DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

BRIEFING

August 12, 1997

MEMORANDUM FOR DEPUTY SECRETARY SUMMERS

FROM: Timothy F. Geithner TFG
Senior Deputy Assistant Secretary (International Affairs)

SUBJECT: Briefing for Your Lunch with Eisuke Sakakibara, Vice Minister of Finance for International Affairs, Ministry of Finance, Japan

Date & Time: Wednesday, August 13, 1997 at 12:00 - 1:30 p.m.

Location: Your Office

PARTICIPANTS:

Treasury: Deputy Secretary Summers
Senior Deputy Assistant Secretary Geithner

Japan: Vice Minister Sakakibara (DOB 27 March 1941)
Minister Iwashita, Embassy of Japan (DOB 1 January 1948)

BRIEFING: Overview

BACKGROUND:
Tab 1: Japan's Economic Outlook
Tab 2: Japan's Current Account Surplus
Tab 3: U.S. Economic Policy Toward Japan for 1997-2000 (Internal note, draft August 5, 1997)
Tab 4: Exchange Rates (charts)

cc: David Lipton

OVERVIEW
LUNCH WITH JAPANESE VICE MINISTER SAKAKIBARA
August 13, 1997

OVERVIEW:

Vice Minister Sakakibara specifically requested a meeting with you and asked that the meeting be kept as private as possible; wire services have since (morning of August 12) carried news of the meeting. Sakakibara could raise the following:

- **U.S.-Japan relations** in light of economic data showing a rising current account surplus and weak domestic demand, which conflicts with the GOJ's public commitment to the "objective of promoting strong, domestic-demand-led growth in Japan and avoiding a significant increase in the external surplus."

- **Exchange rates**. The yen depreciated to nearly 120 ¥/$ last week after release of weak economic data for the second quarter. It bounced back to 115 ¥/$ after comments by USTR Barshefsky and strong June current account data were released. The yen could come under renewed pressure if Japanese growth remains weak and South East Asian currencies remain fragile.

- **Thailand** and recent market developments following the IMF package in final stages of negotiation.

This is a prime opportunity to ask what the GOJ plans to do to achieve its objective of domestic demand-led growth. We can use the pressure the Japanese must be feeling from adverse data releases to secure commitments on greater market access and comprehensive deregulation. You may also want to broach the subject of re-establishing a U.S.-Japan deputies-level group, co-chaired by Treasury, State, USTR and Japan's MOF, MOFA, MITI on economic issues, as originally envisioned in the Framework agreement, to address structural issues of concern to us.

MAIN ISSUES:

1. **Japan's Economic Prospects**. Data releases support our projections of weak domestic demand and a rising current account surplus.

- EPA staff have indicated that monthly data imply flat GDP for the first half of the year (Q2/Q4).

    - A large decline in GDP expected for the second quarter will essentially offset first quarter growth artificially boosted by pre-consumption tax spending.

    - The second quarter GDP data -- due for mid-September release -- are expected to show weak domestic demand, led by a large decline in consumer spending, more than offsetting robust export growth.

- Our internal forecast shows growth slowing to 1.9% for the year as a whole, after a strong 3.5% in 1996.

- The Government of Japan intends to reduce the central and local **government deficit** to below 3% of GDP by FY 2003, down from an estimated 6.7% of GDP in FY 1996.

    - Our embassy staff in Tokyo estimates that, based on GOJ plans and as a percent of GDP, the deficit will be reduced to 4.6% in FY97 and 3.3% in FY98.

    - The extreme front-loading of the fiscal plan threatens to derail Japan's fragile recovery by dampening domestic demand.

- While weak domestic demand may be suppressing import growth, yen depreciation over the last couple of years is now fueling Japanese exports.

    - We forecast Japan's **current account** surplus will reach roughly $93 billion this year, after $66 billion in 1996.

    - The data support our forecast. Japan's current account surplus for the first half of the year totals $86 billion at a seasonally adjusted, annual rate, and it is increasing.

    - We project another increase next year (to around $138 billion). Others also project an increase, albeit smaller than ours.

    - Vice Minister Sakakibara told Senior DAS Geithner that internally MOF now expects a 1997 current account surplus in line with Treasury's forecast, and a further increase in 1998, although not as large as we predict.

- The Government of Japan has publicly committed itself to promoting strong, domestic-demand-led growth and avoiding a significant increase in the external surplus. However, the GOJ has been slow to recognize that domestic demand has weakened since fiscal consolidation got underway, and that the rising external surplus is not a temporary phenomenon.

    - We need to press for slowing the rapid pace of fiscal consolidation (and leave the details on how to do it to the Japanese).

    - Our embassy staff in Tokyo estimates that, based on GOJ plans and as a percent of GDP, the deficit will be reduced from 6.7% in FY96 to 4.6% in FY97 and 3.3% in FY98. There is scope for the GOJ to slow the pace of consolidation and still meet the Prime Minister's publicly-stated targets (i.e., below 3%) by 2003.

- We can use the current account/domestic demand platform -- and GOJ's commitment to sweeping deregulation and structural reform -- to gain leverage on key deregulation and sectoral items on our agenda.

Key Points:

- Concerned about sharp increase in Japan's current account surplus.

- Appreciate goal of reducing the fiscal budget deficit by 2003, but the front-loaded fiscal consolidation planned for FY97 and FY98 seems inconsistent with GOJ commitment to promote strong domestic demand-led growth.

- In fact, we think second quarter GDP data -- for release in mid-September -- will show a consumption-led contraction that leaves growth essentially flat for the first half of the year.

- Would like to know how GOJ plans to achieve its objective of "promoting strong, domestic-demand-led growth in Japan and avoiding a significant increase in the external surplus."

- Important to reaffirm publicly Japan's commitment to promote strong domestic demand-led growth and to moderate the rise in Japan's external surplus.

- Note that the OECD's WP-3 meeting in September will focus on current account issues and provides an ideal opportunity for further discussion.

- Note that sustained increases in Japan's external surplus likely to create political tensions between our two countries.

2. **Exchange Rates**. The yen has fluctuated between 110 ¥/$ and 120 ¥/$ in recent weeks, alternately weakening with the release of data showing a weak domestic economy and strengthening on strong trade figures showing robust export growth.

The economic package for Thailand was welcomed and short-term pressures seem to have been defrayed. However, it will take sustained, long-term performance before the Thai baht regains credibility and wins the confidence of international investors. Other emerging market currencies have been affected by spillover pressures.

Key Points:

- The renewed rally in Japanese government bonds, the decline of the Nikkei, and the yields implied in forward rate agreements all reflect the view in the markets that the Japanese recovery has not reached a self-sustaining basis.

- Early in the Japanese fiscal year, you had maintained that the market was underestimating the pace of the recovery. Now that further economic data have become available, what is your view?

