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Japan—Recent Economic Developments

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INTERNATIONAL MONETARY FUND

JAPAN

Recent Economic Developments

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Approved by the Central Asia Department

August 26, 1996

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Japan--Basic Data

Area	377,750 square kilometers
Total population (1995)	125.2 million
GDP per capita (1994)	US$38,382
Fund quota:	SDR 8,241.5 million

	1991	1992	1993	1994	1995
	(In trillions of yen)				
GDP					
At constant 1990 prices	477.1	451.8	452.3	454.5	458.7
At current prices	459.0	471.8	475.4	479.1	481.0
	(Percentage change)				
Real GDP	4.0	1.1	0.1	0.5	0.9
Domestic demand	2.9	0.4	0.1	0.8	0.7
Private consumption	2.5	2.1	1.2	1.8	1.7
Residential investment	-8.5	-6.5	2.4	9.2	-6.1
Plant and equipment investment	6.3	-5.6	-10.2	-6.0	3.1
Government consumption	2.0	2.0	2.4	2.2	2.0
Government investment	4.9	14.5	15.7	2.8	1.3
Stockbuilding 1/	0.3	-0.5	-0.2	-0.2	0.2
Foreign balance 1/	1.2	0.7	--	-0.3	-0.8
Nominal GDP	6.7	2.8	0.8	0.8	0.4
	(Percentage change, unless otherwise indicated)				
Prices, incomes, and employment					
Wholesale prices	-0.6	-1.6	-2.9	-2.0	-0.9
Consumer prices	3.3	1.7	1.3	0.7	-0.1
GDP deflator	2.7	1.7	0.6	0.3	-0.5
Real disposable income 2/	3.2	1.9	1.9	1.2	0.9 3/
Household saving rate (in percent)	15.1	15.0	13.4	12.8	12.1 3/
Unemployment (in percent, period average)	2.1	2.2	2.5	2.9	3.1
Manufacturing					
Employment of regular workers	2.4	0.7	-0.7	-2.2	-1.8
Output	1.7	-6.1	-4.5	0.9	3.3
Hourly compensation 4/	5.8	4.5	3.1	2.6	1.7

Basic Data (concluded)

	1991	1992	1993	1994	1995
Productivity	1.6	-3.7	-1.5	3.3	4.7
Unit labor cost	4.3	8.6	4.3	-0.7	-2.3
Inventory ratio to shipments	7.0	9.7	2.0	-4.8	1.6
Financial aggregates					
M2 plus CDs (period average)	3.6	0.6	1.1	2.1	3.2
Domestic credit (end of period)	2.9	2.9	0.8	-0.4	1.8
			(In trillions of yen)		
Fiscal aggregates 5/					
Central government					
Revenue	67.1	63.6	63.6	61.9	60.6
Expenditure	68.1	71.1	76.5	78.0	80.2
Deficit (-)	-1.1	-7.6	-12.9	-16.1	-19.6
Deficit/GDP (-, in percent)	-0.2	-1.6	-2.7	-3.4	-4.1
General government					
Deficit/GDP (-, in percent)	3.5	0.1	-1.4	-2.6	-3.6
			(In 100 billions of yen, unless otherwise indicated)		
Current account balance	91.8	142.3	146.7	133.4	103.9
Trade Balance	129.2	157.8	154.8	147.3	123.4
Exports	414.7	420.8	391.6	393.5	402.6
Imports	285.4	263.1	236.8	246.2	279.2
Services	-56.3	-55.7	-47.8	-49.0	-53.9
Income	35.0	45.1	45.3	41.3	41.6
Net transfers	-16.1	-4.8	-5.7	-6.2	-7.3
Capital and financial account	-92.7	-129.2	-117.0	-89.9	-62.8
Net errors and omissions	-10.5	-12.4	0.3	-17.6	13.1
Reserve assets	11.4	-0.8	-30.0	-25.9	-54.2
Export volume (percentage change)	8.0	5.3	1.6	3.6	4.9
Import volume (percentage change)	2.6	-1.4	1.3	10.9	12.3
Gross official reserves, minus gold					
End of period (billion $)	72.1	71.6	98.5	125.9	183.2
Exchange rates (period average)					
Yen per U.S. dollar	134.7	126.7	111.2	102.2	94.1
Nominal effective exchange rate (1990 = 100)	108.4	113.7	136.5	147.1	154.5
Real effective exchange rate (relative normalized unit labor costs; 1990 = 100)	106.0	109.3	131.7	139.6	145.3

1/ Contribution to real GDP growth.
2/ Disposable income deflated by the private final consumption deflator.
3/ Staff estimate.
4/ Based on average employee compensation and monthly hours index (Labor Force Survey).
5/ Fiscal year beginning April 1.

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I. Introduction

This review of recent economic developments focuses on the weak recovery that began in 1994, and the subsequent strengthening of growth since mid-1995. Chapter II examines developments in output and prices, while Chapter III reviews the role fiscal policy has played in providing support to demand, and the resulting sharp deterioration in the fiscal position. Monetary developments, including the reduction in interest rates to record lows in 1995, are discussed in Chapter IV. Chapter V analyzes developments in the external sector and exchange markets. Developments in trade and structural policies are reviewed in Chapter VI, followed by an analysis of the situation in the financial sector, including the policy initiatives taken over the past year to address these problems.

The annexes to the chapters study specific issues pertaining to the main text. Annex I examines the implication of the rebasing of the national accounts data to 1990. Alternative indicators of government debt stock are discussed in Annex II, including developments in gross and net debt over time and in comparison with other G-7 countries.

II. Output and Price Developments

1. Aggregate demand and output

The pace of economic recovery remained slow through the first half of 1995 (Table 1 and Chart 1). 1/ This was in part due to factors that led to the previous downturn, including significant drops in asset prices and wealth. In addition, the yen appreciated sharply in the second quarter of the year, and consumer confidence was further battered by the Kobe earthquake, terrorist attacks and worsening labor market prospects. As a result, the economy grew at an annual rate of 3/4 percent in the six quarters since the trough in the fourth quarter of 1993, compared to an average rate of 5 percent in three previous upturns (Chart 2).

Economic activity accelerated in the second half of the year, despite sharp negative contributions to growth from net exports, as private sector demand picked up and public sector spending, which had contracted in the first half of the year, began growing. This upturn was influenced by expansionary financial policies, including historically low interest rates and the introduction of a sizable public spending package in September. The economy grew by a further 3 percent (quarterly rate) in the first quarter of 1996, with positive contributions from all components of domestic demand. However, this strong pace was in part the result of the leap year (which accounted for an estimated 0.5 percentage points of growth), and recent

---

1/ The Economic Planning Agency released last December new constant price national accounts data, based on 1990 prices. See Annex I for a comparison of the new series with their 1985 price-based counterparts.

Table 1. Japan: Growth Rates of Real GDP and Demand Components, 1990-96 1/

(Percentage change from previous year or quarter)

	1990	1991	1992	1993	1994	1995	1995 I	1995 II	1995 III	1995 IV	1996 I
Private consumption	4.4	2.5	2.1	1.2	1.8	1.7	0.1	0.7	1.2	0.6	2.4
Private gross fixed investment	9.4	2.9	-5.8	-7.6	-2.5	0.8	0.7	0.4	-0.9	3.4	3.1
Residential	4.8	-8.5	-6.5	2.4	9.2	-6.1	1.0	-6.7	-5.7	7.2	8.4
Business	10.9	6.3	-5.6	-10.2	-6.0	3.1	0.5	2.8	0.6	2.3	1.5
Final private domestic demand	5.9	2.6	-0.3	-1.4	0.6	1.4	0.2	0.6	0.6	1.3	2.6
Government consumption	1.5	2.0	2.0	2.4	2.2	2.0	4.2	-1.2	0.2	-0.4	3.3
Government fixed investment	4.9	4.9	14.5	15.7	2.8	1.3	-3.4	3.2	5.8	6.9	8.6
Final domestic demand	5.4	2.7	0.9	0.3	1.0	1.5	0.3	0.7	1.0	1.7	3.3
Stockbuilding 2/	-0.2	0.3	-0.5	-0.2	-0.2	0.2	0.0	-0.1	0.1	0.1	0.1
Private	-0.2	0.4	-0.5	-0.1	-0.3	0.3	0.1	-0.0	0.1	0.1	0.0
Government	0.0	-0.1	0.0	-0.0	0.1	-0.0	-0.0	-0.0	-0.0	-0.0	0.1
Total domestic demand	5.2	2.9	0.4	0.1	0.8	1.7	0.3	0.6	1.1	1.8	3.4
Foreign balance 2/	-0.0	1.2	0.7	-0.0	-0.3	-0.8	-0.2	0.1	-0.5	-0.6	-0.3
Exports	6.9	5.4	4.9	1.3	4.6	5.0	-0.0	4.2	-1.6	1.3	0.1
Imports	7.9	-4.7	-1.1	1.7	9.0	13.5	1.9	4.3	3.0	6.4	2.8
Real GDP	5.1	4.0	1.1	0.1	0.5	0.9	0.1	0.6	0.6	1.2	3.0
Memorandum items:											
Government expenditure 3/	2.9	3.2	7.3	8.5	2.5	1.7	0.5	0.9	2.9	3.2	6.0
Nominal GDP	7.5	6.7	2.8	0.8	0.8	0.4	0.3	-0.0	1.2	0.5	3.6
GDP deflator (1990=100)	2.3	2.7	1.7	0.6	0.3	-0.5	0.2	-0.7	0.6	-0.6	0.6
Output gap (percent of potential GDP)	3.2	3.2	0.8	-1.7	-3.5	-4.7	-4.9	-4.9	-4.9	-4.4	-2.0

Sources: Economic Planning Agency, Annual Report on National Accounts; and data provided by the Japanese authorities.

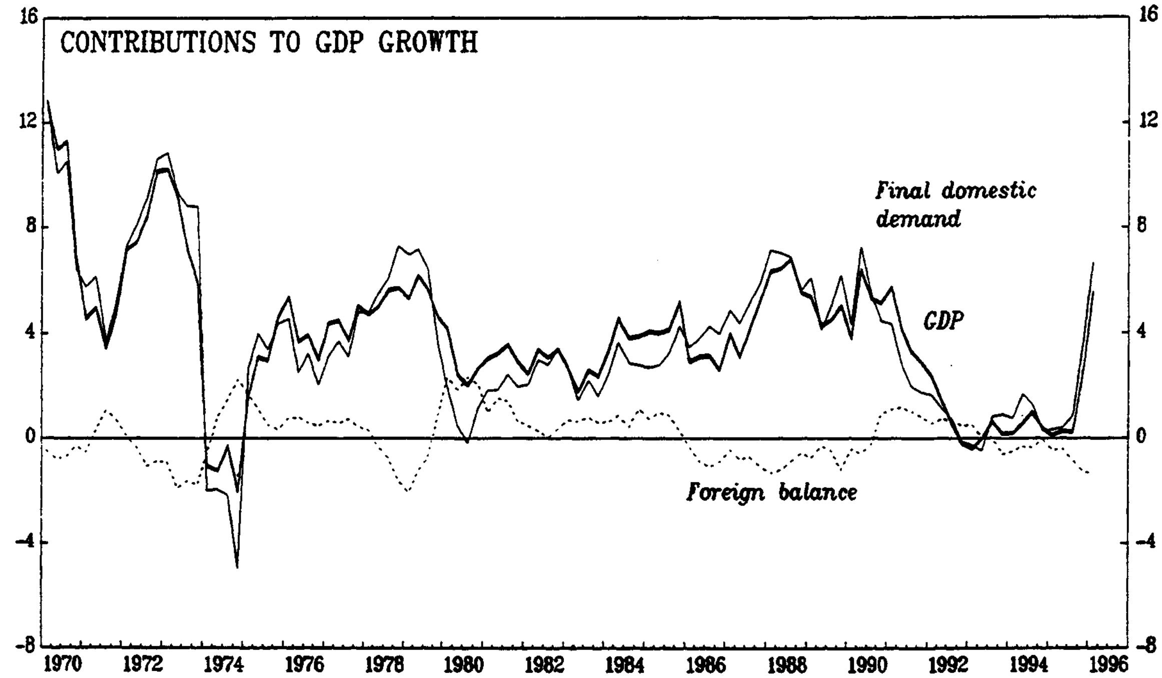
1/ At 1990 prices.
2/ Contribution to real GDP growth.
3/ Government consumption and investment.

