FRBSF Weekly Letter

June 27, 1986

A New Direction For Japan

The extraordinary economic gains made by Japan since World War II have transformed it into a major economic power. Japan currently ranks second among industrialized nations in the size of its gross domestic product (GDP), and third in its share of trade among major industrial countries, behind the U.S. and West Germany.

Japan's success has, however, led to increased tension in the international trading system. In particular, there is a widespread perception that Japan's aggressive export growth and its reluctance to expand imports have contributed to the loss of jobs among its trading partners. Reactions to Japan's massive trade surplus, which soared from $2 billion in 1980 to a record $56 billion in 1985, include rising protectionist sentiment in the United States and Europe that threatens the free trade system painstakingly nurtured over the past four decades.

Japan has responded to these pressures by lowering tariffs and liberalizing other types of import restrictions, by encouraging its citizens to purchase foreign consumer goods, especially those from the United States, and by enacting policies designed to increase access by foreign financial institutions to domestic finance. Yet despite these measures, Japan's external imbalance continues and protectionist sentiment abroad is stronger than ever.

Its continued trade imbalance has prompted Japan to change the focus of its macroeconomic policies toward increasing domestic spending. "The Report of the Advisory Group on Economic Structural Adjustment for International Harmony," otherwise known as the Maekawa Report released April 7, 1986, calls for a major restructuring of the Japanese economy. Its issue has raised the expectation that Japan is seriously considering policies that will fundamentally change its postwar economic philosophy. This *Letter* discusses the Maekawa report, its potential implications, and the likelihood that Japan will fundamentally restructure its economy to reduce its trade surplus.

The Maekawa Report

In late October 1985, Prime Minister Yasuhiro Nakasone asked that a nongovernmental advisory committee, chaired by Mr. Haruo Maekawa, the former Governor of the Bank of Japan, formulate a set of medium and long-term policy recommendations concerning Japan's economic and social structure that would, among other things, reduce trade frictions with the rest of the world.

Whereas Japan's post-war policies were designed to support industrialization, export-led economic growth, and a high household saving rate, the Report recognizes that the goals established soon after the war have been achieved. According to the Report, Japan has reached a stage of economic maturity that now requires a reduced dependence on exports, more imports from the rest of the world, a greater allocation of resources to improve the quality of life, and a greater contribution toward solving major world problems such as the debt problem of developing countries. Achieving these goals would lower Japan's large trade surplus and foster more harmonious relations within the world economy.

The Report offers a set of policy recommendations to achieve these goals. First, it calls for expanded domestic demand to replace exports as the major driving force of the economy. Specifically, it recommends stimulating domestic demand by increasing government expenditures, reforming taxes (to stimulate housing and to lower the savings rate, in particular), and restructuring labor market conditions, such as reducing working hours to increase leisure time and hence consumption.

Second, the Report recommends a restructuring of production away from manufacturing toward the service sector, increased reliance on foreign suppliers to contribute more than raw materials to domestic production, and increased direct investment by Japanese firms in other countries. In addition, it states that import restrictions on agricultural products should be relaxed so that existing land use may be shifted from agriculture to housing.

Third, to improve market access by foreign producers further and to encourage imports of manufactured goods, the Report calls for restructuring the complex set of tariffs, import quotas, standards and certification, and government procurement policies now in existence.

Fourth, the Report states that Japan and the other major trading countries must make greater efforts in their domestic policies — improving the coordination of their monetary and fiscal policies in particular — to ensure that exchange rates remain stable and in line with economic fundamentals.

Fifth, fiscal policy in the major industrial countries, according to the Report, should be balanced over time, with governments making efforts to reduce their reliance on debt-financing. Sixth, the Report reaffirms the commitment to international liberalization of Japanese finance and the need to implement more policies that provide a more direct connection between international and domestic finance. Finally, the Report urges Japan to take a more active role in the world economy to alleviate the debt problem of developing countries and to promote economic and technological cooperation, especially with developing countries.

Implications

The Maekawa Report is of interest to foreign observers principally because of its potential effects on economic relations with Japan. We will focus on the recommendations that seek to reduce the Japanese trade surplus.

The net exports of Japan, or any other country, reflect, among other things, the balance between the domestic supply of savings on the one hand and the demand for those savings to finance domestic investment and deficits in the public sector on the other. When the supply of savings exceeds domestic demand, the excess savings are invested abroad. This is true for Japan at present, and it means that Japan must be a net exporter. As a net saver, Japan buys fewer goods from abroad than foreigners buy from Japan. The counterpart to Japan's excess supply of savings is the excess demand for those savings among its trading partners. When the demand for domestic savings exceeds the supply, as in the United States, the country in question incurs an external deficit.

Although Japan has enjoyed external surpluses during most of the past two decades, the massive surpluses now causing so much concern are a recent phenomenon. They result from a high and relatively stable Japanese savings rate along with a significant drop in the demand for financing domestic investment and the public sector. Gross savings as a percentage of Japan's GDP stabilized in the neighborhood of 31 percent between 1979 and 1984 — the highest savings rate among the major OECD countries. In contrast, gross fixed capital formation has fallen from 32 percent of GDP in 1979 to 28 percent in 1984, while the general government fiscal deficit has dropped from nearly 5 percent of GDP in 1979 to 2.7 percent in 1984. During this period, the current external balance as a percentage of GDP shifted from a deficit of nearly 1 percent in 1979 to an unprecedented surplus of 3 percent in 1984.

Over the same period, the current external deficit of the United States increased from 0.1 percent to 2.6 percent of GDP because of a decline in the savings rate and an increase in the government deficit. Thus, a significant portion of the excess supply of savings in Japan was matched by an excess demand for savings in the U.S.

