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Coordinating Policies with Japan

Behind the recent calls for Japan to follow more expansionary policies is the notion that countries running trade surpluses, and not just those with trade deficits, have an obligation to adjust their domestic financial policies to help achieve international payments balance. Asking both deficit and surplus countries to direct domestic financial policies toward achieving external balance is tantamount to calling for international policy coordination. To evaluate the desirability of policy coordination with Japan, it is useful first to consider some recent developments in the U.S. and Japanese trade balance positions and the two countries' respective financial policies.

Trade linkages to fiscal policies

Interest in the U.S. over international policy coordination has risen in tandem with the U.S. multilateral trade deficit, and the bilateral trade with Japan in particular. Although the U.S. has had a multilateral trade deficit in every year since 1975, a major shift occurred in the early 1980s when the trade imbalance began to grow exponentially. The U.S. trade deficit increased more than fourfold between 1981 and 1986 — from $40 billion to $170 billion. Similarly, the U.S. bilateral deficit with Japan grew more than threefold during this period, climbing from $18 billion in 1981 to $59 billion in 1986. In sharp contrast, the Japanese multilateral trade surplus broke previous record highs and grew from $9 billion in 1981 to $83 billion in 1986.

The most important element in the trade balance situation is that the U.S. and Japan have pursued diametrically opposed fiscal policy stances since the early 1980s. The U.S. in 1981 implemented a major tax reduction that provided a significant fiscal stimulus to the economy but also resulted in a string of unprecedentedly large peacetime budget deficits. Japan, in contrast, embarked in 1979 upon a period of fiscal restraint with the intent of reducing its budget deficit problem that had begun in the early 1970s.

The basic macroeconomic explanation for the causal linkages between budget deficits and trade deficits is well-known. The cut in U.S. taxes generated a rise in the budget deficit that needed to be financed. In concept, this financing requirement could have been met by either a rise in net private domestic saving (private domestic saving less private investment) or by a capital inflow from abroad (foreign saving).

In the case of the United States, the rise in the budget deficit was not accompanied by a substantial increase in net private domestic saving. The U.S. private saving rate — low both by historical and international standards — increased little. U.S. private investment was moderately strong. The result is that foreign funds were relied upon to finance our budget deficit.

In contrast to the U.S., the rise in Japan's budget deficit in the early 1970s coincided with a sharp rise in its net private saving surplus. The aftermath of the first oil price shock consisted of a sharp fall in the rate of domestic investment and a fall in aggregate demand that prompted Japan to pursue an expansionary fiscal policy. The high private saving rate remained steady. Japan's growing budget deficits therefore were financed from domestic private saving that had earlier been directed at strong corporate investment demands. Japan's shift from budget surplus in the early 1970s to a series of deficits peaking at an equivalent of 5.5 percent of GNP in 1978 did not result in foreign capital inflows into Japan and associated trade deficits.

At the end of the 1970s, however, Japan undertook a major shift in fiscal policy. Japan adopted a moderately restrictive fiscal stance to reduce budget deficits and to slow the growth of a public debt that had grown fivefold since the mid-1970s. The restrictive policy stance was successful in gradually reducing the general government budget deficits to the equivalent of about 1.5 percent of GNP.

A consequence of lower total government budget deficits in the 1980s in the face of continued strength in net private saving is that Japan has been flush with funds to lend to the rest of the world. Capital outflows from Japan, also spurred by significant deregulation of international financial transactions associated with the 1980 Foreign Exchange Law, were largely responsible for Japan's increasingly large trade surpluses. Surging Japanese exports found their way to world markets generally, and to U.S. markets in particular. U.S. markets were particularly lucrative because of the strong dollar and the high rate of aggregate demand growth in the U.S. associated with the fiscal expansion in the aftermath of the tax cut begun in 1981.