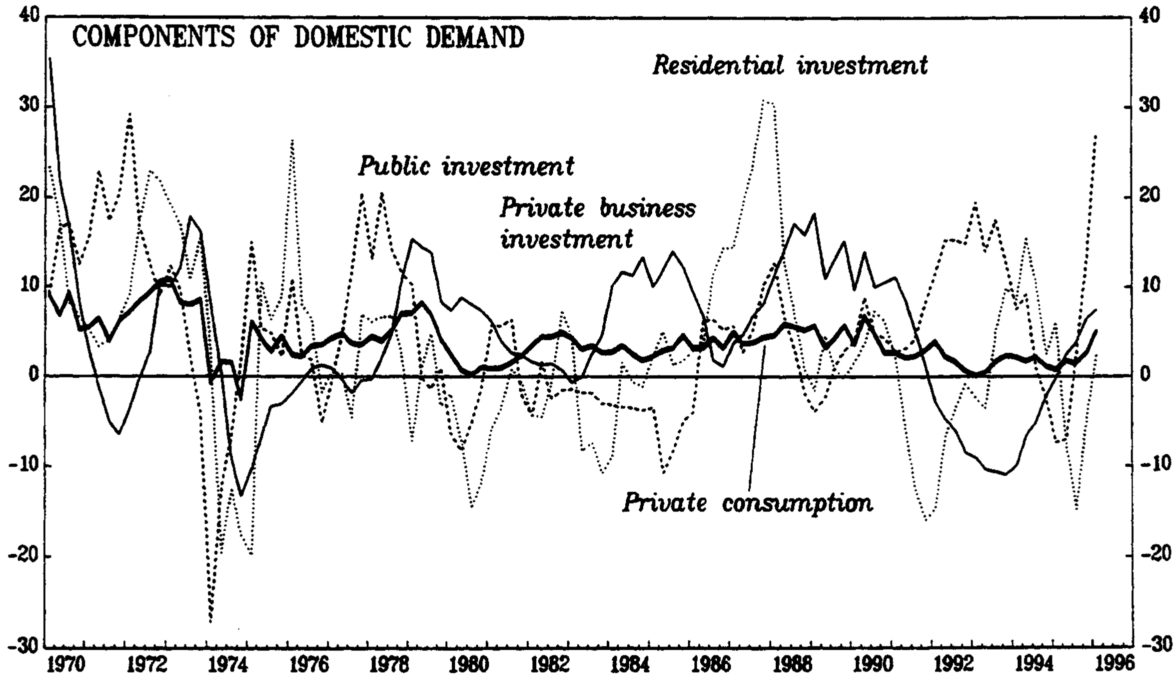
CHART 1

JAPAN

GROSS DOMESTIC PRODUCT AT 1990 CONSTANT PRICES, 1970-96

(Percentage change from previous year)





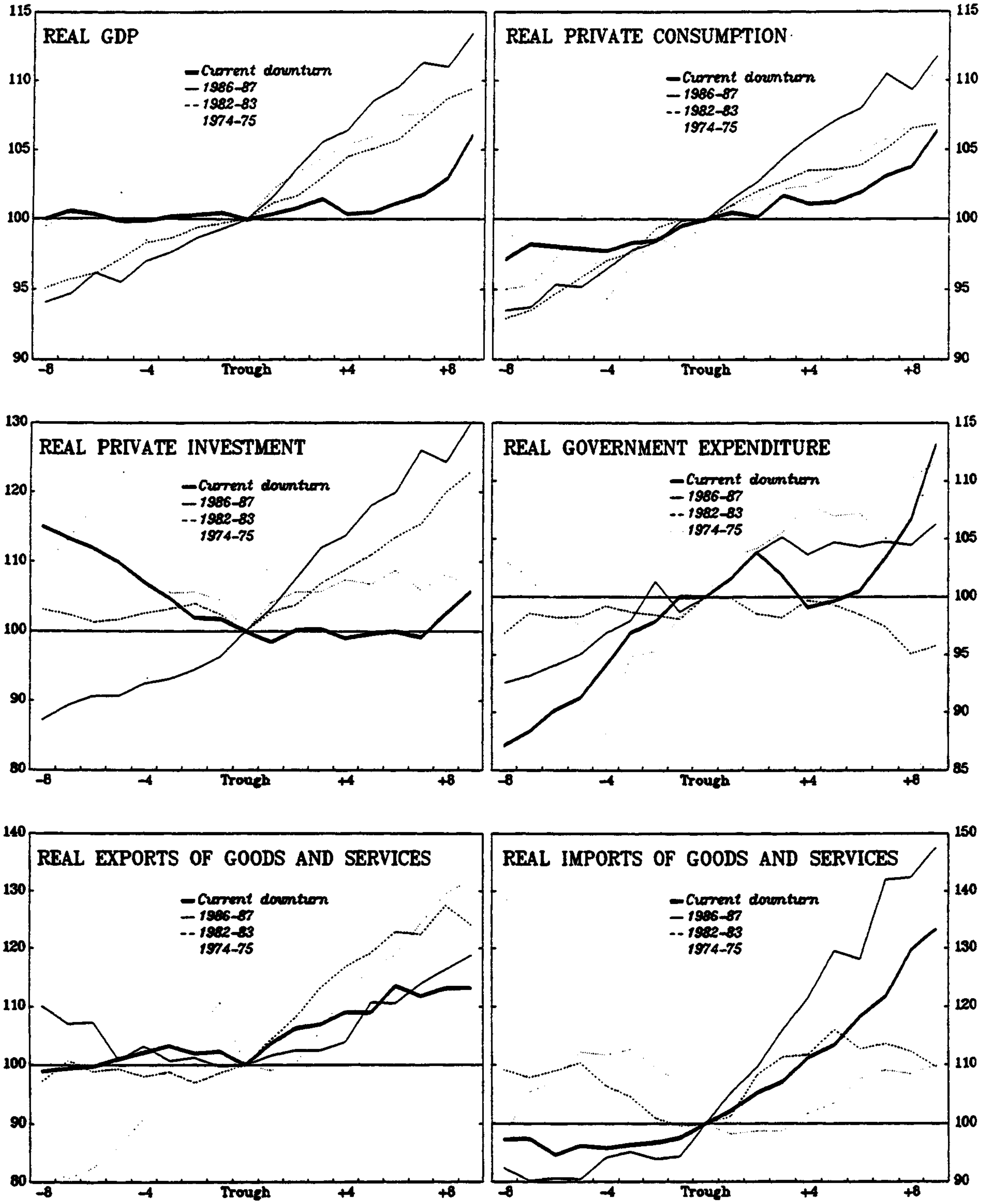
Source: EPA, National Income Accounts.

CHART 2

JAPAN

COMPARISON OF FOUR CYCLICAL DOWNTURNS 1/

Index (trough of cycle=100)



Source: Nikkei Telecom.

1/ Troughs defined as: 1993Q4 for current downturn; 1987Q2 for 1986-87 downturn; 1983Q2 for 1982-83 downturn; 1975Q1 for 1974-75 downturn.

monthly indicators suggest that part of these gains would be offset in the second quarter.

Private real consumption grew by 1.7 percent in 1995. The slow growth reflected, in part, weak income growth. Employee compensation rose by only 1.6 percent, as the spring wage round (*shunto*) resulted in an historically low 2.8 percent increase, while hours worked rose by only 0.1 percent, and bonus payments declined for the fourth consecutive year. The gain in employee compensation was almost fully offset by reductions in property income, as interest rates declined to historically low levels. As a result, nominal disposable income grew by only 0.4 percent. Nevertheless, falling consumer prices helped boost real disposable incomes and consumption. Durable goods consumption picked up, especially in the latter half of the year, reflecting a replacement cycle for goods purchased during the bubble period, low interest rates, and--following the yen's decline--improved consumer confidence. As a result, the household saving rate fell slightly, to about 12 percent of disposable income.

Consumption grew strongly in the first quarter of 1996. The increase was consistent with strong growth in monthly indicators, including retail sales and the family expenditure survey. Although the reasons behind the increases are not fully understood, the extra day provided by the leap year may have had some effect. However, recent indicators of private consumption have fallen back, suggesting a drop in expenditures in the second quarter.

While part of the surge in consumption in the first quarter was temporary, improving labor market conditions suggest there is a basis for steady growth in the second half of the year. The spring *shunto* agreement was again 2.8 percent, marking the first time in five years the wage increase had not fallen. Total hours worked recorded increases of about 1/2 percent in both the fourth quarter of 1995 and first quarter of 1996, and strong growth in corporate profits led to expectations that bonuses would increase. The ratio of job offers to job seekers has also increased in recent quarters. However, the unemployment rate remains at an historic high.

	1990	1991	1992	1993	1994	1995	1996 Q1 1/
	(Percentage change, unless otherwise indicated)						
Real private consumption 2/	4.0	2.1	1.9	3.9	1.9	1.7 3/	5.0 3/
Real household disposable income	3.4	3.2	1.9	1.9	1.2	0.9 3/	...
Household saving rate (levels):							
Total	14.1	15.1	15.0	13.4	12.8	12.1 3/	...
Excluding asset income	5.7	6.3	7.3	6.7	7.7	8.0	...

1/ Growth over the first quarter of 1995.
2/ These figures may differ slightly from those shown in Table 1, as the latter include consumption expenditures by non-profit institutions serving households.
3/ Staff estimate.

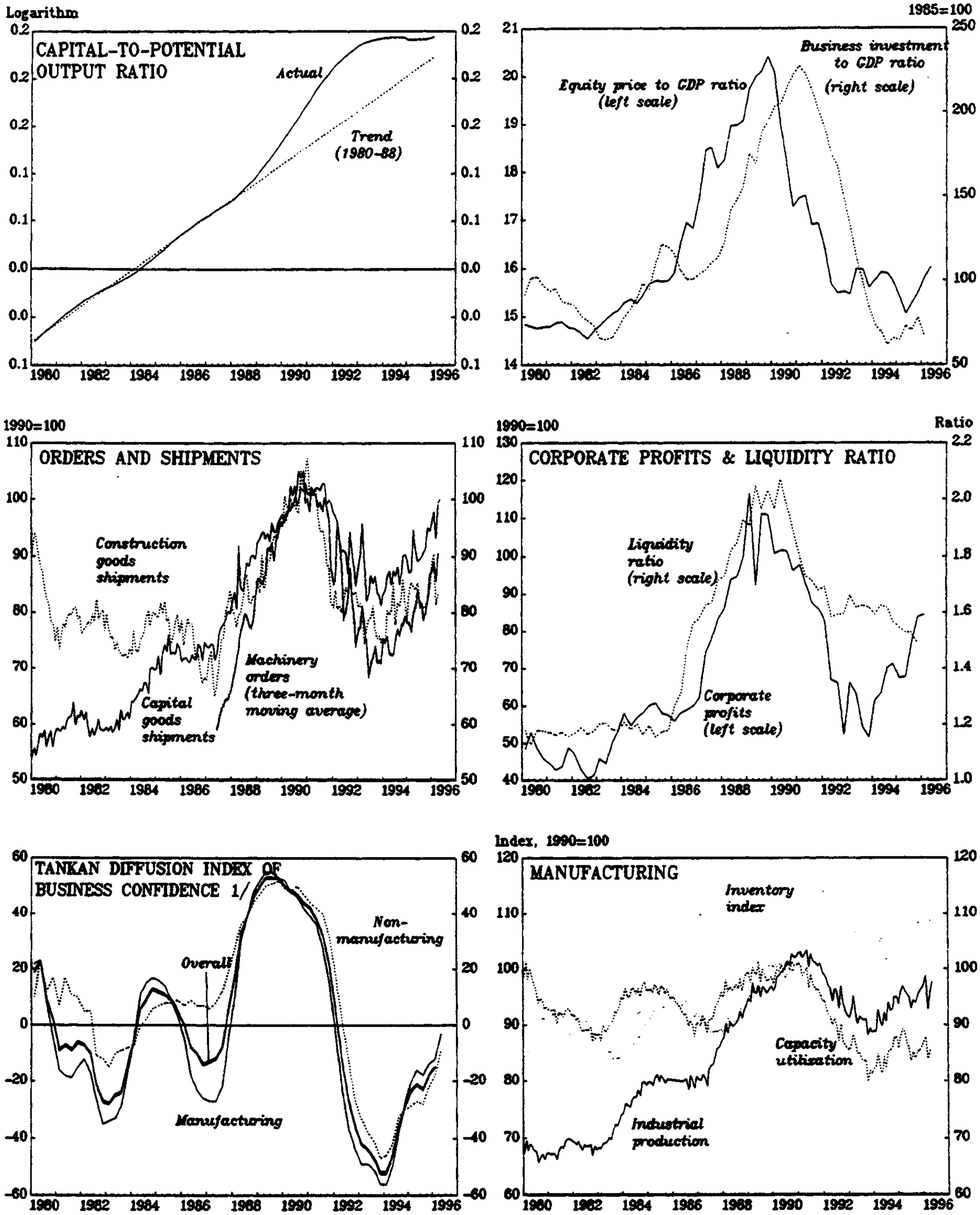
Private business investment grew by 3.1 percent in 1995, following three years of contraction. The growth rate remained subdued in comparison to previous recoveries, however, reflecting a sizable, albeit diminishing, capital stock overhang, low capacity utilization rates, and uncertainties resulting from large fluctuations in the yen's value. 1/ Nevertheless, a number of economic fundamentals suggest that positive investment growth will continue, although at a moderate pace (Chart 3). Corporate profits rebounded sharply in 1995, especially among large manufacturing firms, as they restructured activities, increased their reliance on lower-cost imported parts, and as labor costs moderated. Moreover, the cost of capital fell sharply, as interest rates were lowered and equity prices rebounded following the yen's depreciation. Overall business conditions, as reported in the Bank of Japan's *Tankan* survey, have also improved markedly in recent quarters. In addition, the survey reported that principal enterprises intend to increase their investment in the current year, while the rate of decline among small enterprises has been revised downward sharply. Factors suggesting that the pace of growth in business investment will remain moderate, however, include: continued balance sheet pressures in the real

1/ Estimates of the capital stock overhang are problematic, as it is not certain if all of the investments undertaken during the bubble period are presently profitable at current relative prices, exchange rates, and demand patterns. In the event that some of these projects have been abandoned, the size of the estimated overhang based on capital stocks calculated using a simple perpetual inventory method would be overstated.

