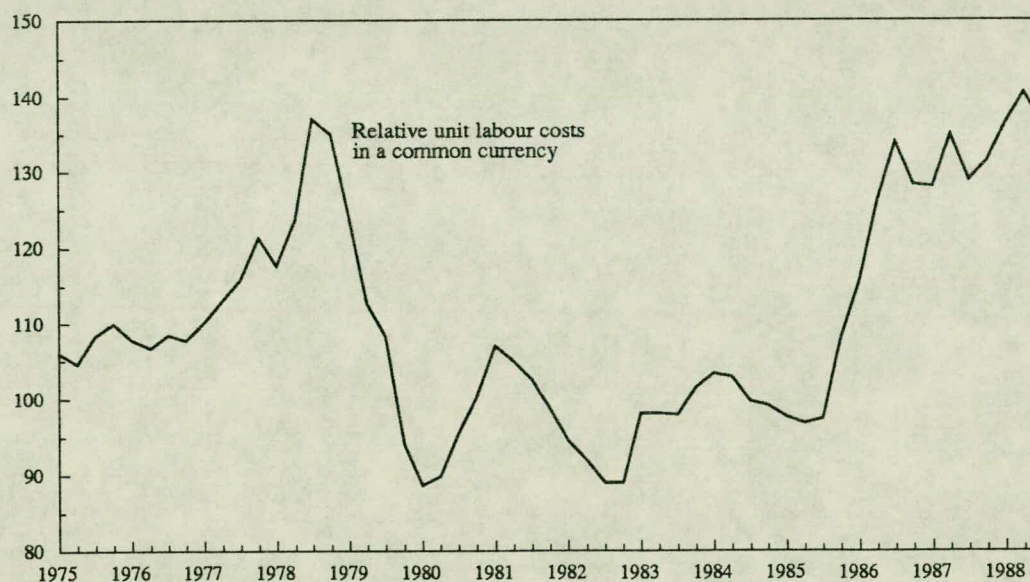
percentage of GDP/GNP	1960	1970	1980	1985	1986	1987	1988	1989*
Japan	0.5	1.0	- 1.0	3.7	4.3	3.6	2.8	2.7
UK	- 1.0	1.5	1.3	0.9	0	- 0.6	- 3.1	- 2.8

* IMF forecast for Japan, FSBR for UK

Competitiveness

10. The chart below shows a sharp rise in Japanese relative unit labour costs since 1985.

JAPANESE REAL EFFECTIVE EXCHANGE RATE
(1985=100)



Bilateral Trade

11. Table 10 shows that Japan has become an increasingly important trading partner for the UK, and that the UK's bilateral trade account has generally been in deficit. This was true even in 1983 when the UK had an overall trade surplus. The UK's bilateral trade deficit with Japan widened from 0.4 per cent of UK GDP in 1979 to 1.2 per cent of UK GDP in 1987.

Table 9: Japanese Shares of UK Merchandise Exports and Imports

	UK Exports to Japan as % of UK Exports	UK Imports from Japan as % of UK Imports
1970	1.8	1.5
1979	1.5	3.2
1983	1.3	5.1
1987	1.9	5.8
1988	2.1	6.1

Table 10b: UK Trade in Goods with Japan

	UK Exports to Japan (£b)	Japanese Exports to UK (£b)	Balance (£b) % of UK GDP in brackets
1970	0.1	0.1	0.0 (0)
1979	0.6	1.5	-0.9 (-0.4)
1983	0.8	3.4	-2.6 (-0.7)
1987	1.5	5.5	-4.0 (-1.0)
1988	1.7	6.5	-4.8 (-1.2)

12. The visible trade deficit of £4 billion in 1987 was partly offset by a significant surplus on invisibles of between £1.5 billion and £2 billion. (The Japanese estimate is £3.5 billion, so this range may be subject to error). This surplus consisted of a surplus on services (shipping, travel, insurance etc) of around £1 billion, together with a surplus on investment income which in large part reflects the way in which banking funds are channelled through London by Japanese financial institutions.