3. **Thailand**. Thai markets were relatively stable on August 11, with little in the way of a positive reaction to the completion of the financial assistance package in Tokyo and some remaining skepticism about the sufficiency of a $16 billion Fund program to help Thailand. Overall, the Thai stock market continues to droop on the realization that the party is over and growth will be meager at best. On August 11 property developers and banks led the day's decline as the SET dropped 4.6 points (0.7%) to 632.25. The baht was also down 0.3% to 31.39/$ in the onshore market. Markets were closed in Thailand on August 12 for the Queen's Birthday, but the baht dropped 1% in offshore markets to 31.48/$ from 31.18/$.

Key Points:

- Tokyo conference: Welcome the results of the IMF conference in Tokyo to discuss multilateral and bilateral financing for Thailand's economic recovery program.

- Multilateral assistance: Emphasize importance of making sure that commitments by the World Bank and Asian Development Bank are speedily translated into actual lending.

- Bridges: Explore with Sakakibara the current Japanese position on a bridge loan through the BIS to either WB/ADB loans or to a second tranche of the Fund program.

- Transparency: Express U.S. desire to see strong transparency provisions in this program, including the publication of the Bank of Thailand's balance sheet, along with its forward obligations.

- Capital controls: Explain our position on the necessity of removing capital controls on a speedy basis based on a plan laid out in the Fund program.

4. **Upcoming G-7 Meeting** (presumably September 8, ahead of the September 9 WP-3 meeting). This will be Sakakibara's first Deputies meeting as Vice Minister. The meeting will focus on surveillance in preparation for the Hong Kong G-7 ministerial, IMF issues (e.g., quotas, capital account amendment) and possibly other Denver follow-up such as the Africa Initiative.

- With respect to the Hong Kong G-7 Ministerial (September 20), we understood informally from the Japanese embassy that we would start with a working lunch, continue through late afternoon, and finish the day with a social dinner. That same evening the IIF is hosting a dinner in honor of EBRD President Jacques de la Rosiere and has been trying through Gyohten to persuade MOF to forego the social dinner so that the G-7 Ministers and Governors could attend the IIF dinner instead. We have not received anything in writing from the Japanese and it might be useful to ask in a general way about MOF plans and arrangements.

- <u>IMF Quota Increase</u>. At the July Deputies' meeting, you indicated that no more than 35% increase was justified in view of the liquidity situation. Japan has pushed for a larger increase not because of liquidity but because a larger overall increase would facilitate the share adjustment that is Japan's primary concern. The Executive Board (and G-7 Directors in particular) will be addressing the issue further beginning next week. G-7 Deputies will need to resolve any remaining differences at the September 8 Deputies' meeting. You could reiterate that we are prepared to close by Hong Kong if an acceptable deal is worked out and, in that context, to accommodate Japan's desire for a share increase as best we can.

- <u>SDRs</u>. We have some interest in delaying signaling support for an exact doubling -- to a new allocation of SDR 21.4 billion -- so that SDRs could be packaged with a quota deal, particularly given that the NAB legislation may still be in Conference during late September. However IMF staff seem to be already aware of the G-7's tentative accord on the amount.

<u>Key Points</u>:

- Would be interested in your plans for arranging the Hong Kong Ministerial.

- Would appreciate your support for a 35% quota increase as merited by the liquidity situation. Understand your concerns about share adjustment, but think this is still achievable with the smaller, 35% increase.

- Would like to package agreement on SDRs with one on the quota. As you know, we have certain sensitivities related to our legislative cycle -- NAB legislation may be in final stages (Conference) in late September.

IMI: C. Carnes, M. Grewe
August 11, 1997

JAPAN: ECONOMIC OUTLOOK

KEY ISSUES

- *Growth Slowing.* We project real GDP growth will slow for 1997 as a whole, down from 3.5% in 1996, as domestic demand slows, while net exports rise. We expect negative second quarter growth will follow an artificially strong first quarter (buoyed by pre-consumption-tax-hike spending).

- *Fiscal Policy.* Under current plans the fiscal deficit will be reduced by more than 2% of GDP this year. The Prime Minister is publicly committed to reducing the combined central and local government deficit (excluding the social security surplus) to below 3% by the year 2003 from over 7% in FY1996, and his Cabinet has set specific spending cut targets to meet that goal.

- *Monetary Policy.* Monetary policy remains accommodative, with the overnight call rate averaging below 0.5% and ten-year bond rates around 2.1%. The markets still expect short-term interest rates to remain below 1% at least into the fall. However, market expectations for limited credit tightening appear to have shifted into early next year.

- *Financial System.* Market concern about Japan's banks continues due to lower bank profits as bad loans are written off, a slower growth outlook, and the potential impact of financial reforms. It will take a few more years of concentrated effort by the banks to complete write-offs, and even longer for the collateral underlying bad loans to clear the market. The system is still vulnerable to an economic downturn; MOF still has to take further measures to strengthen banks and implement reforms aimed at improving supervision and bank disclosure.

- *External Sector.* After falling 41% to $66 billion (1.4% of GDP) in 1996, Japan's current account surplus is projected to rise to over 2% of GDP in 1997 in Treasury and Fed forecasts. (The OECD, IMF and Consensus have all forecast a smaller rise, but have recently revised their forecasts upward.)

DISCUSSION

GROWTH

Japan's real GDP grew 3.5% in 1996. The May Treasury forecast predicts slower growth of 1.9% in 1997. Consensus forecasts predict 2.0% growth, while IMF and OECD forecasts are a little higher (2.2-2.3%), and the Fed forecast of 2.7% is at the high end.

- We expect real GDP to fall significantly in the second quarter, virtually offsetting an artificially strong first quarter growth of 6.6% (saar) that was boosted by pre-consumption tax spending.

- The contribution to growth from domestic demand is expected to fall from 4.5% in 1996 to 1.0% in 1997, while the contribution from net exports is expected to rise from -0.9% to 1.0%. Already in the last quarter of 1996, net exports accounted for 41% of GDP growth.

RECENT STATISTICS

Recent economic indicators have been mixed, suggesting strong export growth but lackluster domestic demand in the wake of fiscal consolidation.

- Industrial production in June was 8.0% above its level a year ago. However, on a seasonally adjusted basis, second quarter production was unchanged from the preceding quarter, while inventories surged, up 7.1% from the first quarter.

- Capacity utilization rose to 78.5% in May, up from 76.1% in April and from 73.8% for 1996 as a whole.

- Retail sales declined 4.0% (year-on-year) in June, following an 3.3% decline in May, while passenger car sales also continued to decline post-consumption tax hike, falling 11.4% (y/y) in July, 5.0% (y/y) in June, and 9.4% (y/y) in May.

- The June unemployment rate remained at a (seasonally adjusted) record of 3.5%.

PRICES

Inflation ticked up in April in response to the consumption tax hike, but this is expected to be a temporary spike.

- Consumer prices in May rose 1.9% over a year earlier, mostly due to the 2 percentage point hike in the consumption tax. In June, the Tokyo Consumer Price Index rose 0.4% month-on-month (seasonally adjusted) and 1.9% year-on-year.