CHART 3

JAPAN

INDICATORS OF BUSINESS INVESTMENT, 1980-96



Source: Nikkei Telecom.

1/ Percentage of respondents reporting improving business conditions versus deteriorating.

estate sector; caution in the construction sector due to real estate weakness, and among wholesalers amid reorganization in the distribution system; and continued weak demand among part manufacturers as import penetration in manufacturing steadily increases.

After strong growth in 1994, residential investment declined by over 6 percent in 1995. The contraction was centered in the middle of the year, as confidence was hit by the yen's appreciation and worsening labor market situation, and as households delayed activity in anticipation of lower interest rates. In the event, a lowering of rates and a continued decline in land and housing prices boosted housing affordability, and housing starts increased sharply beginning in September. Homeowners shifted to banks for increasing shares of housing finance to take advantage of relatively cheaper fixed-rate mortgages. While residential investment grew by a further 8.4 percent in the first quarter of 1996, its growth is anticipated to slow substantially in the remainder of the year, as the recent surge in housing starts may partly reflect expectations of an increase in interest rates.

	1990	1991	1992	1993	1994	1995	1996 Q1 1/
			(Percentage change)				
Private residential investment (at constant prices)	4.8	-8.5	-6.5	2.4	9.2	-6.1	6.0
Housing construction starts							
Units	2.8	-19.2	1.7	5.0	5.0	-6.1	3.7
Floor space	3.6	-13.5	2.6	9.9	10.6	-6.1	5.0

1/ Growth over the first quarter of 1995.

On a national accounts basis, stockbuilding contributed positively to growth in 1995, after three years of negative contributions. This pattern continued in the first quarter of 1996. Industrial inventories rose by 3 percent in 1995. Industrial production increased by 3.6 percent in 1995, while shipments rose by 2.9 percent, resulting in a 1.6 percent increase in the inventory-shipment ratio. Production in the first quarter of 1996 stood some 3/4 percent higher than at the same period in 1995, while shipments were almost 1 1/2 percent higher. Nevertheless, inventories rose further, with the inventory-shipment index near its cyclical peak. Excess inventories are acute in the electrical machinery and chemical sectors, and their runoff is anticipated to dampen the growth of industrial production over the near term.

	1990	1991	1992	1993	1994	1995	1996 Q1 1/
			(Contribution to real GDP growth unless otherwise indicated)				
Stockbuilding	-0.2	0.2	-0.4	-0.1	-0.2	0.2	0.2
Private	-0.2	0.3	-0.5	-0.1	-0.3	0.3	0.2
Public 2/	--	-0.1	--	--	0.1	--	--
Industrial inventory (Index (1990 = 100)	100	108	113	109	104	107	110
Finished goods inventory-shipment ratio (1990 = 100)	100	107	117	120	114	116	117
Industrial production (change in percent)	4.1	1.8	-6.1	-4.6	0.9	3.6	0.8

1/ Contribution to real GDP growth over the first quarter of 1995.
2/ Inventories of public enterprises.

Real government consumption rose by 2 percent in 1995, equaling its average growth rate over the 1990-94 period. Public investment, in contrast, rose by only 1.3 percent, the smallest increase since 1989. However, this annual change masks a strong increase in investment through the year, with growth of 12.8 percent on a four-quarter basis. Investment rose initially in the second quarter as reconstruction efforts began relating to the Kobe earthquake, and as the government intentionally front-loaded public works spending in an effort to boost the economic recovery. Investment growth quickened in the fall with the adoption of the September package of stimulus measures, and further accelerated in the first quarter of this year. As a result, public investment now accounts for 10 percent of real GDP, its highest share since 1978. It is anticipated, however, that investment will begin to decline in the latter half of this year, as the effect of past packages unwinds.

In contrast to an acceleration of domestic demand in 1995, the negative contribution to growth from real net exports widened to -0.8 percent of GDP. This was largely the result of a sharp increase in imports of goods and nonfactor services, which grew by 13.5 percent, compared to a 5 percent increase in exports. The surge in imports reflect rising domestic demand and the change in relative prices following the yen's sharp appreciation, as well as structural shifts associated with outsourcing of production and changes in the distribution system.

2. Saving-investment balances

There has been a marked shift in the domestic public and private sector's net saving patterns over the 1990s. While the private sector net

saving position has improved by almost 8 percentage points of GDP to 5 1/4 percent in 1995, the public sector's net saving position has worsened by about 7 percentage points (Table 2). Enterprise net saving has accounted for all of the improvement within the private sector, while household net saving has declined as a share of GDP since 1992. A worsening in general government net saving has accounted for more than three-fourths of the public sector net saving performance.

The improved private sector net saving position is largely the result of a lower share of enterprise investment in GDP, although the latter rose slightly in 1995. The decline in recent years has reflected the effects of overaccumulation of capital during the bubble period, of low capacity utilization rates during the protracted recession, and, until recently, declining profits and relatively high costs of capital. Household net saving has declined as a share of GDP since 1992 in light of a sharp slowdown in the growth of disposable incomes, despite a significant tax cut introduced in 1994 and extended into 1995, which outpaced a slowdown in consumption expenditures. The worsened public sector position reflects both the endogenous effects of the business cycle on general government revenues and public enterprise profitability, as well as expansionary policy decisions taken with a view to boost economic activity. The latter includes the reduction in household taxes mentioned earlier, as well as the impact of five stimulus packages since 1992, which have raised general government investment shares significantly.

3. Price developments

Inflation has been on a declining trend since the recession began in 1991. The effect on prices of weak demand and a slowdown of wage increases has been reinforced by the sharp appreciation of the yen through mid-1995, although this has been slightly reversed subsequently. The year-on-year rate of consumer price inflation has declined from about 3 1/2 percent in early 1991 to deflation of 1/2 percent in the last quarter of 1995, although underlying consumer prices have remained roughly stable since last November (see Ch26
art 4 and following tabulation). "Core" inflation, excluding perishable food and energy prices, has also declined since 1991, with core prices stabilizing in early 1995. In terms of composition, core goods prices have fallen at a 1 1/2 percent annual rate since late 1994, which has been offset by a similar rate of increase in the prices of services.

Table 2. Japan: Saving and Investment Balances, 1990-95

(In percent of GDP)

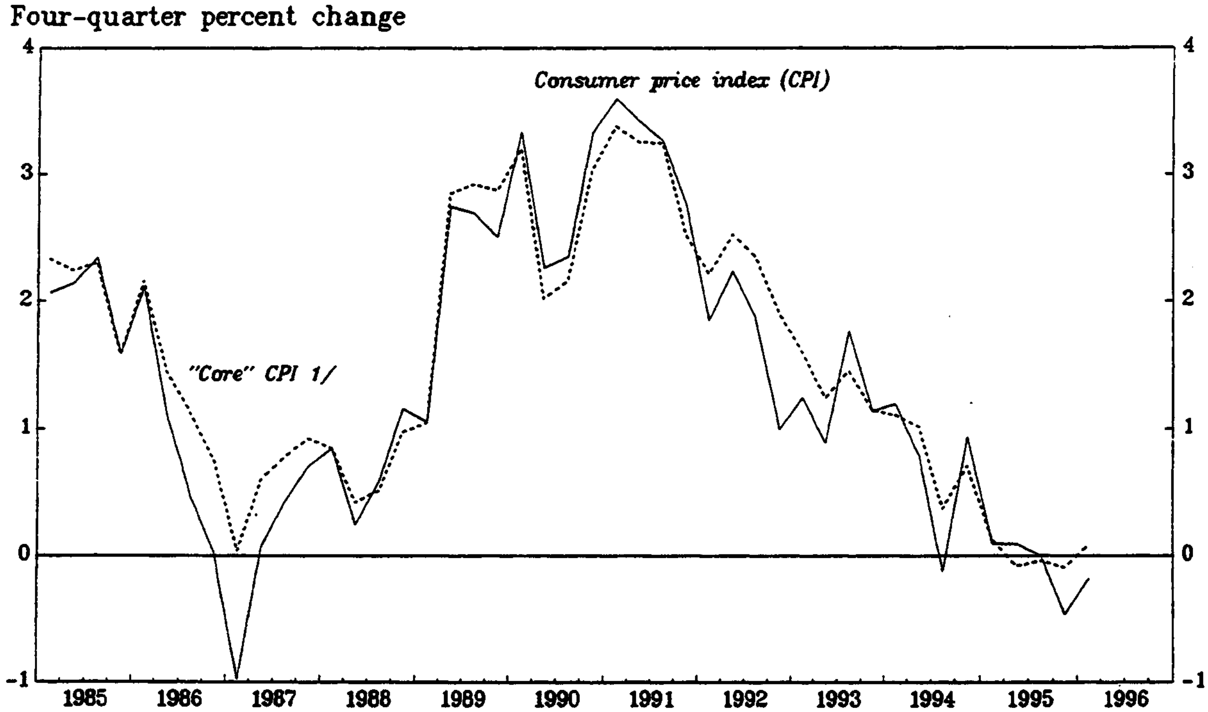
	1990	1991	1992	1993	1994	1995
Foreign balance 1/	1.2	2.2	3.2	3.1	2.8	2.2
Saving-investment balances						
Private sector	-2.6	-1.1	1.8	4.7	5.8	5.3
Households	3.3	4.5	5.0	3.9	3.2	3.1
Private enterprises	-5.9	-5.6	-3.1	0.8	2.5	2.2
Public sector	3.8	3.2	1.3	-1.6	-3.0	-3.2
General government	3.9	4.0	2.7	-0.3	-0.9	-1.6 2/
Public enterprises	-0.1	-0.8	-1.4	-1.2	-2.0	-1.6 2/
Gross national saving	33.5	34.3	33.9	32.8	31.5	30.8
Private sector	23.2	24.5	25.1	25.8	25.8	25.3
Households	9.2	9.7	9.8	8.9	8.6	8.2
Priate enterprises	14.0	14.7	15.3	16.9	17.1	17.1
Public sector	10.3	9.8	8.8	6.9	5.7	5.5
General government	8.9	9.1	8.3	6.2	5.7	4.8 2/
Public enterprises	1.4	0.7	0.5	0.8	0.1	0.7 2/
Gross domestic investment	32.3	32.1	30.7	29.7	28.7	28.7
Private sector	25.7	25.5	23.3	21.1	20.0	20.0
Households 3/	5.9	5.2	4.8	5.0	5.4	5.1
Private enterprises	19.9	20.3	18.4	16.1	14.6	14.9
Public sector	6.6	6.6	7.5	8.5	8.7	8.7
General government	5.0	5.1	5.6	6.5	6.6	6.4 2/
Public enterprises	1.5	1.5	1.9	2.0	2.1	2.3 2/
Memorandum item:						
Real GDP growth	5.1	4.0	1.1	0.1	0.5	0.9

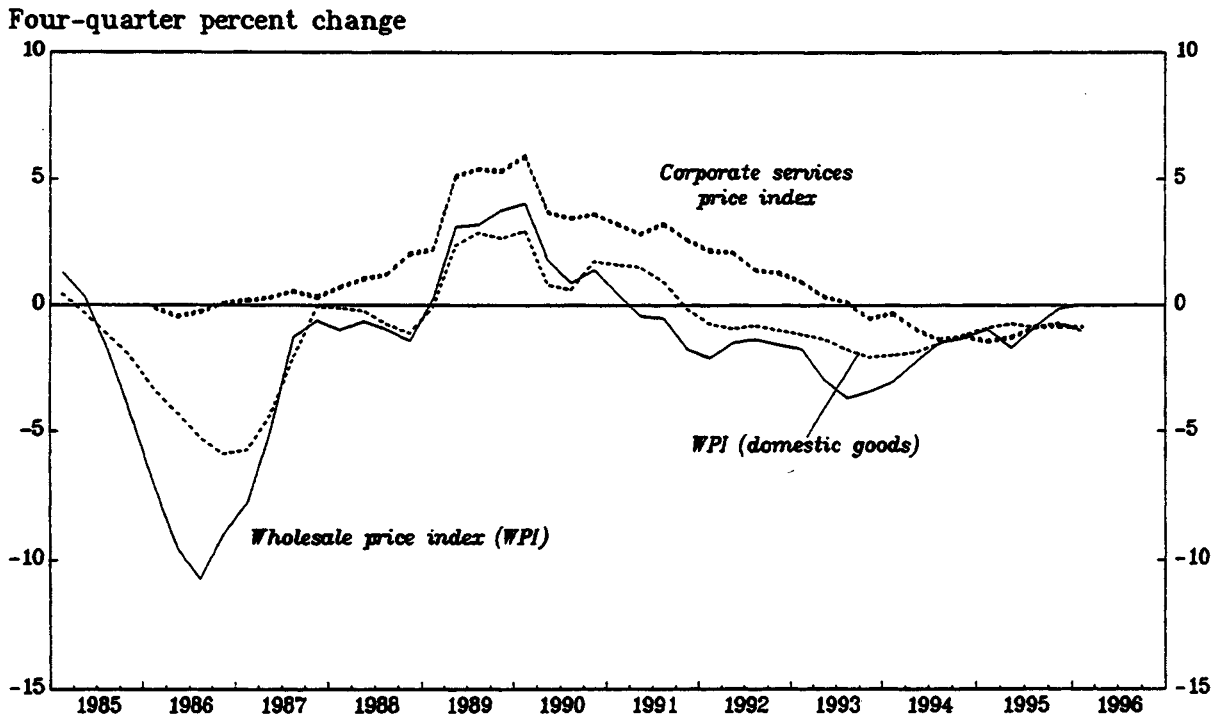
Source: Economicy Planning Agency, Annual Report on National Accounts; and staff estimates.

