



Rice Minister

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22 May 1989

Charles Powell Esq
No 10 Downing Street
LONDON SW1

Dear Charles

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.

... 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 three areas of reform: land and agriculture, distribution and air transport services. However, it would be a bad mistake to follow the US line in pressing the Japanese to pursue a general fiscal expansion designed to stimulate domestic demand further. The Japanese Government should, however, be looking for ways of boosting directly demand for imports eg by reducing protection for agriculture.

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 has reflected constructive action not matched in Germany;
- the chances of Japan triggering US and European protectionist action are greater than with Germany; and
- the German surplus, which is bigger as a share of GDP, is more of a European problem than the Japanese surplus, 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 three areas of reform suggested in the paper. We have not included in the paper any reference to the reforms we have been seeking in the Japanese financial system because our analysis suggests that the consequences could be if anything a larger, not smaller, current account surplus if the reforms stimulate higher exports of financial services by Japan.

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 further structural reforms, including those we have highlighted, 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 is not the best time to be arguing for these reforms, with the Japanese preoccupied with their domestic political problems, but it would be wrong to give up on what will be a long-term process.

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).

Yours sincerely

A handwritten signature in dark ink, appearing to read 'J M G Taylor'.

J M G TAYLOR
Private Secretary

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. The surplus has made an important contribution to world savings. There is at present no scope for expansionary policies 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. There is no current scope for expansionary Japanese macroeconomic policy.
 - iv. Some further yen appreciation would promote external adjustment and curtail inflationary pressures in Japan.
 - v. Further structural reforms would promote efficiency in the Japanese economy and may, on balance, tend to reduce the current account surplus.
 - vi. Japan should free the market for land by changes in taxation, and reduce the support and protection given to agriculture.
 - vii. Japan should adopt pro-competitive policies in its distribution sector.

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

ix. 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 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 into 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 ^{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. 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.

5. In 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 a important contribution to global savings. Nevertheless the continued current account surplus may further fuel protectionist pressures on trade; while the build up of Japanese overseas assets in the form of direct investment can also excite protectionist instincts especially in those countries which do not get (or which actively discourage) such investment.

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 is likely to require some further yen appreciation. A sharp appreciation of the yen in the near future could 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 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. It is worth noting that UK export performance to Japan was strong in 1988, with a 17 per cent rise.

Macroeconomic Policies

8. Discussions at the Summit will touch on the possible macroeconomic policy measures Japan could take to promote external adjustment. There is no current scope for the Japanese Government to act to stimulate the economy by a general fiscal expansion at a time when the Japanese economy is already expanding rapidly. But there is scope for policy changes which have fiscal implications (such as reducing protection) and which would lead to higher imports. 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, such as in the areas singled out in this paper, may tend to bring about a lower current account surplus.

11. It would be wrong to expect early, substantial, effects. The Maekawa report of 1986 stressed the need for structural reform across a wide range of issues, and for building up the domestic economy. The momentum for change needs to be encouraged over a long period. In time, the Japanese should become less concerned to prove themselves abroad; less worried about the future; and more concerned with the quality of life at home, which compares badly not only with other OECD countries but with countries like Singapore. These shifts in outlook would tend to increase demand for better and cheaper housing, more public amenities and a wider range of consumer goods and services at more reasonable prices. It would increase the propensity to consume both imports and domestic output - and reduce the pressure to export and accumulate excess savings. It would be in the interest of the Japanese citizens themselves, as well as easing their relations with the outside world.

12. 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.

13. The rest of this paper describes three areas of structural reform - land and agriculture, distribution system 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

14. Very rough estimates suggest that the average price of Japanese land may be about forty times that in the US and five times that in the UK. 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.

15. 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 urban housing. Land prices are also kept high by the support and protection against imports given to Japanese agriculture.

16. 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 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

17. 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 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.

18. 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 (including imports of consumer goods) in the 1980s as showing that the distribution system does not prevent imports.