- Wholesale prices rose 1.9% year-on-year in June 1997.

    -- Domestic prices rose 2.0% (y/y) in June 1997. Export prices fell 0.9% (y/y), while import prices rose 5.9%.

MONETARY POLICY

The tight government budget, weak domestic demand, and banking sector problems weigh against an early tightening of monetary policy. Over the past few weeks, market expectations for a rate hike have shifted from the end of this year into early 1998.

On the short end, the overnight call rate continues to average below 0.5%, where it has been since the government lowered the discount rate to 0.5% in September 1995. The interest rate on three-month government bills is 0.51%.

- The markets are hedging against some edging up of interest rates at the end of this year or beginning of next. The interest rate on the three-month December 1997 future contract is 0.70%, while the interest rate on the three-month March 1998 future is 0.79%.

On the long end, rates rose to the 2.6% level at the end of June after the quarterly BOJ "Tankan" survey of business sentiment confirmed that large manufacturers are figuring the positive effects of recent export growth into their investment decisions. However, the persistence of sluggish indicators for the economy is encouraging the view that -- at least for the time being -- GOJ will continue its accommodative monetary stance.

- The yield on the 10-year benchmark bond is now around 2.1%, significantly below last year's level of 3.3% (end-July 1996).

- After raising the long-term prime rate from 2.5% to 3.1% in May, banks -- finding the rate hike not sustainable -- lowered the rate to 2.9% (June 11), and then 2.7% on July 10.

Narrow measures of the money supply are growing rapidly but broader measures are growing more slowly.

- M1 grew at a 8.6% rate in May 1997 (year-on-year) and an annualized 12.0% in the last three months.

- The closely watched M2+CDs grew 2.8% in June (y/y), slowing slightly from 3.1% in May and 3.2% in April.

FISCAL POLICY

We expect fiscal measures to reduce the budget deficit by more than 2% of GDP and slow growth by 0.4% of GDP in FY97. The main elements of fiscal consolidation are:

- Elimination of the ¥2 trillion income tax rebate at the end of 1996 and an increase in the consumption tax from 3% to 5% on April 1.

- Spending declines as existing fiscal packages run their course. Introduction of any new package this year is highly unlikely.

- The IMF estimates Japan's structural deficit will fall from 3.3% of GDP in 1996 to 1.7% of GDP in 1997.

For next year (FY98), the Prime Minister's fiscal reform council has announced spending cuts that include 7% reduction in public works spending, 10% reduction in foreign assistance, decrease in defense spending below the FY 1997 level, and constrained growth in social security.

EXCHANGE RATE AND THE CURRENT ACCOUNT

Appreciation of the yen between 1990 and 1995, stronger growth, and structural changes have contributed to a decline in Japan's current account surplus.

- Japan's real trade weighted exchange rate appreciated 49% between April 1990 (its lowest point since the Plaza Agreement) and April 1995. The lagged effects of this appreciation helped to lower Japan's current account surplus from $132 billion (3.1% of GDP) in 1993 to $66 billion (1.4% of GDP) in 1996.

- In 1996, in yen terms, Japan's exports rose 8.2% in 1996 to ¥43.6 trillion while imports rose 23.5% to ¥34.5 trillion. Export volumes rose only 0.7% while yen export prices rose 7.4%. Import volumes rose 9.9% while yen import prices rose 12.4%.

We project that the depreciation of the yen since April 1995 and slower growth in Japan in 1997 will boost Japan's overall current account surplus to $93 billion (2.1% of GDP) in 1997 and $139 billion (3.0% of GDP) in 1998. The Fed projects nearly as big an increase. The OECD, IMF and Consensus Economics foresee a smaller but still significant rise (to 2% of GDP in 1998).

- Since its high in April 1995, the yen has depreciated 22% on a real trade-weighted basis, reversing two-thirds of its appreciation since the April 1990 low.

- We estimate Japan's current account surplus for the first half of 1997, seasonally adjusted and annualized, amounts to about $86 billion.

The bilateral surplus will likely rise more strongly than the forecasted rise in Japan's overall surplus.

- For the first half of the year, Japan's customs basis bilateral trade surplus with the U.S. totaled $18.5 billion, a 32% increase over the same period a year ago. Not only are U.S. imports up by 5.3%, but exports are also down 3.8%.

- The rise follows a year in which Japan's bilateral trade surplus with the U.S. narrowed, from $59.1 billion in 1995 to $47.7 billion in 1996. In 1996, U.S. exports to Japan rose 5.0% to $67.5 billion; U.S. imports from Japan fell 6.7% to $115.2 billion.

COMPARATIVE FORECASTS

	Real GDP Growth (%)			Inflation (CPI %chg)			Current Account ($bn)		
	1996	1997	1998	1996	1997	1998	1996	1997	1998
Treasury	3.5	1.9	2.5	0.1	1.7	1.6	66	93	139
IMF		2.2	2.9		1.3	1.2		78	90
OECD		2.3	2.9					80	98
Fed		2.7	2.1		1.1	0.8		90	120
Consensus		2.0	1.9		1.5	0.8		79	89

Source: July 1997 forecasts (except June for Treasury, OECD and Fed, and May for IMF). Treasury and Fed forecasts sensitive.

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JAPAN'S CURRENT ACCOUNT SURPLUS

Both Prime Minister Hashimoto and Finance Minister Mitsuzuka have reiterated support for the objective of strong domestic-demand-led growth and avoidance of a significant increase in the current account surplus. However, the bulk of the Prime Minister's political will is behind his fiscal structural reform program. The Prime Minister has pledged to reduce the fiscal deficit (excluding the social security system's surplus) from 6.7% of GDP in FY 1996 to less than 3% of GDP by FY 2003, with most of the reduction in fiscal years 1997 and 1998. This is likely to dampen domestic demand and increase the current account surplus.

Recent Treasury-MOF discussions on forecasting Japan's current account surplus have raised some areas of disagreement. We believe the key points are:

- Exchange rates matter most. Changes in exchange rates affect trade flows with a lag of 1-2 years. MOF has ignored the lagged effect. Yen depreciation of 32% since April 1995 is stimulating Japanese exports.

- Structural change -- moving Japanese production offshore and deregulatory opening of Japanese markets to competition -- is a significant factor but is not occurring rapidly enough to offset the impact on trade of movements in the yen.

- Deficient domestic demand in Japan -- reflecting public expenditure cuts and the effect of tax increases on consumer spending -- is likely to contribute to external surpluses.

- Internal Treasury forecasts project a sharp increase in Japan's current account surplus from $66 billion in 1996 to over $90 billion in 1997 and $140 billion or more in 1998, depending upon the extent of structural change. Forecasts shown us by MOF show virtually no increase.

The outstanding issues between us include:

(1) the MOF's desire to focus on the goods and services balance instead of the current account;

(2) different views about the role of real exchange rates and structural change; and,

(3) different forecasts of the strength of domestic demand in Japan.