1/ Current account balance.
2/ Staff estimate.
3/ Residential investment.

CHART 4

JAPAN
PRICE DEVELOPMENTS, 1985-96





Source: Nikkei Telecom.

1/ CPI excluding perishable food and energy.

	1990	1991	1992	1993	1994	1995	1996 Q1 1/
	(In percent)						
CPI inflation (period average)	3.1	3.3	1.7	1.3	1.7	-0.1	-0.2
Core CPI inflation	2.9	3.1	2.2	1.4	0.8	--	0.1
Contribution of:							
Core inflation	2.6	2.8	2.0	1.2	0.7	--	0.1
Goods	1.3	1.6	0.7	0.2	--	-0.7	-0.5
Services	1.3	1.2	1.3	1.0	0.7	0.7	0.6
Perishable food	0.5	0.5	-0.3	--	--	-0.1	-0.2
Energy	--	--	--	--	--	--	-0.1
WPI inflation (period average)	2.0	-0.6	-1.6	-2.9	-2.0	-0.9	--
Domestic goods	1.5	1.0	-0.9	-1.5	-1.7	-0.8	-1.0
Imported goods	7.8	-8.0	-6.7	-10.4	-5.4	--	...
Exported goods	1.5	-5.5	-3.4	-7.9	-2.8	-2.3	...
GDP deflator	2.3	2.7	1.7	0.6	0.3	-0.5	-0.1
Memorandum items:							
Output gap (in percent of potential GDP)	3.2	3.2	0.8	-1.7	-3.5	-4.7	-2.0
Terms of trade change	-6.3	9.9	7.3	8.4	7.9	-0.4	-6.9

1/ Growth over the first quarter of 1995.

Domestic wholesale prices have fallen steadily at about a 1 1/4 percent annual rate since the fourth quarter of 1991. Overall wholesale price deflation, which includes the influence of imported wholesale goods, began in early 1991 and declined more rapidly than the decline in domestic wholesale prices until the second half of 1995, when the effects of the yen's recent depreciation were felt. Several factors account for the larger and more persistent drop in wholesale prices relative to consumer prices: the exclusion of services from the WPI, whose prices continued to rise until mid-1993 (although these have also recently declined, due largely to falling rental prices); the larger weight of imports in the WPI; and the inclusion of export prices in the WPI. The foreign trade component price indices have been falling mainly due to the appreciation of the yen, although the recent reversal of the yen has boosted these prices moderately since mid-1995.

III. Fiscal Policy

This chapter discusses fiscal policy developments since the bursting of the asset-price bubble in 1990-1991. Section 1 briefly reviews fiscal developments during the FY 1992-94 period and then discusses policies and developments in FY 1995 and FY 1996. Section 2 deals with medium-term policy issues. 1/

1. Recent fiscal developments and budgetary performance

a. Developments during FY 1992-94

Since the onset of the economic slowdown in the latter half of FY 1991, fiscal policy has played an important role in providing countercyclical support to domestic demand (Chart 5). Four major fiscal stimulus packages were adopted between August 1992 and February 1994. In total, the four packages amounted to over ¥45 trillion, equivalent to 9 1/2 percent of GDP. The core of the packages consisted of substantial increases in public investment. Direct spending on public investment was boosted by about ¥20 trillion (4 percent of GDP) over the level that would otherwise have occurred, and, as a result, real public investment rose by over 40 percent from 1991 to 1994 (Chart 6). In addition, the fourth package (announced in February 1994) included a major cut in income taxes amounting to ¥6 trillion (1 1/4 percent of GDP). Virtually all of the cut was due to a 20 percent across-the-board reduction in national and local personal income taxes. 2/

During FY 1994, while the tax cuts provided stimulus from the revenue side, public investment declined as the effects of previous packages unwound, and no major fiscal stimulus packages were introduced in FY 1994. Toward the end of the fiscal year (early in calendar year 1995), two supplementary budgets were adopted: the first included agricultural support in the wake of the Urúguay Round agreement; and the second included urgent reconstruction and relief measures from the earthquake that hit the Kobe region in mid-January. Even with these supplementary spending measures,

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1/ The staff analysis uses national income accounts (NIA) data for the general government, consisting of the central government, local governments, and the social security funds. NIA data are available through FY 1994 (April-March); data for FY 1995 and beyond are staff estimates and projections. The main Japanese fiscal accounts concepts are narrower, focusing on the general account of the central government and the Fiscal Investment and Loan Program (FILP). These concepts are referred to as necessary below. See "Japan--Recent Economic Developments," SM/93/142 (7/6/93), especially Annexes I and II, for detailed descriptions of the structure of the public sector and FILP operations.

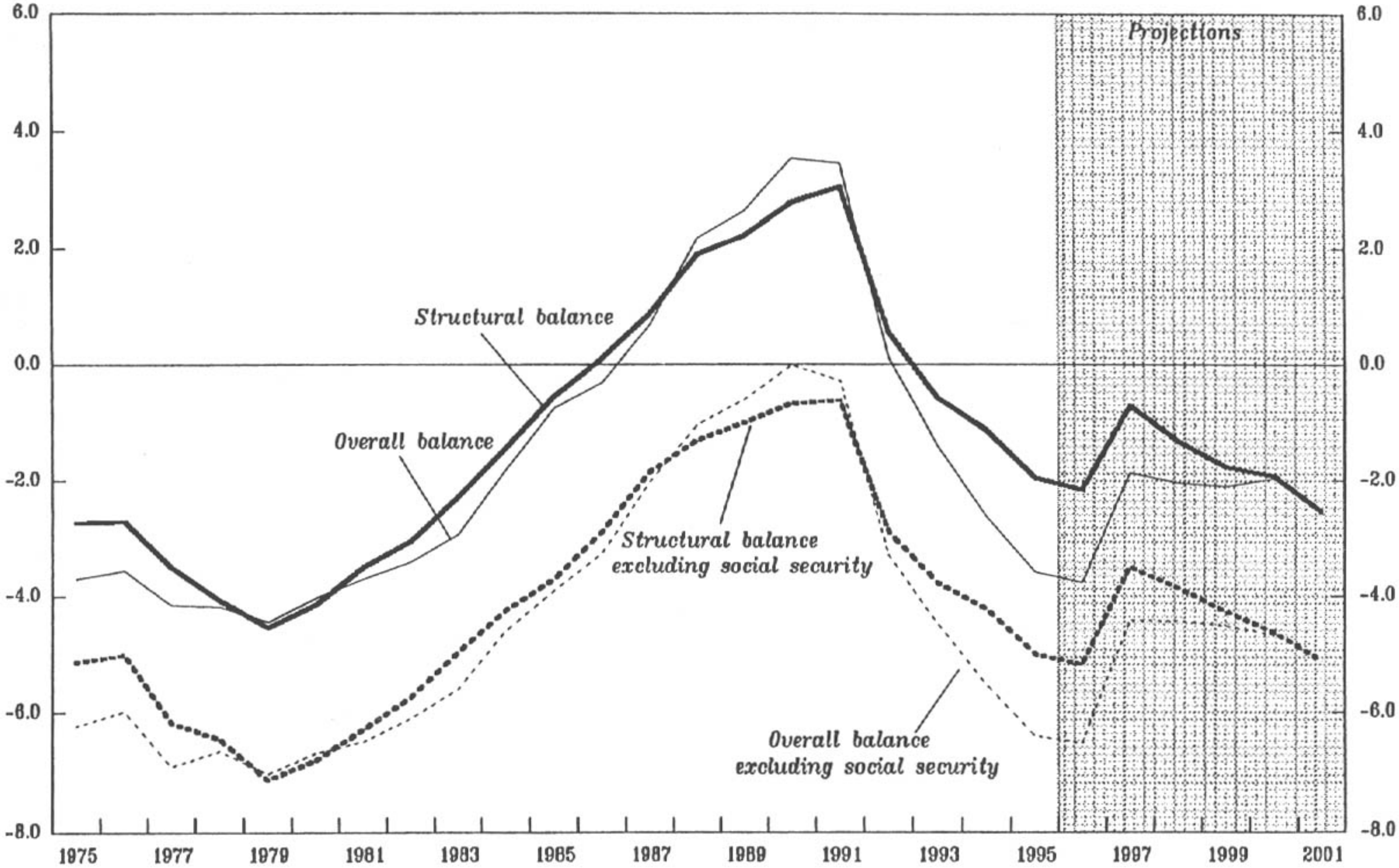
2/ For detailed descriptions and staff analyses of each package, see "Japan--August 1992 Economic Stimulus Package" (EBD/92/193, 9/1/92), "Japan--April 1993 Economic Stimulus Package" (EBD/93/68, 4/23/93), and "Japan--February 1994 Economic Stimulus Package" (EBD/94/22, 2/14/94).

CHART 5

JAPAN

GENERAL GOVERNMENT BALANCE, FY 1975-2001 1/

(In percent of GDP)



Sources: Ministry of Finance; Economic Planning Agency; and staff estimates and projections.

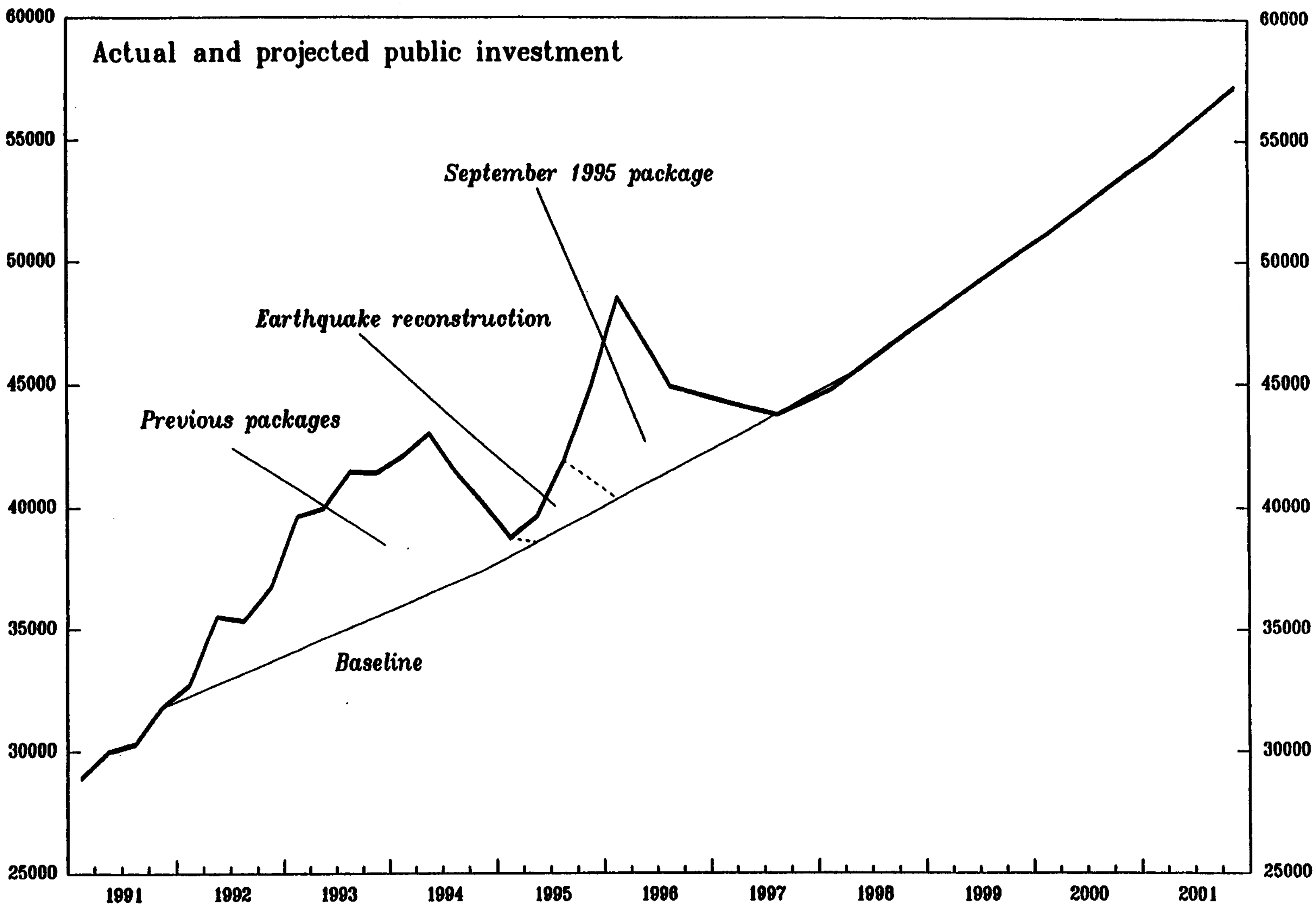
1/ The fiscal year is from April to March.