The Maekawa Report proposes to reduce Japan's external surplus by simultaneously reducing the supply of savings and increasing investment spending. Saving would be reduced by tax and labor market reforms that increase consumption and leisure time. Investment spending would be stimulated specifically through tax incentives that favor the housing sector.

While these steps should, in principle, reduce Japan's trade surplus, there are constraints to their implementation. For example, the household sector's saving pattern and long-established cultural attitudes suggest that the Japanese may not be very responsive to economic incentives to reduce their rate of savings. In addition, the availability of only limited social security benefits will remain a great incentive for the Japanese to save. Although still high in comparison to other countries, gross savings as a percentage of GDP in Japan have already declined 9 percent from a peak of 40 percent in 1970. While the aging population should generate a further decline in savings, this will occur too slowly to rectify the current external imbalance.

On the spending side, Japan is understandably reluctant to pursue an expansionary fiscal policy because of the fear that it might increase its fiscal deficit. Due to large deficit spending in the 1970s, the ratio of general gross government debt to GDP in Japan in 1985 was already a high 70 percent — second only to Italy's 99 percent among OECD countries, and well above the United States' 48 percent.

It may also be difficult to stimulate additional investment spending in Japan because there has been an increasing tendency for Japanese capital to flow abroad since 1973. The first oil price shock, which adversely affected the productivity of capital in Japan encouraged the Japanese to invest abroad. This capital outflow was reinforced by the desire to avoid potential trade barriers, the liberalization of Japanese financial markets and, more recently, the appreciation of the yen. Furthermore, it reflected the demand for Japanese savings abroad, notably to finance U.S. federal budget deficits.

Government policy in Japan has traditionally favored the manufacturing sector, as shown by the increase in that sector's real share of GDP from 30 percent in 1970 to 40 percent in 1982. In contrast, the real share of services and construction in GDP remained roughly the same at 33 percent in 1982 as in 1970. By focusing on investment in services and housing, the Report targets areas that have received less attention and which therefore offer significant growth potential.

The development of services and housing would also improve the quality of life in Japan's population. However, while there is a general recognition within Japan that a reallocation of resources towards housing in particular is overdue, the Report is not necessarily advocating a full-fledged "U.S. model" in which government programs and the tax code provide important incentives to own a home. Budget constraints, as well as the limited availability of land, may limit the pace of Japanese housing development.

In addition to issues of feasibility and effectiveness, the Report's recommended policies involve costs to Japan and the world economy. The attempt to lower the rate of savings in Japan will limit the availability of capital to finance investment spending in Japan and other regions of the world. This would raise world interest rates, reduce world economic growth and, possibly, make resolution of the international debt problem more difficult.

Impact on government policy

The first U.S. accounts of the Maekawa Report frequently gave the impression that it reflected new national goals that would soon be implemented. This is incorrect. The Report was prepared by a nongovernmental advisory group. It did not explicitly involve either the major governmental agencies or parliament. In Japan, it has already been criticized for being too bold and for failing to incorporate a sufficiently representative range of views. Those familiar with the arduous process of decision-making by consensus in Japan will recognize that the absence of an imprimatur, particularly from the government, makes the Report vulnerable to criticism.

Second, the Report is viewed in some Japanese circles as a reaction to U.S. pressure and Prime Minister Nakasone's commitment to President Reagan to deal with the trade issue. In the opinion of some observers, this may limit serious consideration of the policy recommendations simply because, in their view, direct U.S. pressure cannot resolve the basic economic issues dividing the two countries. Such a viewpoint, however, does not consider the broader implications of the Report.

While the Report's recommendations are not likely to be implemented soon, they reflect a growing awareness that impatience with Japan's large and continuing external surplus threatens the world trading system from which Japan has benefited so greatly. They also reflect the realization that timely changes in economic policies are needed to defuse protectionist sentiment among Japan's trading partners. Thus, the adoption of measures addressing the international concerns that prompted the Maekawa Report should prove to be in Japan's own self-interest. However, achieving a more balanced world trading environment will be difficult unless Japan's major trading partners (particularly the U.S.) take steps to reduce their own domestic spending.

Thomas F. Cargill and Ramon Moreno

Research Department
Federal Reserve
Bank of
San Francisco

Alaska Arizona California Hawaii Idaho
Nevada Oregon Utah Washington

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 6/4/86	Change from 5/28/86	Change from 6/5/85 Dollar	Percent[7]
Loans, Leases and Investments[1] [2]	201,317	112	9,616	5.0
Loans and Leases[1] [6]	182,782	456	9,545	5.5
Commercial and Industrial	52,438	207	249	0.4
Real estate	66,603	− 86	3,340	5.2
Loans to Individuals	39,222	92	4,984	14.5
Leases	5,633	3	254	4.7
U.S. Treasury and Agency Securities[2]	10,736	− 325	− 748	− 6.5
Other Securities[2]	7,799	− 19	819	11.7
Total Deposits	207,511	4,259	8,593	4.3
Demand Deposits	54,283	3,240	6,017	12.4
Demand Deposits Adjusted[3]	36,387	2,787	5,482	17.7
Other Transaction Balances[4]	16,713	983	2,620	18.5
Total Non-Transaction Balances[6]	136,515	37	− 43	0.0
Money Market Deposit Accounts—Total	46,794	253	2,799	6.3
Time Deposits in Amounts of $100,000 or more	35,848	− 326	− 2,469	− 6.4
Other Liabilities for Borrowed Money[5]	21,671	−1,260	− 873	− 3.8

Two Week Averages of Daily Figures	Period ended 6/2/86	Period ended 5/19/86
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (−)	127	28
Borrowings	18	41
Net free reserves (+)/Net borrowed(−)	109	− 13

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