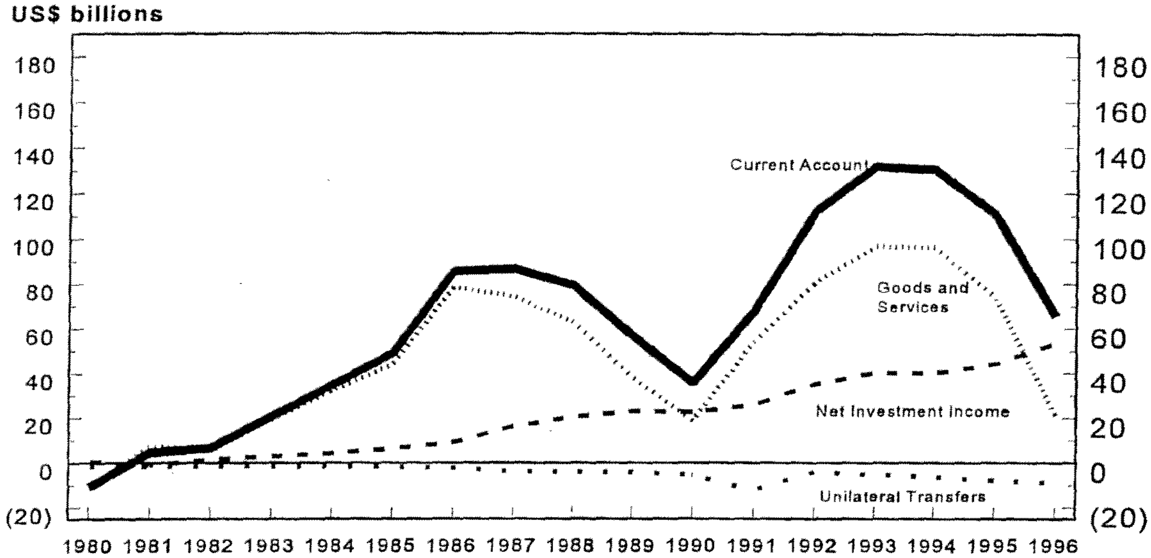
Of these, the single most important issue is the role of the exchange rate.

CURRENT ACCOUNT VS. GOODS AND SERVICES BALANCE

MOF has sought to shift focus from the current account, which includes a growing investment income component, toward the goods and services balance. While we have good reason to focus on the current account, we are concerned about potentially large increases in both the current account surplus and the goods and services balance.

The current account essentially consists of the goods and services balance, a significant and growing income on net investments and a small negative flow of unilateral transfers. With the latter two following a relatively steady trend, swings in the current account surplus are dominated by swings in the more changeable goods and services balance.

Chart 1: Components of Japan's Current Account Surplus



There is good reason to focus on Japan's current account.

- It has public visibility and the attention of financial markets.
- The net investment income component captures the lasting impact of Japan's chronic trade surpluses, which accumulate net external assets.
- The current account reflects the imbalance between saving and investment. In the long run, countries with a lot of net investment income are expected to run goods and services trade deficits, reflecting the fact that they have more income to spend than domestic production.

Regardless of the focus -- current account or goods and services -- we project a sharp rise in Japan's external surplus.

BEST FITTING MODELS PREDICT SHARP GROWTH IN JAPAN'S EXTERNAL SURPLUS

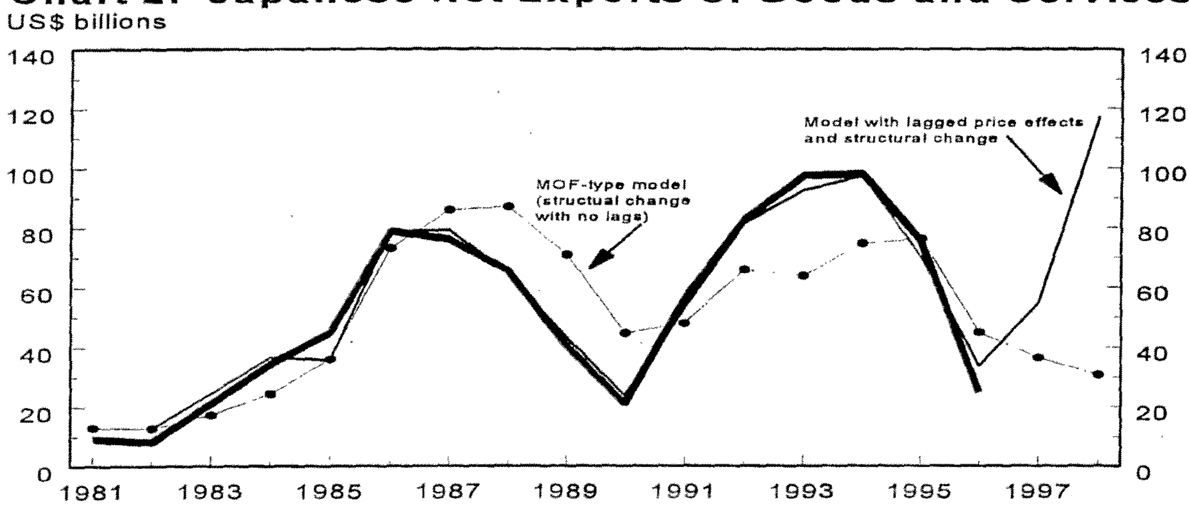
Statistical models that track history most accurately anticipate a large increase in Japan's current account.

- A simple statistical model that includes the lagged effects of exchange rates, domestic and foreign demand, and structural change tracks history well. (We use MOF data on the overseas production ratio to proxy structural change.) This model predicts a large increase in the goods and services balance.

- The Japanese forecasts shown us by the MOF underestimate exchange rate effects and depend heavily on structural change -- moving production overseas and opening Japanese markets to imports through deregulation -- to explain why the trade surplus will not increase significantly. The models do not include the lagged effect of exchange rates.

- We have developed a simple statistical version of the MOF analysis that confirms the MOF prediction of no significant increase in the trade surplus. However, this model fits actual trade data poorly.

Chart 2: Japanese Net Exports of Goods and Services



Critical Factor is Real Exchange Rate

<u>Exchange Rate</u>. The most critical factor in explaining movements in the current account is the real exchange rate.

- Large movements in the real value of the yen are followed by large movements in the trade balance after 1 or 2 years.

    - As a quick rule of thumb, a 10% depreciation of the yen decreases the goods and services surplus \$10 billion (0.2% of GDP) the same year as the dollar price of Japanese exports falls, has little net effect by the next year, and increases the surplus by \$20 billion (0.4% of GDP) the second and subsequent years as the cheaper yen stimulates purchases of more Japanese exports.

- o The real trade-weighted yen depreciated 17% in 1996 from the preceding year. Despite the yen appreciation of recent weeks, if the yen remains at its current level for the rest of the year, that would imply an additional 11% real yen depreciation on average this year relative to last year.