CHART 6

JAPAN

PUBLIC INVESTMENT PROFILE, 1991-2000

(Billions of Yen)



Sources: Ministry of Finance; Economic Planning Agency; and staff estimates and projections.

capital spending for FY 1994 at the level of the general government declined by about 4 percent from the previous year. As revenues declined by over 1 1/2 percent of GDP, reflecting a major income tax cut, the structural deficit of the general government (excluding social security) for FY 1994 widened by about 1/2 percent of GDP from the previous year, implying a positive overall fiscal stimulus. 1/2/

b. FY 1995 budgetary operations

Almost immediately after Diet approval of the initial budget, a large supplementary budget (amounting to ¥2.7 trillion yen, or over 1/2 percent of GDP) was adopted in May 1995 to appropriate additional expenditures for earthquake reconstruction. 3/ With the supplementary budget offsetting the decline in the deficit that would otherwise have occurred, the initial stance of fiscal policy for FY 1995 was cyclically neutral--implying a continuing high level of demand support.

Amid growing concerns that the economic recovery was faltering in mid-1995, the Government announced a major economic stimulus package, the fifth since the onset of the recession, in September 1995. The package consisted wholly of expenditure increases, totalling ¥14.2 trillion (3 percent of GDP). The central government portion of the expenditure measures was submitted to the Diet in the form of a second supplementary budget for FY 1995, which was approved in mid-October. Local governments boosted budgetary appropriations through their supplementary budgets, most of which were approved in December.

The cornerstone of the package was a large increase in direct spending on public investment (over ¥8 trillion, or 1 1/2 percent of GDP). Table 3 provides the main elements of the September 1995 package and compares them with the previous four packages. The additional public investment included: general public works (¥4 trillion); public works solely financed by local governments (¥1 trillion); education, telecommunication networks, science and technology projects (¥1 trillion); disaster relief (¥0.7 trillion); and other investments including earthquake reconstruction and agricultural support projects (¥1.6 trillion). The package also emphasized measures to stimulate activity in the real estate market, providing for land purchases

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1/ The structural budget balance is an indicator of the budget balance adjusted for the influence of the business cycle. It is estimated by evaluating expenditures and revenues at an assumed full-employment level of output, yielding a measure of the budgetary position at this output level.

2/ Indicators of the structural balance on a calendar-year basis show a withdrawal of stimulus by 1/4 percent of GDP in 1994, as most of the stimulus in FY 1994 was concentrated in January-March 1995.

3/ In accordance with the conventional process of budget formulation, the proposals for the initial budget for FY 1995 was finalized at end-December 1994, before the devastating earthquake hit the Kobe region.

Table 3. Japan: Summary of Economic Stimulus Packages, 1992-95

(In trillions of yen, unless otherwise indicated)

Date proposed	August 1992	April 1993	September 1993	February 1994	September 1995
Total package	10.7	13.2	6.2	15.3	14.2
(in percent of GDP)	(2.3)	(2.8)	(1.3)	(3.2)	(3.0)
Tax reductions	--	0.2	--	5.9	--
(in percent of GDP)	(--)	(--)	(--)	(1.2)	(--)
Public investment 1/	6.2	7.6	2.0	4.0	8.1
(in percent of GDP)	(1.3)	(1.6)	(0.4)	(0.8)	(1.7)
Land purchases	1.6	1.2	0.3	2.8 2/	3.2 3/
(in percent of GDP)	(0.5)	(0.3)	(0.1)	(0.6)	(0.7)
Increased lending by Housing Loan Corporation	0.8	1.8	2.9	1.2	0.5
(in percent of GDP)	(0.2)	(0.4)	(0.6)	(0.3)	(0.1)
Increased lending by government-affiliated financial institutions	2.1	2.4	1.0	1.5	2.4
(in percent of GDP)	(0.5)	(0.5)	(0.2)	(0.3)	(0.5)

Sources: Data provided by the Japanese authorities; and staff estimates.

1/ Includes disaster relief, unidentified land component of public investment, and FILP lending to public corporations for public works.
2/ Including ¥0.5 trillion of land purchases to be conducted over a five-year period.
3/ Including ¥0.5 trillion of land purchases by a government-affiliated urban development organization.

totalling ¥3.2 trillion. 1/ Furthermore, the lending authority of the Housing Loan Public Corporation was increased by ¥0.5 trillion, and that of other public financial institutions was raised by ¥2.4 trillion for the provision of loans, mainly to small businesses, and for investment in new business activities. 2/3/

Taking into account the impact of the September package, expenditures at the general government level are estimated to have risen in FY 1995 by about 5 percent, with 10 1/2 percent growth in capital expenditures. Overall expenditures in relation to GDP rose further to 35 1/2 percent in FY 1995, compared with 34 1/2 percent in FY 1994.

Revenue developments in FY 1995 reflected the impact of the tax reform package, as well as the weaker-than-expected economy. The tax reform package replaced the FY 1994 temporary income tax cut with a permanent cut in personal income taxes (¥3.5 trillion) and a temporary income tax cut (¥2 trillion). A rise in the consumption tax rate from 3 to 5 percent was scheduled for April 1997. The lag between tax reductions and the consumption tax increase was a device to provide fiscal stimulus in the intervening period. 4/ During FY 1995, as the economy proved to be weaker than initially expected, the revenue estimates were revised downward. A third supplementary budget was adopted in end-December to finance the ¥3 trillion in revenue shortfalls. 5/

These expenditure and revenue developments have increased the general government deficit (excluding social security) sharply to 6 1/2 percent of GDP from 5 1/2 percent of GDP in FY 1994 (Table 4). The structural balance of the general government (excluding social security) deteriorated by about 3/4 percent of GDP to 5 percent of GDP. The social security surplus slightly declined from the previous year to 2 3/4 percent of GDP.

1/ This includes government purchases of land for future public works sites (¥2.7 trillion) and land acquisition by a government-affiliated urban development organization (¥0.5 trillion).

2/ Other measures included employment stabilization, import promotion, additional financial liberalization, and further acceleration of deregulation.

3/ See also "Japan--September 1995 Economic Stimulus Package" (SM/95/250, 9/20/95).

4/ For a detailed discussion of the 1994 tax reform package, see "The Tax Reform Issues in Japan (Chapter II of "Japan--Background Papers," SM/95/163 Supplement 1, 7/12/95).

5/ The supplementary budget authorized a cut in transfers to local governments (¥1 trillion) and issues of additional government bonds (¥2 trillion).

Table 4. Japan: General Government Balances, FY 1988-96

Fiscal year 1/	1988	1989	1990	1991	1992	1993	1994	1995 Est.	1996 Est.
	(In billions of yen)								
General government	8,214	10,702	15,329	15,920	567	-6,694	-12,618	-17,493	-18,607
Central government	-4,189	-4,875	-1,401	-829	-10,067	-13,580	-16,899	-20,476	-21,194
Local government	261	2,423	1,349	-363	-5,294	-7,825	-9,648	-10,693	-11,233
Social security	12,141	13,154	15,381	17,111	15,928	14,712	13,928	13,676	13,821
General government excluding social security	-3,927	-2,452	-52	-1,191	-15,361	-21,405	-26,547	-31,169	-32,427
	(In percent of GDP)								
General government	2.2	2.7	3.5	3.5	0.1	-1.4	-2.6	-3.6	-3.7
Central government	-1.1	-1.2	-0.3	-0.2	-2.2	-2.8	-3.5	-4.2	-4.2
Local government	0.1	0.6	0.3	-0.1	-1.1	-1.6	-2.0	-2.2	-2.2
Social security	3.2	3.3	3.6	3.8	3.4	3.1	2.9	2.8	2.8
Structural balance 2/	1.6	1.9	2.4	2.5	0.5	-0.6	-1.1	-1.9	-2.1
General government excluding social security	-1.0	-0.6	--	-0.3	-3.3	-4.5	-5.5	-6.4	-6.5
Structural balance excluding social security 2/	-1.6	-1.3	-1.0	-1.1	-2.9	-3.8	-4.2	-5.0	-5.2
Memorandum items:									
General government revenues	33.6	34.0	34.7	34.6	32.9	32.5	31.8	32.0	32.3
General government expenditures	31.4	31.3	31.2	31.1	32.7	33.9	34.4	35.5	36.0

Sources: Economic Planning Agency, Annual Report on National Accounts, 1996; and staff estimates and projections.

1/ The fiscal year begins on April 1.
2/ In percent of potential GDP.

c. FY 1996 budgetary operations

Fiscal policy for FY 1996 is characterized by a cyclically neutral budget with large carryover effects from the September 1995 package. As the FY 1996 budget proposal included a controversial disbursement of the funds to the Deposit Insurance Corporation as a part of the arrangement to resolve the *jusen* problem, Diet deliberation was prolonged. After the introduction of a provisional budget for the first 50 days of the fiscal year, the budget was approved by the Diet without revisions in mid-May.

The FY 1996 initial general account budget envisages a deficit of 3 1/2 percent of GDP (Table 5). This is about 1 percent of GDP lower than the revised general account deficit in FY 1995, which had widened to 4 1/2 percent of GDP from an initial estimate of 2 3/4 percent due to the adoption of three supplementary budgets. Compared with the initial FY 1995 budget, expenditures follow a slightly contractionary medium-term path, while the revenue projection is noticeably weaker.

Budgeted revenues for FY 1996 are more conservative, after four years of major revenue shortfalls (Table 6). The revenue estimates are predicated on the official economic outlook, which envisages 2.7 percent growth in nominal GDP for FY 1996, and reflect the impact of extending the temporary income tax cut (¥2 trillion) into FY 1996. The estimates also incorporate the effects of the tax measures introduced for FY 1996, including cuts in the rates of the land holding tax and the securities transactions tax, although their revenue implication is very small (less than ¥250 trillion). Among major tax items, while corporate tax revenue is projected to be buoyant with growth of 6 percent, individual income tax revenues are projected to decline by 1.5 percent, owing mainly to the decline in interest income reflecting lower interest rates. As a result, tax and stamp duty revenues are budgeted to rise by only 1.3 percent over the revised estimate for FY 1995. As other revenues are expected to decline, total revenues are projected to be flat, implying a small decline as a ratio to GDP.

Compared with the initial budget for FY 1995, total general account expenditures are budgeted to rise by only 1.7 percent, and general expenditures to grow by 2.4 percent, in line with the nominal growth rate of potential GDP. Looking at the components of general expenditures, current expenditures grow by only 1.5 percent, while capital expenditures grow by relatively high rate of 5.2 percent. The differentiation in growth rates between the two types of expenditures reflects the authorities' view that the multiplier is higher for the capital expenditures than for current expenditures--thus the spending mix is designed to provide further support to activity. Compared with the revised budget for FY 1995, expenditures are significantly smaller, owing to a reduction in public investment (about 1 percent of GDP) that was boosted substantially during FY 1995 by supplementary measures, including the September package.

As with the initial general account budget, the initial FILP budget for FY 1996 is also cyclically neutral, returning toward the underlying trend

Table 5. Japan: Central Government General Account Budget, FY 1991-96 1/

(In billions of yen)

	1991 Settlement	1992 Settlement	1993 Settlement	1994 Initial	1994 Settlement	1995 Initial	1995 Revised (May 95)	1995 Revised (Oct. 95)	1995 Revised (Dec. 95)	1996 Initial
Expenditure	68,149	67,047	72,642	69,230	69,818	69,908	72,634	77,395	76,391	71,122
General expenditure	37,940	40,376	43,665	40,856	43,117	42,142	44,848	49,902	49,902	43,141
Social security	12,151	12,757	13,346	13,482	13,603	13,924	14,014	14,548	14,548	14,288
Public works	7,421	8,589	10,088	7,755	9,906	8,135	9,572	13,107	13,107	8,490
Defense	4,441	4,589	4,602	4,684	4,723	4,751	4,734	4,734	4,734	4,846
Official aid	860	893	950	999	985	1,035	1,035	1,028	1,028	1,072
Foodstuff control	379	349	308	274	265	272	272	272	272	271
Other	12,691	13,200	14,371	13,662	13,721	14,074	15,204	16,213	16,213	14,176
No-interest lending program (Public Works)	1,270	1,288	1,290	1,300	1,201	1,300	1,300	1,300	1,300	1,300
Emergency financial stabilization fund										685
Interest payments 2/	11,672	10,898	10,704	11,699	10,813	11,777	11,797	11,504	11,413	12,027
Transfer of local allocation tax to local governments	15,800	14,204	13,950	12,758	12,069	13,215	13,215	13,215	12,302	13,604
Other 3/	1,467	281	3,033	2,618	2,618	1,474	1,474	1,474	1,474	365
Revenue	63,826	57,941	57,538	57,171	54,958	57,276	57,176	57,194	54,283	54,057
Taxes and stamp duties	59,820	54,445	54,126	53,665	51,030	53,731	53,593	53,593	50,681	51,345
Miscellaneous	4,005	3,496	3,412	3,506	3,928	3,545	3,583	3,601	3,602	2,712
Of which:										
Proceeds from sales of NTT and JNR shares	1,270	205	177	173	163	173	173	173	173	172
Deficit	4,323	9,107	15,103	12,059	14,860	12,632	15,458	20,201	22,108	17,065
Financing	4,323	9,107	15,103	12,059	14,858	12,630	15,458	20,201	22,107	17,065
Bond issues	8,197	9,817	19,207	16,261	19,108	14,072	16,900	21,602	23,508	21,394
Deficit-financing bonds	--	--	--	3,134	4,144	2,851	3,415	3,626	5,532	11,998
Construction bonds	6,730	9,536	16,174	10,509	12,346	9,747	12,011	16,502	16,502	9,031
Other 4/	1,467	281	3,033	2,618	2,618	1,474	1,474	1,474	1,474	365
Debt repayment	-3,865	-3,730	-3,010	-2,661	-2,609	-1,444	-1,444	-1,444	-1,444	-4,348
Other	-9	3,019	-1,094	-1,541	-1,641	2	2	43	43	19
Carried over surplus	-9	1,474	-1,660	4	-96	2	2	609	609	19
Carry in	2,435	2,443	969	4	2,629	2	2	609	609	19
Carry out	-2,443	-969	-2,629	--	-2,725	--	--	--	--	--
Drawdown from reserve funds	--	1,545	566	-1,545	-1,545	--	--	-566	-566	--
Memorandum items:										
In percent of GDP 5/										
Expenditure	14.9	14.4	15.2	14.5	14.6	14.5	15.0	16.0	15.8	14.3
Revenue	14.0	12.4	12.1	11.9	11.5	11.8	11.8	11.8	11.2	10.8
Deficit	0.9	2.0	3.2	2.5	3.1	2.6	3.2	4.2	4.6	3.4
Bond financing (net)	1.0	1.3	2.8	2.3	2.9	2.3	2.9	3.9	4.3	3.3
Deficit-financing bonds (gross)	--	--	--	0.7	0.9	0.6	0.7	0.8	1.1	2.4
General public works expenditure 6/	1.9	2.1	2.4	1.9	2.3	2.0	2.2	3.0	3.0	2.0

Source: Data provided by the Japanese authorities.