International Direct Investment

13. In 1984 (latest published data) UK companies had a stock of direct investment of £630m in Japan, about the same as Japanese companies' UK assets. In the period 1985-7 the net flow of direct investment by UK firms in Japan was £140m, compared to net Japanese corporate direct investment flows in to the UK of £900m, mostly in 1987.

Japanese Productivity and Comparative Advantage

14. Japan has a large and efficient manufacturing sector which is a major net exporter, particularly of capital goods. The large Japanese and German surpluses on manufacturing trade are shown in Table 11.

Table 11: Manufacturing Trade Balances 1987

	Billions of Dollars	Ratio of manufacturing exports to manufacturing imports
United States	-130	0.6
Japan	164	3.4
Germany	107	1.6
France	-3	1.0
United Kingdom	-14	0.9
Italy	30	1.3
Canada	-13	0.8
Total of Above	140	

15. It is difficult to obtain reliable estimates of levels of productivity, but output per employee is probably about 10-30% higher in Japanese manufacturing than in the UK. This gap has fallen in the 1980s, as manufacturing output per employee in manufacturing has grown more rapidly in the UK than in Japan.

Table 12: Output per Employee in Manufacturing

	<u>Annual average percentage change</u>		
	1960-70	1970-80	1980-1988Q3
UK	3.0	1.6	5.2
Japan	8.8	5.3	3.1
Major 7 Average	5.2	3.3	3.6

THE JAPANESE CURRENT ACCOUNT SURPLUS

1. This annex sets out the arguments in the introduction in more depth.


(a) The Reasons for the Japanese Current Account Surplus

2. Individual countries have tended to run current account surpluses and deficits for decades rather than years. Japan has followed this pattern: current account deficit until 1917 and again from 1937 to 1950, followed by a period of balance and, since 1965, an emerging surplus. Since 1965 Japan has had a current account deficit in only four years, associated with the two oil price shocks. The emerging current account surplus, which grew rapidly between 1981 and 1986 to reach 4.3 per cent of GDP, is associated with an excess of national savings over national investment.

3. Several reasons can be identified for the high level of saving in relation to investment. The main explanation lies in household saving behaviour, although companies have been able to finance investment from self-generated funds and the Government has contributed by reducing its net financial deficit from 5 per cent of GDP in the late 1970s to under 1 per cent in 1988.

4. The household gross savings ratio out of disposable income in Japan was 21 per cent 1986 (OECD National Accounts) compared to 11½ per cent in the US and 9 per cent in the UK.

Reasons for the exceptionally high of household savings rates include:

- 
- i. Preparation for old age. Japan has a relatively young population but this will age rapidly; the proportion of the population over 65 is expected to almost double by 2010. Japan is expected to have a higher proportion of those aged over 65 than any other G7 country by 2020. Pensions and health care have improved, but the basic state pension is still low and the ageing of the population suggests that

there will be pressures to keep down social security and pensions expenditure. Behaviour may not have fully adjusted to past improvements, and there are real doubts as to whether provision for the elderly will be further improved. An ageing population not only prompts individuals to save but also makes an increase in national savings appropriate in advance of the expected higher cost of pensions and social security.

ii. Housing costs are higher in relation to earnings (6-7 times earnings on average in Tokyo) and deposits on home purchases are generally close to 50 per cent of the purchase price. A prospective purchaser in Tokyo has to accumulate savings equivalent to about 3 times his or her annual salary.

iii. Spending on consumer durables is low, and this may reflect less leisure time and smaller living space.

iv. Structural rigidities in the taxation of land, protection of agriculture, and the distribution system, tend to act to reduce imports and to reduce the income available for spending on consumer goods.