- o The current real trade-weighted value of the yen is roughly equal to its value in 1991, which preceded a large increase in Japan's trade surplus (see above chart).

- MOF has ignored lags in trade flows and thus has underestimated the impact of the exchange rate.

Domestic Demand. Slow growth in Japan's domestic economy has suppressed demand for imports into Japan. A stimulus to domestic demand that would return Japanese output to its full potential would reduce the trade surplus by $10-15 billion, holding the exchange rate constant, and even more if the stimulus led to an appreciation of the yen.

Structural Change. MOF argues that structural change -- the shifting of Japanese production offshore and deregulatory opening of Japanese markets to foreign competition -- will prevent the current account surplus from rising significantly. We have found that, while the overseas production ratio is a significant factor, structural change is not occurring rapidly enough to offset the shorter-term impact of exchange rates and projected economic growth rates.

- Foreign direct investment and overseas production by Japanese manufacturers have been growing for over a decade, and are still far below the levels of U.S. and German firms.

- Incorporating these measures of structural change has little effect on forecast of Japan's external balances. (We find no connection between the stock of foreign direct investment and Japanese trade behavior, and a positive relationship between the overseas production ratio and both exports and imports, with a slightly larger effect on imports.)

- MOF sees the rising share of manufactures in imports as evidence of structural change. Our statistical model of Japanese trade separates fuel imports -- the primary class of non-manufactured imports -- from other imports to improve predictability of each class of imports and factor in structural change.

- Nevertheless, we are sympathetic to arguments that structural change will have an increasing impact on future current account surpluses. The Japanese haven't made a convincing case for it yet, but we judgmentally adjust our forecast downward because we believe that our statistical measures understate the impact of structural change. Structural change may explain the moderately large error in the statistical model's prediction of the 1996 goods and services balance (see chart above).

ALTERNATIVE FORECASTS

Outside forecasts also predict a rise in Japan's current account surplus, although not as strongly as we do.

Table 1: Forecasts of Japan's Current Account Surplus

Japan's Current Account Surplus (US$ billions)	1996 (actual)	1997 (forecast)	1998 (forecast)
Treasury (internal)	66	93	139
Federal Reserve		90	120
IMF		78	90
OECD		80	98
Consensus		73	78
Salomon Bros.		94	143
MOF-provided BOJ-type*		68	89
MOF-provided EPA-type*		76	86

Source: June 1997 forecasts (except May for IMF; April for MOF-provided). Treasury and Fed forecasts sensitive.
* Converted at Y/$ of 118 in 1997 and 115 in 1998.

NEXT STEPS

We are still waiting for more information from MOF on the (EPA and BOJ) models shown us, and on the assumptions underlying their predictions. For our part, we are providing MOF, per their request, the data series used in our statistical analysis.

Now is the time to press for concrete evidence for the role of structural change, if MOF can provide it, and to seek MOF acceptance of the importance of lagged exchange rate effects. We may not be able to reach agreement on an appropriate model, but the more evidence we can provide that bolsters the case for predicting a sharp increase in Japan's external surplus the more we may be able to stimulate MOF thinking about contingency planning should forthcoming data on trade and domestic demand bear our predictions out.

Treas./IMI: C. Carnes, 2 July 1997
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U.S. ECONOMIC POLICY TOWARD JAPAN (1997-2000) draft 8/5/97

This Administration faces two major risks vis-a-vis Japan:

- a rising current account surplus which may spark political tensions in the face of historically closed Japanese markets; and,

- spillover to the international financial system should the legal, regulatory and supervisory environment not be appropriately revised to deal with problem institutions and the competitive pressures arising from "Big Bang" market opening.

An appropriate U.S. economic strategy, aside from protecting against these risks, could yield substantial benefits:

- a strengthened global financial system;

- a more balanced bilateral trade relationship;

- new opportunities for U.S. firms;

- a more vibrant domestic economy in Japan; and,

- greater choice for Japanese consumers.

This note outlines a U.S. economic strategy for Japan, with greater emphasis on areas of Treasury influence, for the remainder of this Administration (through 2000). The first section will review the 1993-96 strategy and its performance. The next section discusses considerations in selecting appropriate objectives. The remaining sections outline our major strategic objectives for the 1997-2000 period.

1993-96 U.S. ECONOMIC POLICY TOWARD JAPAN

The 1993-96 U.S. economic policy toward Japan, designed to integrate Japan more fully into the global economy and to ensure a more balanced division of the benefits of that integration, established the following three objectives:

I. Increasing the level of manufactured imports as a share of Japanese GDP and increasing the level of intra-industry trade.

II. Reducing Japan's current account surplus over the medium term to a more sustainable level.

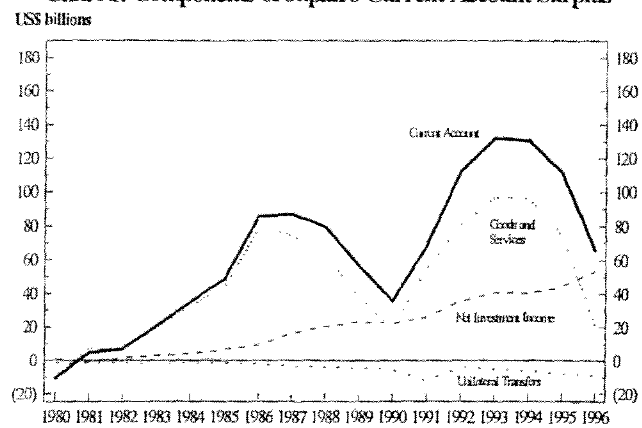
III. Increasing the rate of growth of U.S. exports to the Japanese market, especially in targeted strategic sectors.

To achieve these objectives, we negotiated for fiscal stimulus, market access to strategic sectors, structural reforms (competition policy, financial liberalization and incentives for foreign direct investment), and increased support for multilateral development assistance. Under the 1993

Framework agreement, the Japanese agreed to reduce the current account surplus over the medium-term, pursue sector-specific bilateral agreements, and establish a bilateral Deregulation and Competition Policy Working Group on regulatory and structural barriers.

On balance, the strategy worked well for the period. By the end of 1996, Japan's current account surplus had been roughly halved, imports comprised a larger share of Japanese GDP, and U.S. exports to Japan had grown.

Chart 1: Components of Japan's Current Account Surplus



- Japan's current account surplus peaked for the period in 1993 at $132 billion (3.1% of GDP) and then decreased sharply over the last couple of years to $66 billion (1.5% of GDP) in 1996.

- Both total imports and manufactured imports rose as a share of Japanese GDP. Manufactured imports increased steadily as a share of goods imported from 43% in 1992 to 53% in 1996.

- U.S. exports to the Japanese market picked up from a stagnant pace at the beginning of the period to grow robustly by 12% in 1994 and 20% in 1995 and then grow more modestly, by 5%, in 1996.