1/ This presentation differs from that of the authorities; certain revenue and expenditure items in the official presentation are reclassified as financing items.
2/ Includes administrative costs.
3/ Comprises cash expenditures related to commitments entered into in previous years as well as noncash expenditures, including equity contributions to international organizations. The figures for FY 1993-95 include central government debt cancellation of local governments' outstanding liabilities under the no-interest lending program.
4/ Bonds issued for noncash expenditures. The figures for FY 1993-95 include transfers to finance central government debt cancellation.
5/ Figures for FY 1995 and FY 1996 are based on staff projections of GDP.
6/ Includes public works spending under the no-interest lending program.

Table 6. Japan: Tax Receipts of the Central Government General Account, FY 1991-96

	1991	1992	1993	1994			1995		1996
	Settlement	Settlement	Settlement	Initial	Revised	Settlement	Initial	Revised	Initial
					(In billions of yen)				
Individual income tax	26,749	23,231	23,686	21,513	20,364	20,418	21,350	19,564	19,338
Corporate income tax	16,595	13,714	12,138	13,813	12,229	12,363	13,726	12,714	13,548
Taxes on goods and services	10,076	10,378	10,778	11,306	11,224	11,219	11,665	11,433	11,611
Of which:									
Consumption tax	(4,976)	(5,241)	(5,586)	(5,740)	(5,684)	(5,632)	(5,980)	(5,748)	(5,948)
Liquor tax	(1,974)	(1,961)	(1,952)	(2,123)	(2,097)	(2,113)	(2,172)	(2,172)	(2,111)
Gasoline tax	(1,537)	(1,563)	(1,627)	(1,797)	(1,797)	(1,813)	(1,850)	(1,850)	(1,875)
Tobacco tax	(1,016)	(1,020)	(1,030)	(1,028)	(1,028)	(1,040)	(1,038)	(1,038)	(1,040)
Custom duties	923	915	881	918	912	908	897	897	968
Stamp revenue	1,749	1,571	1,599	1,625	1,625	1,752	1,762	1,762	1,925
Other	3,728	4,636	5,044	4,490	4,462	4,370	4,331	4,311	3,955
Total tax and stamp revenue	59,820	54,445	54,126	53,665	50,816	51,030	53,731	50,681	51,345
					(Percentage change) 1/				
Individual income tax	2.9	-13.2	2.0	-9.2	-14.0	-13.8	4.6	-4.2	-1.2
Corporate income tax	-9.7	-17.4	-11.5	13.8	0.7	1.9	11.1	2.8	6.6
Taxes on goods and services	4.7	4.2	3.9	4.9	3.9	4.1	4.0	1.9	1.6
Total tax and stamp revenue	-0.5	-9.0	-0.6	-0.9	-6.1	-5.7	5.3	-0.7	1.3

Source: Data provided by the Japanese authorities.

1/ Percentage changes calculated relative to most recent data of previous year.

level (Table 7). FILP spending is budgeted at ¥40.5 trillion (excluding portfolio investment), unchanged from the initial FY 1995 level. It represents a decline by 8 1/4 percent compared with the revised FY 1995 FILP of ¥44.2 trillion, which incorporates a supplementary rise during FY 1995. 1/ Still, at 8 1/4 percent of GDP, the size of the FY 1996 FILP remains significantly above its level before the downturn. In formulating the FY 1996 FILP, the selective allocation of funds was emphasized, with the goal of contributing to stable economic growth and improving standards of living. Specifically, funds for public financial institutions declined considerably, reflecting lower demand for FILP funds from those financial institutions as a result of low market interest rates. On the other hand, sufficient funds are provided to ensure implementation of public works projects, to the central and local governments and other public works executing corporations.

The Local Finance Plan for FY 1996 envisages growth in total local government expenditures of 3.4 percent. Local tax revenues are projected to grow very little (by only 0.1 percent). Transfers from the central government are budgeted to grow by 4.3 percent, reflecting an upgraded boost over the statutorily defined level. 2/ Remaining financing requirements will be met by local government borrowing, which is projected to rise by 15 percent over FY 1995.

While all the initial budgetary plans for FY 1996 indicate a cyclically neutral stance, the other important component is the carryover effects of the September 1995 package. As discussed earlier, the expenditure increases of the September package were all budgeted in FY 1995--in October at the central and in December at the local government level. Given the timing of the budgetary approvals of the package and the normal implementation period of public works projects, the stimulative effects of the package occurring in FY 1995 is estimated to be about one third, and two thirds of the total effect are "carried over" and actually felt in FY 1996. 3/

1/ The FILP fund appropriation can be increased by up to 50 percent during a fiscal year without explicit parliamentary approval, through the use of the "flexibility" clause included in the initial plan.

2/ By law, the transfers are about a third of revenues from three national taxes (individual and corporate income taxes and the liquor tax). In recent years, in light of the increasing financial needs of local governments and slow growth in revenues from the three national taxes, these transfers have been temporarily boosted. These additional transfers are financed by FILP funds borrowed by a special account of the central government.

3/ A distinction between the budgetary accounts and the NIA is important to understand the expenditure carryover. While Japanese budgetary accounts monitor expenditures on a contracts-signed and disbursement basis, the NIA record fiscal activity as actual implementation occurs. Thus, on an NIA basis, the pipeline of contracted, but incomplete or uninitiated, work represents a carryover of the package into the following year.

Table 7. Japan: Fiscal Investment and Loan Program (FILP), FY 1991-96

(In billions of yen)

	1991 1/ Actual	1992 Actual	1993 Actual	1994 Initial plan	1994 Revised plan	1994 Prelim. actual	1995 Initial plan	1995 Revised plan	1996 Initial plan
Sources of funds	49,528	48,086	55,404	47,858	52,132	50,591	48,190	52,125	49,125
Trust Fund Bureau	41,278	40,192	45,982	36,371	40,613	39,437	36,693	40,237	41,910
Postal savings	(18,707)	(14,012)	(12,825)	(10,000)	(...)	(13,760)	(10,000)	(...)	(10,000)
Welfare and national pensions	(7,790)	(7,853)	(7,413)	(7,170)	(...)	(6,921)	(7,380)	(...)	(6,920)
Repayment and other	(14,782)	(18,327)	(25,743)	(19,201)	(...)	(18,757)	(19,313)	(...)	(24,990)
Postal life insurance	6,288	6,023	6,977	8,682	8,682	8,459	8,182	8,186	8,650
Industrial investment special account	63	72	99	56	87	83	65	81	65
Government-guaranteed bonds and borrowing	1,900	1,799	2,346	2,750	2,750	2,612	3,250	3,620	3,100
Uses of funds	39,241	48,086	55,404	47,858	52,132	50,591	48,190	55,083	53,725
Purchase of government bonds	1,087	1,956	2,946	--	--	--	--	2,958	4,600
FILP	38,154	46,130	52,458	47,858	52,132	50,591	48,190	52,125	49,125
Portfolio investments 2/	(7,700)	(9,660)	(9,175)	(8,450)	(8,450)	(8,450)	(7,950)	(7,950)	(8,591)
Central government projects (special accounts)	(754)	(1,104)	(1,130)	(872)	(912)	(866)	(854)	(961)	(807)
Government nonfinancial enterprises	(9,008)	(10,996)	(11,230)	(11,007)	(11,322)	(12,544)	(9,521)	(9,864)	(9,374)
Government financial agencies	(15,557)	(17,756)	(22,244)	(20,643)	(23,906)	(23,048)	(22,240)	(23,145)	(21,273)
Of which: Housing Finance Corporation	5,596	6,865	9,981	8,963	12,163	12,141	10,269	11,150	10,910
Local governments	(4,742)	(6,222)	(7,966)	(6,500)	(7,150)	(7,024)	(7,250)	(9,830)	(8,730)
Other	(393)	(392)	(713)	(386)	(392)	(391)	(375)	(375)	(350)
Memorandum items:									
Increase in FILP activities (in percent) 3/	5.5	19.8	18.7	-9.0	0.9	-2.6	-4.5 4/	4.8 4/	-8.2 5/
FILP activities as a percent of GDP 3/	6.6	7.7	9.3	8.2	9.1	8.8	8.3 6/	9.7 6/	8.2 6/

Source: Ministry of Finance, Zaisei Kinyu Tokei Geppo (Financial and Monetary Statistics Monthly).

1/ Difference between "sources of funds" and "uses of funds" reflects short-term off-program investments of the Trust Fund Bureau.
2/ Reflects the funding of the "lend-back" system under which the postal savings system, public pension funds, and the postal life insurance fund receive funds for portfolio management on their own account.
3/ Excluding portfolio investment.
4/ Compared with preliminary outturn of the previous year.
5/ Compared with revised plan of the previous year.
6/ As a percentage of projected GDP.

At the level of the general government, taking into account the carryover effects and cyclically neutral budgetary plans, the staff estimates that the deficit (excluding social security) will expand by a small margin in FY 1996 to around 6 1/2 percent of GDP. Total revenues are estimated to grow by 3 3/4 percent over FY 1995, reflecting slightly higher growth in nominal output (2.8 percent) than the official economic outlook (2.7 percent) and a scheduled increase in the pension premium rate. Total expenditures are estimated to grow by 4 1/4 percent in FY 1996, rising to 36 percent of GDP from 35 1/2 percent of GDP in FY 1995. The structural deficit of the general government (excluding social security) is projected to widen to 5 1/4 percent of GDP from 5 percent of GDP in FY 1995. The social security surplus is expected to remain unchanged at 2 3/4 percent of GDP (Charts 7 and 8).

2. Medium-term issues

a. Medium-term fiscal position and strategy

Reflecting weak activity and countercyclical fiscal actions, including five packages and tax cuts, the general government deficit (excluding social security) has deteriorated from 1/4 percent of GDP in FY 1991 to 6 1/2 percent of GDP in FY 1996 (Chart 5). The consolidation effort of the 1980s has thus been entirely reversed.