Japanese aggregate demand policy

Given the enormous Japanese trade surplus ($83 billion in 1986) and U.S. trade deficit ($170 billion in 1986), there has been growing pressure on both nations to adjust their financial policies to reduce external imbalances. Policy coordination to achieve this objective would call for a rise in domestic aggregate demand growth relative to output growth in Japan, and a decline in domestic aggregate demand growth relative to output growth in the U.S. The appropriate response under these circumstances would normally be expansionary monetary and fiscal policies in Japan, and contractionary or neutral policies in the U.S.

A major constraint to such monetary policy moves in early 1985 was the strong value of the dollar exchange rate. An expansionary monetary policy in Japan carried out immediately would likely have pushed the yen yet lower against the dollar. Instead, Japan agreed in the September 1985 Group of Five meeting in New York City to follow a *restrictive* monetary policy stance coordinated with other central banks and aggressively supported the yen in the foreign exchange markets. The Bank of Japan spent $2 billion in foreign reserves and engineered a major tightening of monetary conditions.

Interbank rates were raised to 8 percent from under 6 percent between September and December 1985 with the sole objective of causing an appreciation of the value of the yen against the dollar. Domestic conditions at the time did not warrant monetary restraint, and the actions had the effect of *slowing* aggregate demand growth in Japan.

Needless to say, the strategy worked: monetary contraction in Japan during the second half of 1985 helped sustain the rise of the yen against the dollar that had begun in February. But as confidence in the dollar was shaken, the yen's continued rapid advance through the end of 1985 and into 1986 surprised both Japanese policymakers and economists. The recent appreciation to the 140 per dollar range is the yen's strongest value ever.

The desirable aspect of both high interest rates and a strong yen was that they helped position the Bank of Japan to adopt an aggressive expansionary monetary stance and to expand aggregate demand at the beginning of 1986. The Japanese discount rate was lowered in four steps in 1986 to 3 percent from 5 percent, and again in February 1987 to 2.5 percent — a historic low. Money market rates quickly responded and fell to 4 percent by the end of 1986. Average lending rates of Japanese banks for both short- and long-term loans have declined to their lowest levels in the postwar period.

Reflecting the easy stance of monetary policy that has continued to this day is the strong money growth in Japan. Narrow money (M1) growth in Japan was 9.1 percent in 1986, compared with 5 percent in 1985 and a 5.6 percent average over the 1980-84 period. As a consequence, real domestic demand grew 4.0 percent in Japan in 1986 while real GNP grew only 2.5 percent. This faster domestic demand growth relative to output growth was reflected in a decline in Japan's trade surplus in *real* terms, or volume, last year.

Moreover, projections for 1987 and 1988 suggest that growth in real domestic demand will continue to outstrip output growth, and that the fall in Japan's trade surplus will continue. For example, the International Monetary Fund in April projected that Japan's current account surplus would gradually fall from 4.4 percent of GNP in 1986 to 3.7 percent this year and 3.4 percent in 1988. Revisions in this forecast taking into account the recently announced stimulative fiscal package (discussed below) are likely to suggest an even greater fall in the Japanese trade surplus.

The transition of Japan's economy away from its heavy reliance on export-led growth in the early 1980s will not prove easy, however, despite monetary and fiscal moves toward expansion. Real GNP grew only 2.5 percent in 1986, down from 4.7 percent annually over the 1975-1984 period. Unemployment presently stands at about 3 percent of the labor force — the highest since the government began keeping labor statistics in 1953. Moreover, real GNP growth is also projected to be weak this year despite monetary ease and the recently announced fiscal measures.

Slower Japanese economic growth is not, however, an entirely bad omen as it is the result of weakened foreign demand caused by rapid appreciation of the yen and not by a shortage of domestic demand. Real exports of commodities fell 1.3 percent in 1986, while real imports rose 12.5 percent. Total domestic demand growth in Japan, therefore, is not translating into domestic output growth, and thus the Japanese trade surplus is declining in real terms. This is the necessary, but difficult, process of adjustment as Japan moves to become an economy less dependent on exports and as it reduces its trade surpluses.