Table 1: **TRADE PERFORMANCE OF JAPAN AND UNITED STATES (1992-1996)**

Japan Trade Statistics (US$ billions)	**1992**	**1993**	**1994**	**1995**	**1996**
Imports (Goods & Services)					
-- % of Japanese GDP	6.3%	5.8%	5.9%	7.2%	8.1%
Manufactured Imports					
-- % of Japanese GDP	2.8%	2.6%	2.9%	3.4%	4.0%
-- Share of Goods Imports	43.5%	44.9%	48.1%	52.2%	52.7%
Current Account Surplus	$113 b	$132 b	$130 b	$111 b	$66 b
-- % of Japanese GDP	3.0%	3.2%	2.8%	2.4%	1.5%
U.S. Trade Statistics (US$ billions)					
Bilateral Trade:					
U.S. Exports to Japan	$48 b	$48 b	$53 b	$64 b	$68 b
-- % annual growth	-0.6%	0.2%	11.7%	20.3%	5.0%
U.S. Imports from Japan	$97 b	$107 b	$119 b	$123 b	$115 b
-- % annual growth	6.5%	10.1%	11.1%	3.6%	-6.7%
Imports (Goods and Services)					
-- % of U.S. GDP	9.2%	9.2%	9.9%	10.6%	10.8%
Current Account Deficit	$62 b	$100 b	$148 b	$148 b	$166 b
-- % of U.S. GDP	1.0%	1.5%	2.1%	2.0%	2.2%

Sources: International Financial Statistics (IMF), Monthly Statistics of Japan (Statistics Bureau, Management and Coordination Agency, GOJ), and U.S. Commerce Department.

Performance under the 24 bilateral trade agreements negotiated has been mixed. Some agreements -- banking/securities, cellular telephones, semi-conductors -- have been considered successful in opening up commercial opportunities, while others -- insurance (in 1994), paper, telecommunications -- have been viewed as ineffective, thwarted by anti-competitive practices and half-hearted implementation by the GOJ.

Lessons Learned. Aside from certain highly successful sector agreements mentioned above, we have succeeded predominantly in areas of strong Treasury influence, i.e., convincing the Japanese to undertake expansionary fiscal policy (fiscal years 1995-96), support domestic demand-led growth, commit to financial sector reforms, and initiate a broad deregulation agenda.

We have found progress difficult in more ambiguous, wide-ranging areas that do not lend themselves to a discrete list of concrete actions. Anti-competitive practices remain pervasive throughout the Japanese economy, abetted by legislation such as the Premiums Law and the Large Retail Store Law. We have also been blocked when the Japanese perceive little mutual advantage to changing as we propose, suggesting we need to do more work on identifying and building constituency groups in Japan. For example, there has been a lack of concrete progress on structural change and facilitation efforts to attract more foreign investment to Japan, aside from marginal improvements in the conditions for mergers and acquisitions. Japan's ambitious Deregulation Action Plan launched in 1994 effectively shifted the agenda of the Deregulation Working Group from a bilateral process to a process dominated by Japan's domestic interests.

The guidelines laid out in the 1994 strategy paper remain valid. We will be most effective if:

- we focus on concrete, measurable actions within GOJ influence where there is some degree of mutuality between Japan and the U.S.

- our approach is clear, consistent and accompanied by concrete incentives to change and penalties for not changing.

CONSIDERATIONS AND CONSTRAINTS LOOKING AHEAD

Looking ahead, we see most scope for influence where the GOJ has publicly made a strong commitment to goals we share: deregulation and structural reform to achieve a more efficient, sound and vibrant domestic economy. In pressing for less rapid fiscal consolidation, political commitment in Japan for fiscal consolidation, generally supported by the international community, makes a traditional supplemental spending package unlikely. However, with some creativity, we may be able to take a more innovative approach to fiscal stimulus that complements GOJ goals under deregulation and structural reform.

In Japan, the following factors need to be considered in crafting a successful strategy:

Deregulation

- Prime Minister Hashimoto's commitment to sweeping deregulation -- and his agreement with President Clinton to engage in an enhanced deregulation dialogue -- provides an opportunity to influence the regulatory structure, so as to promote opportunities for foreign firms, improve transparency and disclosure, and reduce systemic risk.

- In the past, special interests and the desire to preserve Japanese culture have effectively fended off effective opening of domestic markets to foreign competition. Protectionist pressures persist.

Fiscal and Monetary Policy

- The Prime Ministers's strong political commitment to fiscal consolidation reduces prospects for a traditional fiscal spending package. Concerns about future fiscal demands required by Japan's rapidly aging population and recent high fiscal deficits are widespread. The current perception that spending on public works -- historically the typical type of supplemental expenditure -- has been wasteful, inefficient and susceptible to corruption further limits receptivity to the spending side of the fiscal equation. Senior GOJ officials have recently said that further spending packages are out of the question.

  - We may be more successful in slowing fiscal consolidation from the tax side. There are some Japanese constituencies in favor of tax cuts. For example, it appears MITI and Keidanren would support a corporate tax cut.

  - On the other hand, corporate tax cuts could be perceived in the U.S. as aiding and abetting our commercial adversaries.

- The Prime Minister's commitment to sweeping deregulation may mean greater receptivity to stimulating domestic demand through investment incentives, for foreign as well as domestic investors. This could be particularly important if deregulation and competition policy succeed in opening market access to foreign competition.

  - There may be scope to offer tax credits on investment, including on imported capital goods. We have a precedent for discussing tax policies under SII and Deregulation Action Plan discussions.

- Conventional wisdom holds that there is little scope for monetary policy stimulus. The Bank of Japan has already taken an accommodative stance given the weakness in domestic demand. Short-term interest rates are around 0.5%.

  - There is nearly a 2 percentage point spread between short-term and long-term interest rates. The Bank of Japan could increase monetary growth by purchasing long-term bonds, potentially driving long-term rates lower and stimulating investment. There is some debate about the ability of monetary authorities to have a sustained impact on long-term interest rates.

    - ➛ The downside risk to easing monetary policy further is that the lower rates could lead to yen depreciation, increase orders for Japanese exports and contribute to further widening in Japan's external surplus.

In the United States, our primary consideration will be trade-related tensions likely to surface as Japan's current account surplus rises.

- A rise in Japan's current account surplus above 2% of GDP, roughly expected by many analysts this year, could reactivate political pressures to take immediate corrective action.