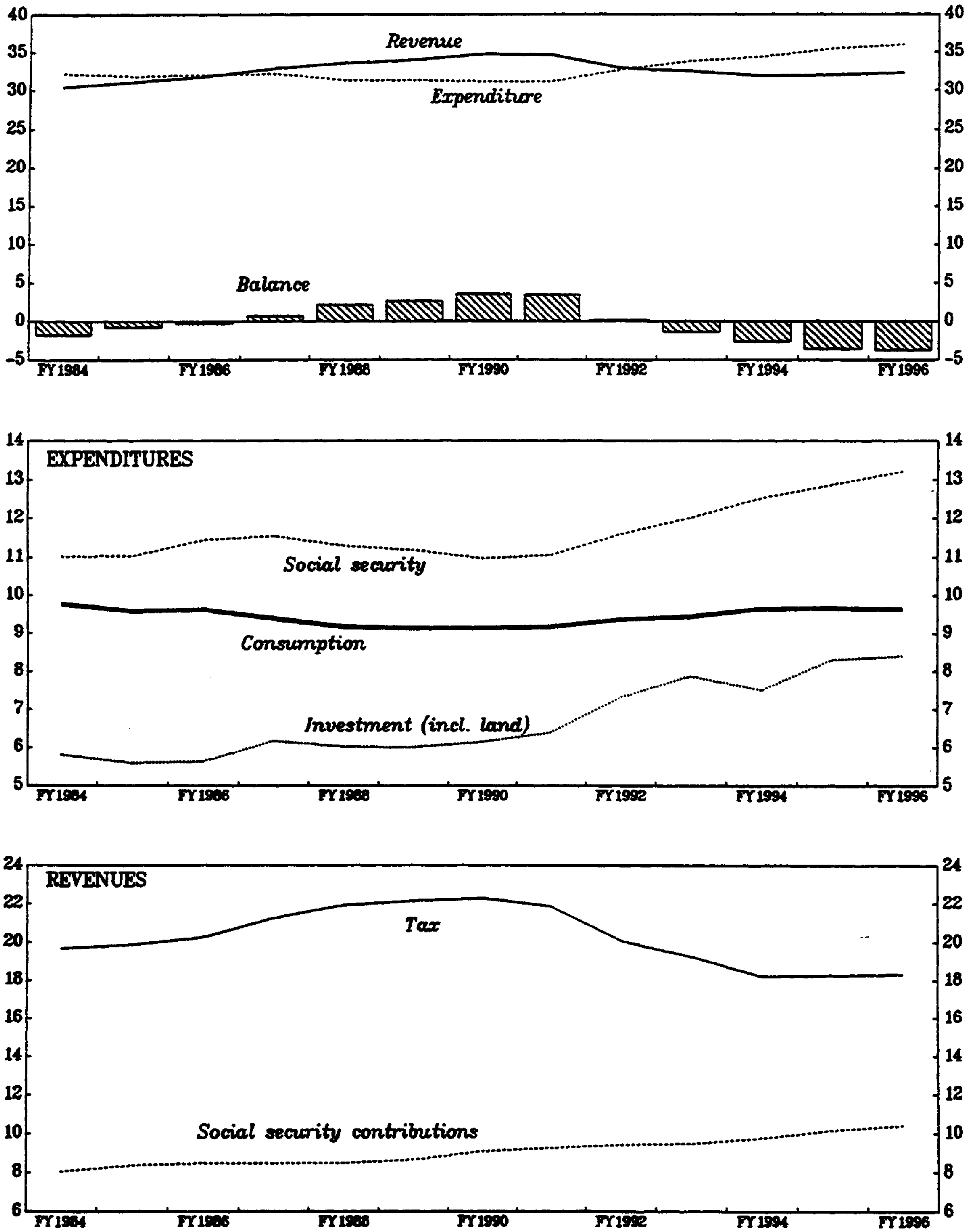
As well as in flow terms, the deterioration in the fiscal position has been reflected in a sharp increase in debt stocks. The gross debt ratio to GDP of the general government has risen from 67 percent to over 90 percent during 1991-96. The net debt ratio to GDP has also risen by over 10 percentage points during the same period. Although at 15 percent of GDP the net debt remains relatively low in 1996 compared with other G-7 countries, it is misleading to look simply at Japan's net debt; sizable assets currently held by the social security fund are intended to finance part of the much larger future liability, and therefore, should not be counted on to offset non-social security sector debts. Excluding social security assets, the net debt ratio to GDP is projected to stand at 60 percent in 1996, implying rise of over 20 percentage points during 1991-96. 1/

Reflecting the authorities' emphasis on the need for consolidation in setting future fiscal policy, announced policies envisage significant consolidation measures in FY 1997. Public investment will decline as the carryover effects of the September package unwind. The consumption tax rate is scheduled to rise from 3 to 5 percent in April 1997, and the ¥2 trillion temporary income tax cut is to be reversed in FY 1997. The effects of these consolidation measures will, however, be partially offset by higher social security payments. Consequently, the structural deficit of the general government is projected to narrow by 1 1/2 percent of GDP in FY 1997.

1/ Annex II discusses indicators of government debt.

CHART 7

JAPAN
GENERAL GOVERNMENT EXPENDITURES AND RECEIPTS
FY1984-FY1996 1/
(Percent of GDP)

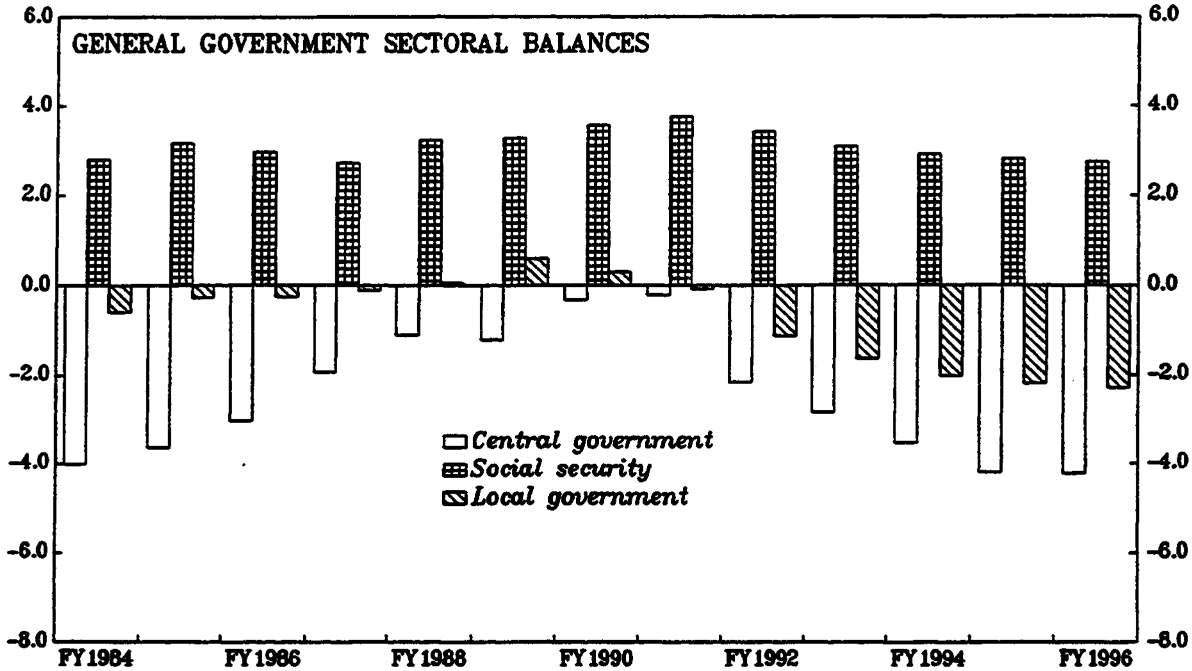


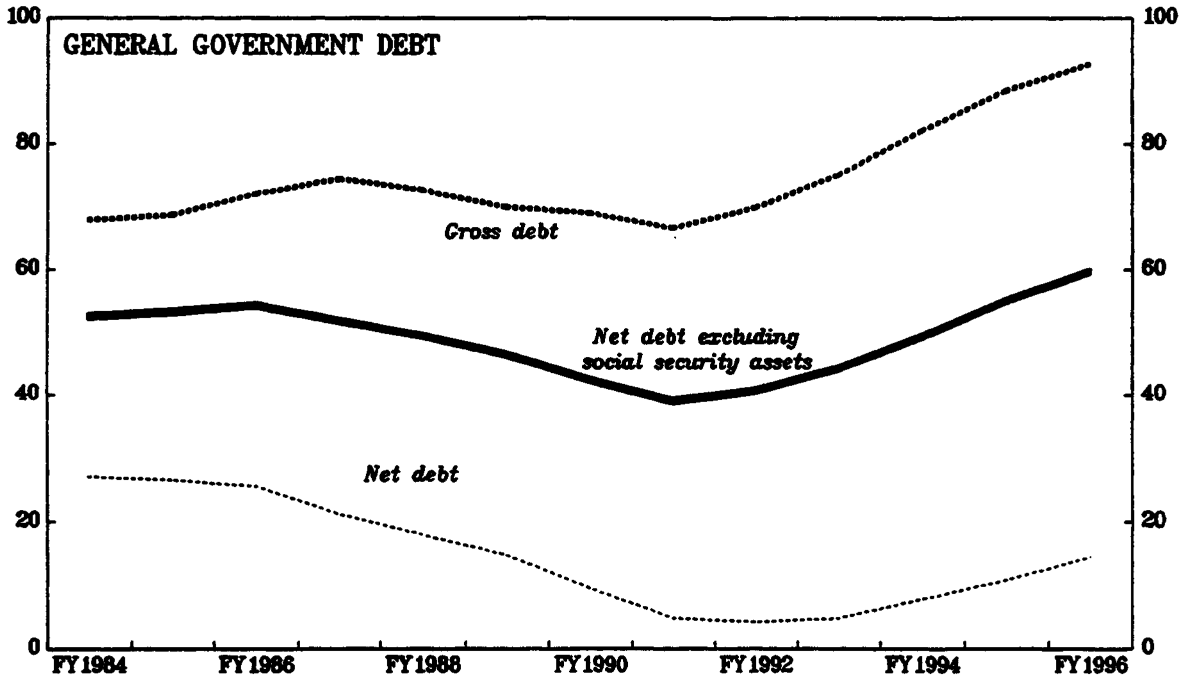
Sources: Economic Planning Agency, Annual Report on National Accounts; and staff estimates.

1/ Figures for FY 1994 and FY 1995 are staff estimates.

CHART 8

JAPAN
GENERAL GOVERNMENT FISCAL INDICATORS
FY1984-96 1/
(Percent of GDP)





Sources: Economic Planning Agency, Annual Report on National Accounts; and staff estimates.

1/ Figures for FY 1995 and FY 1996 are staff estimates.

Without further policy initiatives, the structural deficit is projected to widen beyond 1997. This is driven by three principal factors: population aging raises social welfare expenditure, including medical care spending and central government contributions to public pension funds; public investment spending rises in line with the 10-year public investment plan; and debt-servicing payments grow. By FY 2001, the structural deficit (excluding social security) rises from 3 1/2 percent of GDP in FY 1997 to 5 percent of GDP. Combined with the gradual decline in the social security surplus, which is projected with the assumed full implementation of the 1994 pension reform plan, the overall structural balance is projected to worsen by 1 3/4 percent of GDP during FY 1997-2000 to 2 1/2 percent of GDP.

Until recently, the authorities' fiscal consolidation had been guided by the announced medium-term objective of reducing the "bond-financing" ratio of the general account budget to 5 percent by FY 2000. 1/ As this objective had appeared unrealistically ambitious given the recent deterioration in the fiscal position, the authorities are now in the process of formulating a new consolidation target. In line with past staff advice, the authorities recently presented medium-term fiscal scenarios, with and without new consolidation measures, to illustrate the seriousness of the fiscal sustainability problem. 2/ A special committee has also been established under the Fiscal System Council--an advisory body to the Finance Minister--to study consolidation options. Reflecting the wide recognition of the need for fiscal consolidation, Prime Minister Hashimoto recently convened a joint forum of the four related advisory councils to produce a coherent and coordinated consolidation policy. The authorities' consolidation strategy will become clearer in the fall of this year when the advisory committee presents its recommendation. 3/

b. Allocation of public investment budget

Allocating the public investment budget to efficient projects is important, not only to provide higher multiplier effects on activity, but also to ensure cost-effective management of fiscal policy. In practice, however, as shown in Table 8, the shares of public investment allocated to various sectors of the economy have been very rigid. Large shares held by established sectors, such as agriculture, tend to be maintained over time, while newly emerging sectors tend to get little investment.

1/ The bond-financing ratio is defined as the proportion of overall general account expenditure that is financed through new bond issues. For more discussion of the bond-financing ratio and the authorities' objective of a 5 percent bond financing ratio, see Chapter III and Annex III of "Japan--Recent Economic Developments (SM/95/163)."

2/ The Appendix to Chapter I of the Background Papers discusses new official fiscal scenarios.

3/ Chapter I of the Background Papers updates the staff's analysis of long-term consolidation needs, and discusses consolidation options.

Table 8. Japan: Allocation of Public Works Expenditure of Central Government General Account, FY 1985-96

Fiscal	1985 Actual	1992 Actual	1993 Actual	1994 Actual	1995 Revised	1996 Initial
			(In percent)			
Erosion and flood control	16	16	17	17	15	17
Road improvement	28	26	27	26	25	28
Port, harbor, and airport improvement	8	8	7	7	7	8
Housing	12	12	11	12	13	13
Living environment facilities	15	16	16	17	15	18
Agricultural production	13	13	13	13	12	13
Forestry roads and water supply for industrial use	3	3	3	3	3	4
Disaster relief	5	6	5	5	10	1
Total	100	100	100	100	100	100

Source: Data provided by the authorities.

Considerable efforts have been made by the authorities toward a more flexible allocation of public investment, including a creation of some set-aside funds that are allocated independently of past records, and a classification of project categories by priorities. Achievement of these efforts, however, has been very limited so far, given the strong political pressures from groups with vested interests. As fiscal consolidation is becoming a focal policy issue, initiatives toward allocating efficiency should be increasingly emphasized as a possible source of saving.

c. Transparency in fiscal policy management

The FY 1996 budget is the first initial budget since 1989 that includes financing by deficit-financing bonds. In the recent past, to avoid issuing deficit-financing bonds, the authorities set upwardly-biased revenue projections, used complicated accounting devices, and postponed some statutory payments. While the authorities had viewed this policy as providing a useful constraint on political pressures for spending expansion, the staff had argued that the complications and distortions employed to avoid deficit-financing bonds misstated the true fiscal situation and impaired the pursuit of needed consolidation measures. The decision to issue these bonds in this year's budget contributed to reducing this problem and improving fiscal transparency.