Fiscal action and policy coordination

The fiscal stimulus package announced by Japan on May 29 amounts to another step to coordinate its financial policies with the U.S. as it will complement the effects of expansionary monetary policy in stimulating aggregate demand growth. The primary objective of the six trillion yen ($43 billion) package of spending measures and tax cuts is clear: to lower Japan's trade surplus by exporting less and importing more. As part of the package, in fact, the Japanese government plans to spend $1 billion to buy foreign goods.

Analysts differ as to the magnitude of the likely effects of the fiscal package on aggregate demand and real GNP growth in Japan. In large part, the impact depends on the timing and composition of the proposed $8 billion tax cut and $35 billion rise in expenditures, but several considerations suggest that the new supplementary budget package will significantly raise aggregate demand and output in Japan. First, the new supplementary budget is substantially larger than previously expected and amounts to about 1.8 percent of GNP. Second, it is better structured than previous supplementary budgets to ensure that planned outlays are actually disbursed. That is, the government and its agencies are to finance most of the package and a significantly larger amount is represented by public works expenditures, in contrast to last year's supplementary budget.

Japan's recent willingness to accommodate the U.S. demand for greater domestic expansion is not entirely associated with external pressure, of course. Japanese policymakers are very much concerned with sluggish real GNP growth and the spectre of rising unemployment. Under the present circumstances, they recognize that monetary expansion alone is not sufficient to offset the fall-off in external demand. Nonetheless, these concerns appear a secondary motivation compared with the desire to reduce trade surpluses.

In this light, perhaps most noteworthy about the recently announced expenditure and tax measures is that they represent a marked departure from Japan's earlier policy of fiscal austerity. Japan appears, at least temporarily, to have moved away from its long-term objective of budget deficit reduction to accommodate external pressures for greater aggregate demand growth. If this perception were correct, Japan's actions would amount to the subordination of a long-term national policy objective to the desire to cooperate internationally in moves designed to reduce the country's trade surpluses.

Complementing Japan's moves, the U.S. has also acted to reduce its large government budget deficit. The U.S. general government budget deficit declined from 3.5 percent of GNP in 1985 to 3.2 percent in 1986, and is projected to be less than 3 percent this year.

For the first time in over a decade, Japan and the U.S. have actually coordinated their financial policies. The results are already being felt. Both the U.S. trade deficit and the Japanese trade surplus declined significantly in terms of volume last year. Significant reductions in current dollar terms are likely to occur this year. Even in the best of circumstances, however, trade balance adjustments take time. Japanese trade surpluses and U.S. trade deficits saw five years of uninterrupted growth before they reached their present levels. It may take an equally long adjustment period to bring them down to a sustainable position.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 8/5/87	Change from 7/29/87	Change from 8/6/86 Dollar	Percent[7]
Loans, Leases and Investments[1] [2]	204,649	166	2,786	1.3
Loans and Leases[1] [6]	181,387	104	– 2,216	– 1.2
Commercial and Industrial	50,993	– 38	– 324	– 0.6
Real estate	69,689	93	2,683	4.0
Loans to Individuals	36,984	– 115	– 3,966	– 9.6
Leases	5,441	4	– 61	– 1.1
U.S. Treasury and Agency Securities[2]	16,331	110	5,702	53.6
Other Securities[2]	6,930	– 50	– 702	– 9.1
Total Deposits	207,950	3,448	– 45	0.0
Demand Deposits	53,179	2,511	230	0.4
Demand Deposits Adjusted[3]	36,214	907	– 12,624	– 25.8
Other Transaction Balances[4]	20,236	822	3,076	17.9
Total Non-Transaction Balances[6]	134,535	115	– 3,351	– 2.4
Money Market Deposit Accounts—Total	44,477	146	– 2,299	– 4.9
Time Deposits in Amounts of $100,000 or more	31,347	– 300	– 4,559	– 12.6
Other Liabilities for Borrowed Money[5]	23,229	106	13	0.0

Two Week Averages of Daily Figures	Period ended 7/27/87	Period ended 7/13/87
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	61	– 24
Borrowings	21	18
Net free reserves (+)/Net borrowed(–)	40	– 42

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change