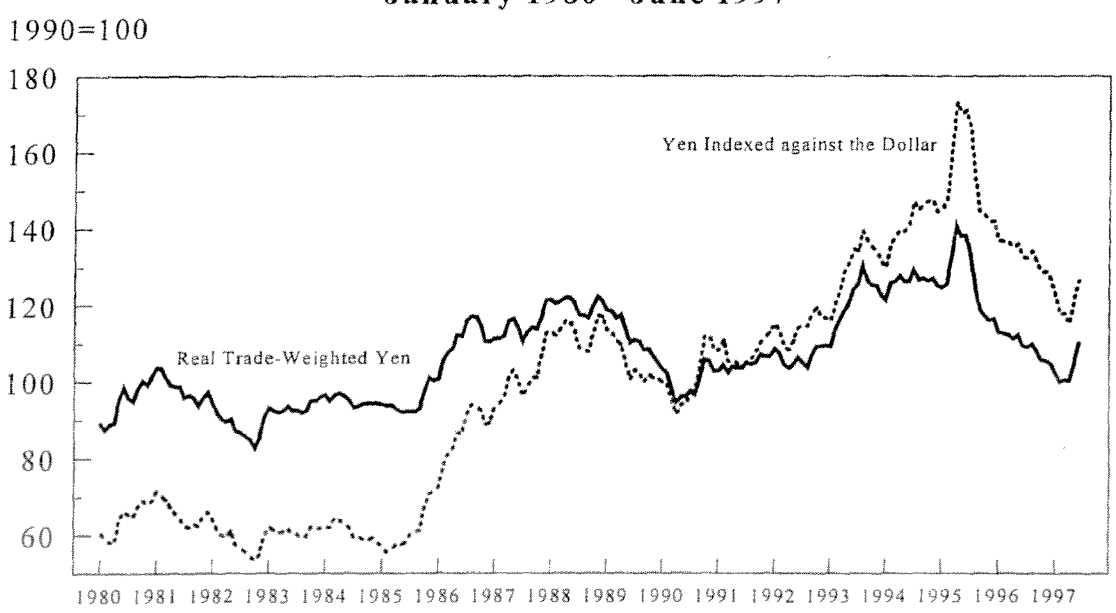
- Market analysts project an even higher current account surplus for Japan in 1998, fodder for a potentially volatile political climate in an election year.

Exchange rates matter most for the current account. Changes in exchange rates affect real trade flows with a lag of one to two years.

- As a quick rule of thumb, a 10% depreciation of the yen decreases the goods and services surplus $10 billion (0.2% of GDP) the same year as the dollar price of Japanese exports falls, has little net effect by the next year, and increases the surplus by $20 billion (0.4% of GDP) the second and subsequent years as the cheaper yen stimulates purchases of more Japanese exports.

- Since its peak in April 1995, the yen has depreciated 27% against the dollar, and 22% on a trade-weighted basis.

Chart 2: Real Trade-Weighted Yen and Y/$ Exchange Rates
January 1980 - June 1997



Source: J P. Morgan, 1990 Trade Weights (monthly averages) (22 OECD and 23 Developing Countries, 1990 avg = 100)

A rise in the index = appreciation/decline in competitiveness;
A fall in the index = depreciation/increase in competitiveness.

- Anecdotally, Japanese exporters appear competitive at exchange rates over 100 ¥/$, but run into difficulty when the yen costs more (i.e., less than 100 ¥/$).

The recent heavy devaluation of currencies in Southeast Asia (Thailand, Philippines, Malaysia and Indonesia) will tend to reduce overall growth in Japan's external surplus.

- Imports and exports for Thailand, Philippines, Malaysia and Indonesia collectively account for 12.2% of Japan's total trade by value.

- The cheaper Southeast Asian currencies encourage imports to Japan (including reverse imports from overseas Japanese manufacturing bases) and as the now more expensive yen dampens purchases of Japanese exports.

1997-2000 U.S. ECONOMIC POLICY TOWARD JAPAN

While our previous strategy coincided with yen appreciation and a virtual halving of Japan's current account surplus, the yen has since depreciated from its April 1995 peak and we expect the current account surplus to rise substantially this year and next. Domestic demand, strong last year, has faltered with rapid fiscal consolidation and imposition of the April 1 consumption tax increase.

We need to focus our policy vis-a-vis Japan on fostering sustainably strong domestic demand, both for its direct benefits to the Japanese but also for helping redress the expected rise in Japan's external surplus by increasing imports into Japan. We can use the GOJ's structural reform and deregulation agenda as a springboard to promote open, transparent and competitive markets (including financial services), and strengthen the financial system against systemic risk and external shocks. Success in deregulation and opening market access to U.S. and other foreign firms would contribute to a more balanced trade relationship over the longer term. Finally, high profile coverage of illegal payoffs to corporate gangsters gives us an opening to advance our agenda on anti-corruption and anti-money laundering, and thereby improve the integrity of Japanese markets.

Macroeconomic Agenda

- **Stimulate domestic demand**, particularly if data shows weak growth in domestic demand.

    - **Moderate pace of fiscal consolidation** -- put off spending cuts and/or provide for targeted tax cuts (to partly offset tax hikes earlier this year) -- to stimulate domestic demand (e.g., supplemental fiscal package, investment incentives).

    - **Maintain accommodative monetary policy** (but don't ease further because of downside risk for yen depreciation).

- **Contain rise in Japan's external surplus.**

More balanced growth requires promotion of domestic demand-led growth. We don't need to tell the Japanese what difficult choices to make. We just need to push them to make good their public commitment to strong domestic demand-led growth -- as well as avoiding a significant increase in the external surplus -- and let them decide how to achieve that objective.

- With limited scope for a more accommodative monetary policy and deregulation a longer-run positive factor, more moderately-paced fiscal consolidation -- slowdown in spending cuts and/or tax cuts -- is needed in the short run.

- While political factors may preclude a supplemental spending package, discussing the need to stimulate domestic demand may be a useful bargaining chip to advance the cause of tax cuts, slowdown in spending cuts at the local government level and/or other items on our agenda.

Financial Sector Agenda

In addition to following up on the remaining issues arising from the 1995 Financial Services Agreement, we have initiated a new dialogue with the Japanese on the Big Bang initiative involving our regulatory community and covering a three-part agenda:

- *Free and Open Markets.* **Promote new opportunities for foreign financial services institutions** (e.g., fund management, securities activities, cross-border capital transactions).

- *Fair and Transparent Markets.* **Improve transparency and disclosure** (e.g., report market value of assets, disclose losses and non-performing assets of effectively-controlled affiliates, tighten non-performing loan definition, disclose trading/derivatives-related activities and management of related risks, report corporations' pension and benefit liabilities).

- *Safe and Sound Markets at International Standards.* **Reduce systemic risk in financial markets** (e.g., improve banking supervision, adopt daily settlement on securities trades, require separation of customer and firm accounts in the securities market, establish legal and regulatory provisions to facilitate liquidation of securities firms in default; strengthen bank bankruptcy procedures and address moral hazard issues).

The recent, high-profile coverage of financial crimes in the banking and securities sector provides the opportunity to add an additional topic to our financial sector agenda:

- *Market Integrity.* **Improve financial system integrity through anti-money laundering and anti-corruption measures** (strengthened anti-money laundering laws and enforcement, improved reporting of suspicious transactions, increased sanctioning authority for financial crimes, tightened asset seizure laws, and curbs on insider trading and differential access to information).