(b) Capital Markets and Investment Flows

5. In the last decade, following the lead taken by Britain in 1979, many OECD countries have removed exchange controls. As financial markets have been de-regulated and financial innovation has taken place on an unprecedented scale, the nationality of individual savers and investors becomes of less significance. This greater flexibility has enabled the sustained use of Japanese and German savings to make good the shortfall of savings in the US and now in the UK. Capital markets have shown themselves able and willing to finance the current account surpluses and deficits without disruptive changes to exchange rates and interest rates. When these capital flows are used to finance productive investment they are sustainable and may persist for considerable periods of time, provided that the appropriate policy framework is in place. Elements in this include:

- appropriate monetary policies to keep inflation under control;

- fiscal policies set within a medium term framework within which governments do not displace private sector savings;
- policy co-ordination contributes to stability in financial markets.

6. Japan has increased its net stock of overseas assets in the 1980s, but this stock is not at an exceptional level, as the table below shows.

Net overseas assets as a percentage of GNP

	1975	1980	1986	1988*
US	5	4	- 6	- 10
Japan	1	1	9	15
Germany	9	4	11	16
France	8	14	6	
UK	2	7	31	
Italy	- 1	9	- 2	
Canada	- 30	- 35	- 36	

*with Gov
1987 fss?*

Source: National Data and International Financial Statistics
*IMF projections

This increase may partly reflect Japanese wishes to hold international assets in portfolios, which was made difficult before the 1980s by controls on currency and asset markets.

(c) Bilateral Trade Flows

7. Japan has a comparative advantage in manufacturing and especially of capital goods, and so runs a trade surplus in manufactures and a deficit in raw materials and services. In recent years, the UK has become a net importer of manufactures on an increasing scale. It is not surprising therefore that it has had a rising trade deficit with Japan.

(d) Structural Reform and the Current Account

8. Better performance through structural reform may result in either an increase or decrease in the current account. The net effect is likely to depend on the response of national saving and the exchange rate. Thus, if a general programme of structural reform were to raise the rate of return on capital employed, one might expect to see higher investment, higher capital inflows and a smaller current account surplus. If structural reform increases consumption and imports the current account will again tend to fall. But the structural reforms will also assist efficient sectors, and the net exports of Japanese manufactures, the sector in which Japan has a clear comparative advantage, could be expected to increase. And it is not certain that further structural reform would increase consumption, as households may respond to some reforms - particularly reforms that reduce the price of land - by building up stocks of net overseas assets. The net effects of further structural reform on the current account surplus are therefore uncertain.

MP

FROM: HUW EVANS
 DATE: 17 MAY 1989
 EXT: 4430

CHANCELLOR<

cc

Economic Secretary
 Sir P Middleton
 Sir T Burns
 Mr Wicks
 Mr Lankester
 Mr Odling-Smee
 Mr Peretz
 Mr Ilett
 Mr Melliss
 Mr Edmonds
 Mr Tyrie

Content with
 this redraft?

OK -
 [Signature]

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JAPAN: CURRENT ACCOUNT SURPLUS AND STRUCTURAL REFORM

1. I attach a revised version of the paper on Japan (originally requested in Charles Powell's letter to Nigel Wicks of 23 January), which takes in your comments on an earlier draft, together with a PS letter. I have sidelined the main changes, which include the removal of the section on financial services (because we think there is little connection with the current account surplus). I have also added paragraph 11 which stresses the general case for structural reform in Japan.

2. The Prime Minister recently told the Japanese ambassador that saving in his country was too high, and should be reduced. The line in the paper, see paragraph 5, is that high Japanese saving is a source of strength for the world economy. I think the best way of reconciling all this is, as in paragraph 4, to draw attention to the structural rigidities that keep Japanese savings artificially high.

3. We are dealing separately with the request from No 10 for a draft speech for the PM's visit to Japan.

See Powell letter immediately behind this paper. I have spoken to Huw about handling. He tells me NLW will be chairing a mtg about this in the next week with a view then to taking yr mind on an outline. That seems reasonably sensible. I might stick this in yr Int'l issues folder for Tuesday if you want a quick preliminary word then

HPE.

H P EVANS
 UNCLASSIFIED

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 [Signature]