19. 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 $\frac{1}{4}$ per cent of Japanese stores have a floorspace of more than 500 square metres.

20. 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 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. Air Transport Services

21. 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.

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

23. 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, reduce prices and reduce the current account surplus.

ANNEX A

LAND AND AGRICULTURE

Land Value and use

1. The price of land in Japan is very high. Estimates suggest that land in Japan is forty times more expensive than in the US and five times more than in the UK. 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. 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.

ANNEX B

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 the combination of long-standing business practices and government policies and regulations, 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

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 2¼-2½ 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 which 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 which 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 Imports</u>	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 (SITC 5-9)	(225)	(104)	(66)	(118)	(159)	(- 14)
raw materials (SITC 0-4)	(4)	(27)	(83)	(36)	(-79)	(- 9)
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 OECD exports has risen to over 12 per cent compared to the UK's share of approximately 8 per cent.

Table 8: Share of OECD Exports of Goods and Services

percentage

	1970	1979	1987
Japan	7.7	9.0	12.4
UK	10.0	9.1	8.3

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

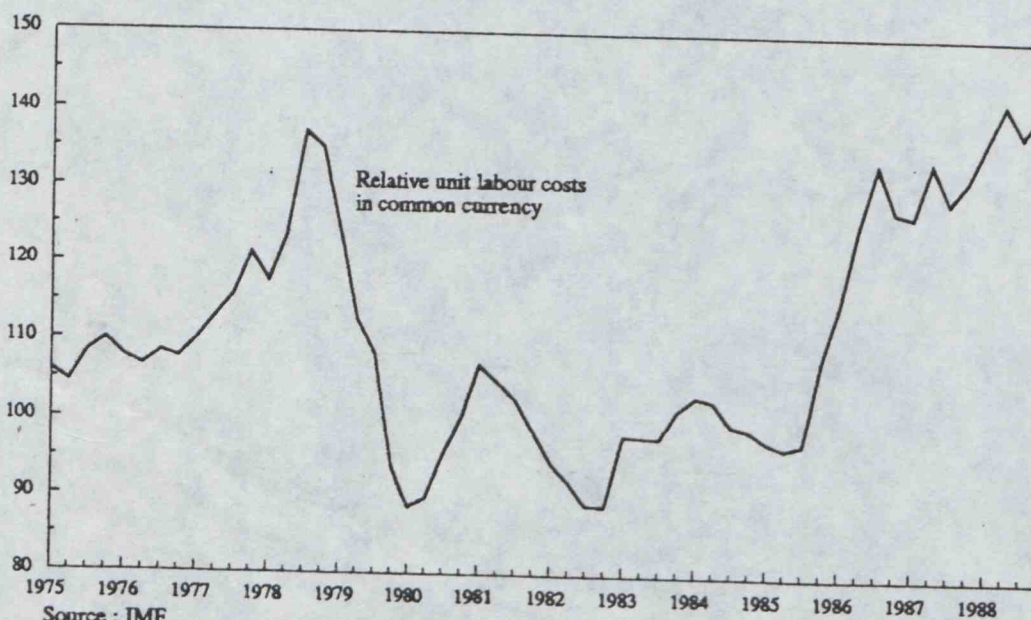
percentage of GDP/GNP	1960	1970	1980	1985	1986	1987	1988	1989*
Japan	0.5	1.0	- 1.0	3.7	4.3	3.6	2.8	2.7
UK	- 1.0	1.5	1.3	0.9	0	- 0.6	- 3.1	- 2.8

* 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)



21000, 3573/112/808a.13.3.

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 10a: 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
<hr/> Total of Above	<hr/> 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, part of which is probably due to the longer hours worked in Japan. 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, reduce the potential growth of the economy and so the growth of imports.

(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	26
Italy	- 1	9	- 2	
Canada	- 30	- 35	- 36	

Source: National Data and International Financial Statistics
*uncertain estimates.

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.

1974/12/3/0002.13.3.

(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.