Part of Prime Minister Hashimoto's deregulation agenda is to undertake sweeping deregulation to make Japan's financial market comparable with those of New York and London by 2001. Five government advisory councils have issued recommendations to carry out "Big Bang" financial reforms.

- The Foreign Exchange Reform Council's work is done. A new Foreign Exchange Law goes into effect April 1, 1998. The law removes virtually all restrictions on cross-border capital transactions and international payments, allows a much broader range of Japanese institutions to conduct foreign exchange business, allows Japanese residents to exchange currency using establishments overseas, facilitates more rapid approval of new forex-related financial products and gives the government greater leeway in imposing economic sanctions. This reform will push liberalization in other areas, since failure to reform will accelerate the movement of transactions offshore.

- The other four advisory councils released reports in mid-June recommending measures to deregulate Japan's financial markets. These reports -- while still imprecise on implementation details -- will be used to determine and craft necessary legislative changes for introduction in the Diet in Spring 1998. In many areas, however, the degree of change in the market will be determined by the wording of amendments to existing laws and implementing regulations that have yet to be developed, and that will be shaped in large part by input from vested interests. Significant potential remains for dilution and delay of the "Big Bang" objectives of "free, fair and global" Japanese financial markets by 2001.

Our primary interest in financial deregulation centers on promoting new opportunities for foreign firms, improving transparency and disclosure and reducing systemic risk.

<u>Trade agenda</u>

- **Launch a competition policy initiative** to reduce restrictive barriers and private practices that inhibit market access.

- **Expand market access in key sectors** by fully implementing, aggressively monitoring and, where necessary, revisiting existing Framework agreements.

- **Revitalize bilateral dialogue on deregulation** (results-oriented approach focussed on key sectors and key structural policies).

We do not need a new Japan trade strategy since the full potential of the Framework has not yet been realized.

- First, we need to dispel the perception, entrenched in Japan, that government-business cooperation and market barriers -- not open competition -- benefits Japan's economy.

    - The primary obstacle to changing public perception is concern that open competition might cause the disintegration of traditional Japanese culture and failure of inefficient single proprietor shops.

    - Recent developments -- the Prime Minister's commitment to sweeping deregulation and the penetration of a few U.S. firms into the Japanese retail market -- may cultivate a better appreciation for consumer choice. We can also use the cost-saving and growth-promoting effects of deregulation to sell our market-opening agenda.

- We need to cultivate agencies in the Japanese government that are pro-reform. For example, the EPA has written that Japan's potential growth rate would fall by 50% if serious deregulation is not enacted.

- We can evaluate each Framework Agreement to determine whether our market access objectives have been met and what additional steps may be required. Separately, we can identify if any other strategic sectors (particularly, high-wage, high technology industries where U.S. firms are typically competitive) that would benefit by being added to the Framework.

- In tandem, we need to pursue forward movement on structural issues such as competition policy, distribution and transparency/government practices.

Enhanced Initiative on Deregulation. The United States and Japan have agreed to create a limited number of sector-specific and structural working groups that would report to a high-level group. The high-level group on deregulation would be chaired at the Deputy Secretary level by USTR and MOFA, with participation at the Assistant Secretary level by other key agencies (i.e., Treasury, State; and for Japan, MOF, MITI). Sector groups have been established in housing, telecommunications, medical devices/pharmaceuticals, with two working groups on structural policy (one for competition policy and distribution, and the other for administrative reform and transparency issues) under the aegis of the deregulation group. The financial services group would continue to operate as it has in the past, but would report to the high-level group. Additional working groups could be established as agreed.

ACTION PLAN

- Establish a U.S.-Japan deputies-level group, co-chaired by Treasury, State USTR and Japan's MOF, MOFA, MITI on economic issues, as originally envisioned in the Framework agreement, nominally covering all economic issues including macroeconomic issues, but really used as a vehicle for advancing the trade and deregulation agendas.

  - The group could meet annually or semiannually as necessary, with meetings keyed to big events like Summits between the President and Prime Minister.

Macroeconomic Policy Agenda

- Press GOJ to stimulate domestic demand.

  - In our dialogue with MOF, we need to ask how they plan to achieve their objective of domestic demand-led growth, in the face of recent weak data releases.

  - Moderating the pace of fiscal consolidation is in order. Instead of reducing the deficit as a share of GDP from 6.7% in FY96 to 4.6% in FY97, the GOJ could, for example, slow the pace to 5.6% in FY97 and 4.6% in FY98, with future reductions of only 0.4% per year needed to achieve the GOJ goal of 3% by 2002.

- o We should not push for specific tax and spending measures, leaving specific policy choices to the GOJ to decide.

- o We can agree with the Japanese on the need for medium- and long-term consolidation due to aging demographics while still pushing for a slower approach in the short run.

- Monitor Japan's current account surplus and exchange rate for use in policy dialogue.

  - o The OECD's WP3 meeting in September will focus on current account issues and provides an ideal opportunity to discuss Japan's external surplus.

- Use domestic demand/current account situation to push deregulation, market access and financial sector reform.

Financial Sector Agenda

- The next Treasury-MOF talks on financial services is later this fall. We will continue to pursue market opening, increased transparency and disclosure, and enhanced systemic stability.

- We will also continue to encourage Japanese participation in multilateral fora, such as IOSCO, G-7/G-10 Deputies, the OECD, WTO and APEC to promote further liberalization in the financial sector and adherence to international agreements on regulatory cooperation and accounting standards.

- Anti-Money Laundering. We are working with the Japanese through the G-7 Financial Action Task Force on Money Laundering and the newly created Asia-Pacific Group on Money Laundering. An FATF review of Japan, which starts in December, presents a particular opportunity to press the Japanese for key actions ahead of their review.

- WTO Financial Services Negotiations. We are asking the Japanese to bind measures as agreed in our bilateral financial services agreements into the WTO Financial Services negotiations.

Trade Agenda

- First, we need to ensure the effective launching of the revitalized deregulation initiative. The high-level group is tentatively scheduled to meet for the first time in mid-October. Most working groups will meet between now and the first high-level group meeting, focussing on developing deregulation work plans for each group. Particular attention should be focussed on the working groups dealing the structural and transparency issues.

- Greater emphasis on competition policy would enhance our Japan trade strategy. We are concerned that Japanese deregulation, without strong competition policy enforcement, may in practice evolve into a cover for reorganizing industry and legal structures in ways that promote industrial policy and inhibit foreign access to the Japanese market. Competition policy objectives under deregulation talks, as well as the bilateral Antitrust Cooperation Agreement proposed by Justice should be reviewed in this context.

- The U.S. Government should establish a systematic, across-the-board mechanism for regularly assessing market access under the Framework agreements, in particular the extent to which they have met their specific quantitative and qualitative criteria. Where agreements have failed to meet their objectives, determine the cause and develop concrete solutions, which may require more aggressive implementation or even renegotiation of substantive provisions.

5 August 1997
Treas./IMI/Carol Carnes
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