Over the medium term, the staff also has encouraged the authorities to look at comprehensive fiscal indicators, similar to those used by the Fund and the OECD, in assessing both short-term policy actions and longer-term consolidation needs. The use of these measures will enable a better assessment of the effects of fiscal policy on economic activity, ensure greater international comparability, and facilitate the ongoing discussion of Japan's fiscal policy.

IV. Monetary Developments

1. Monetary policy and interest rates

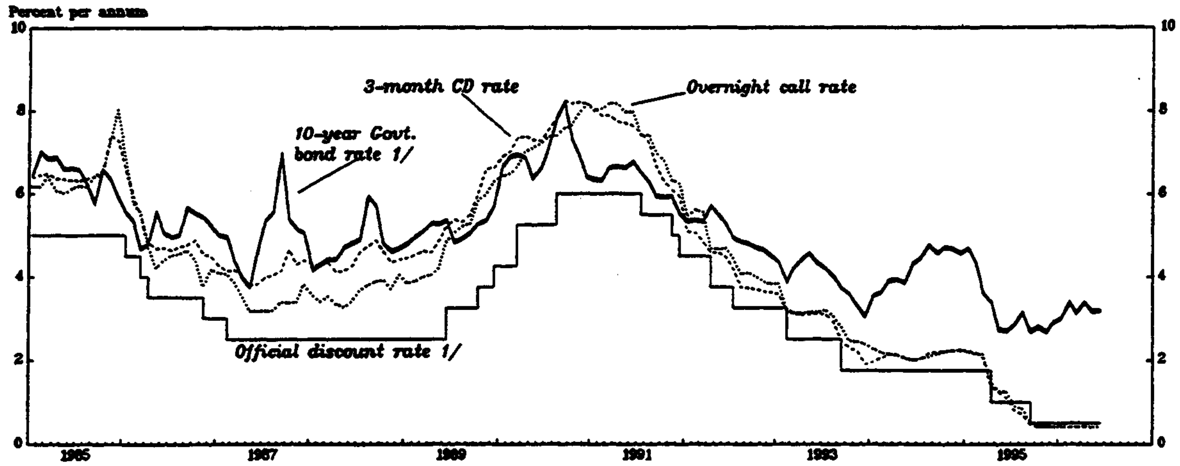
In response to weakening economic activity, the Bank of Japan (BOJ) began to ease monetary conditions in mid-1991. The official discount rate (ODR) was lowered in seven steps from 6 percent to 1 3/4 percent in September 1993, and remained unchanged through 1994 and early 1995 (Chart 9). Short-term market rates fell from 8 percent in early 1991 to around 2 percent in early 1994, remaining stable through the year. The decline in long-term interest rates over the same period was smaller, with the 10-year government bond rate falling from over 6 1/2 percent to around 4 3/4 percent in late 1994. As a result, the previously inverted slope of the yield curve was reversed.

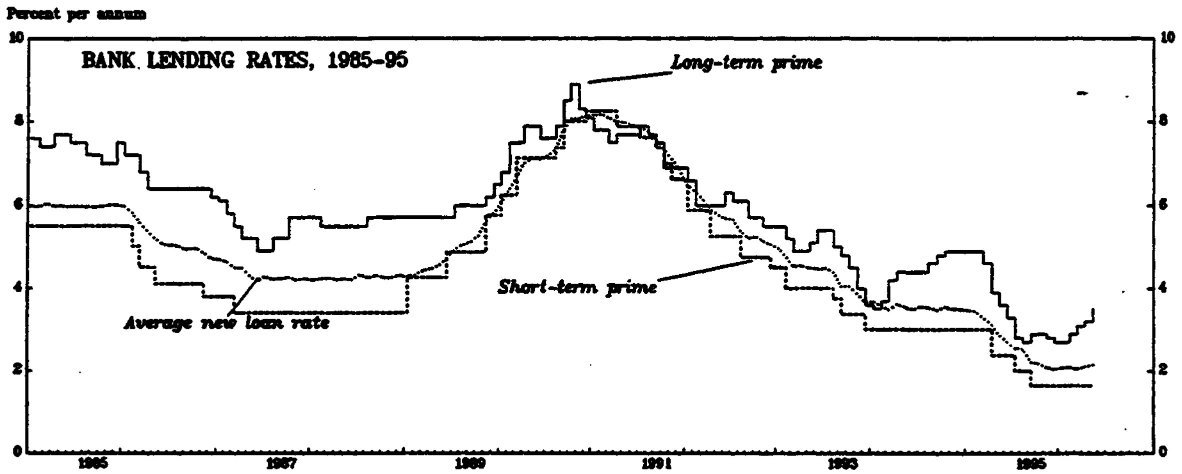
Monetary policy was further eased in 1995, against the background of sharp swings in the exchange rate. As the yen appreciated sharply and equity prices dropped in early 1995, the BOJ eased reserve conditions to

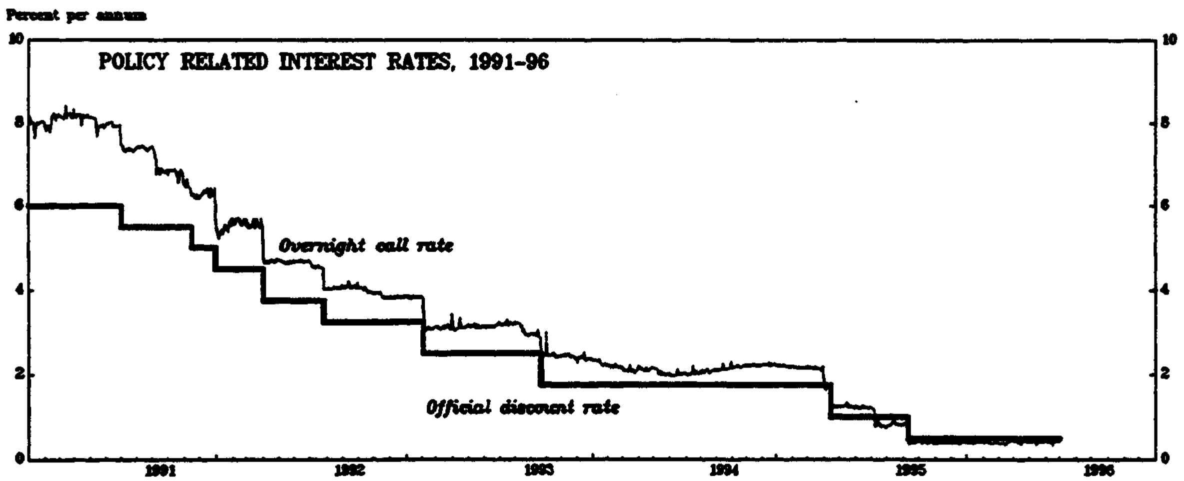
CHART 9

JAPAN

SELECTED INTEREST RATES, 1985-96







Source: Bank of Japan, Economic Statistics Monthly; and staff calculations.
1/ End-period.

accommodate a decline in the interest rate on overnight call money by 1/2 percentage point at end-March, bringing it for the first time to below the ODR. Market reaction was unfavorable: the yen was propelled higher, while equity prices declined. Reflecting the decline in the call rate, short-term market rates declined by about 1/2 percentage point. Amid ongoing upward pressure on the yen, the BOJ followed through by cutting the ODR to 1 percent in mid-April, while the overnight call rate fell to 1/4 percentage point above the ODR, as did other short-term market rates. Long-term bond yields fell gradually by around 2 percentage points to around 2 3/4 percent by late June, reflecting the easing in monetary policy and expectations that additional monetary steps would be taken to support activity.

In early July, following the lowering of the U.S. federal funds rate, and accompanied by coordinated intervention by the U.S. Federal Reserve and the BOJ in exchange markets, the BOJ again guided down short-term rates by injecting liquidity to markets. The overnight call rate fell to 1/4 percentage point below the ODR, which was left unchanged at 1 percent. On this occasion, the market reaction was favorable: equity prices rose and the yen fell. Short-term market rates declined by about 1/4 percentage point, reflecting the decline in the call rate, while long-term bond yields rose to around 3 percent, resulting in a steepening in the yield curve through early September.

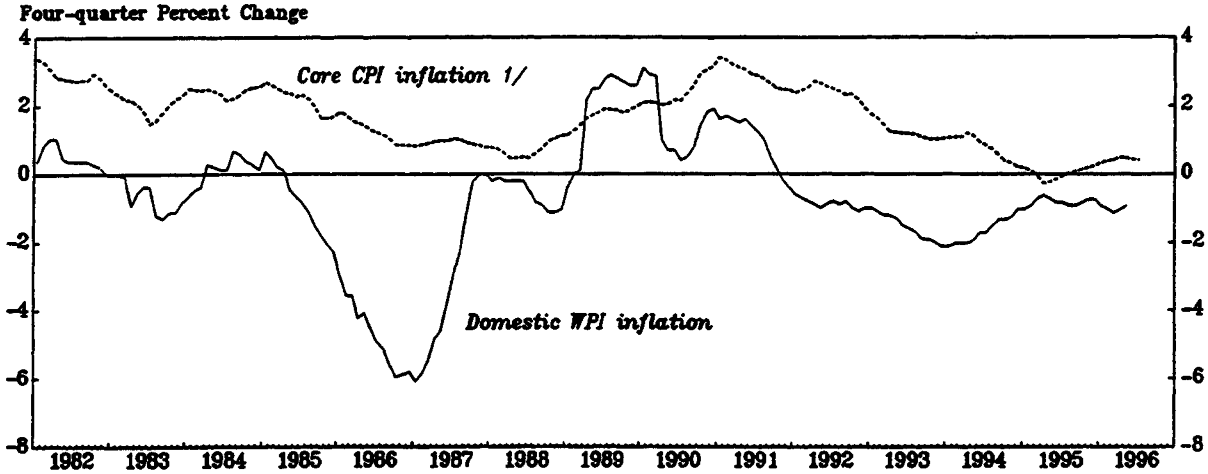
In early September, the BOJ cut the ODR to 1/2 percent and guided down the call rate to around 0.4 percent. Other short-term market rates have been broadly stable since September, although they rose briefly in late February as markets interpreted remarks by Finance Minister Kubo as a signal of imminent tightening. In late April, amid signs of strengthening activity, the market reacted nervously to the BOJ's public comments regarding its future policy stance--long-term yields jumped by around 20 basis points to around 3.4 percent. These expectations of tightening faded in mid-May, and bond yields fell back, following the Governor's statement that the BOJ still needed to "provide necessary support through monetary policies to ensure the continuation of the ongoing recovery." Overall, long-term yields have risen by about 50 basis points since September, reflecting a pick-up in growth. These developments have implied a steepening of the yield curve, as the differential between the 10-year government bond rate and the 3-month CD rate has widened from 2 1/4 percent in September 1995 to 2 3/4 percent in June 1996.

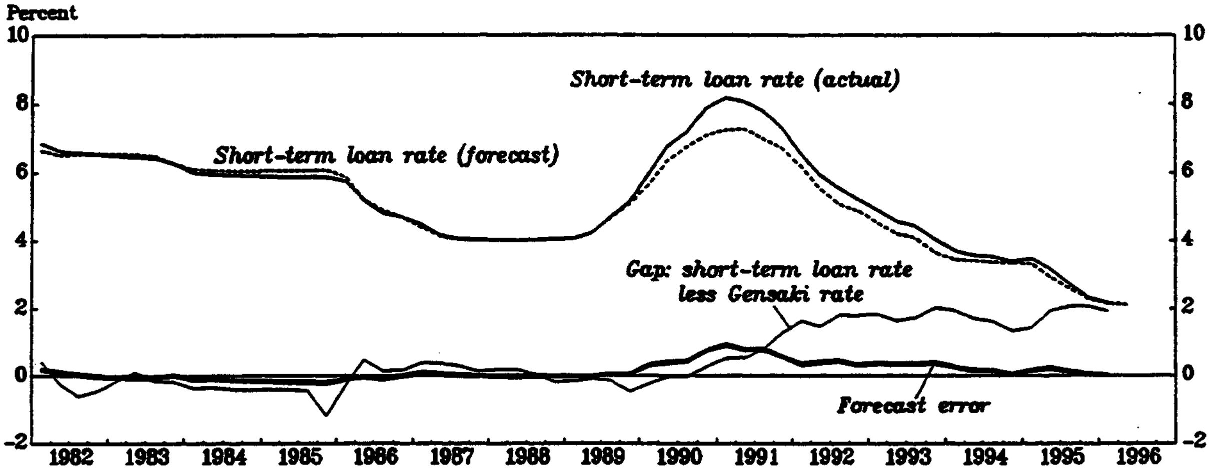
Overall, since the easing of monetary policy began in 1991, the ODR has been cut by 5 1/2 percentage points; short-term market rates have dropped by over 7 percentage points; and bond yields have fallen by over 3 percentage points. While declines in nominal interest rates have done much to cushion the weakening in aggregate demand, part of their impact on monetary conditions has been offset by declining inflation. As shown in Panel 1 of Chart 10, "core" CPI inflation (excluding fresh food and energy) has dropped from over 3 percent in early 1991 to about 1/4 percent recently, while the domestic wholesale price inflation has fallen from 1 1/2 percent in early

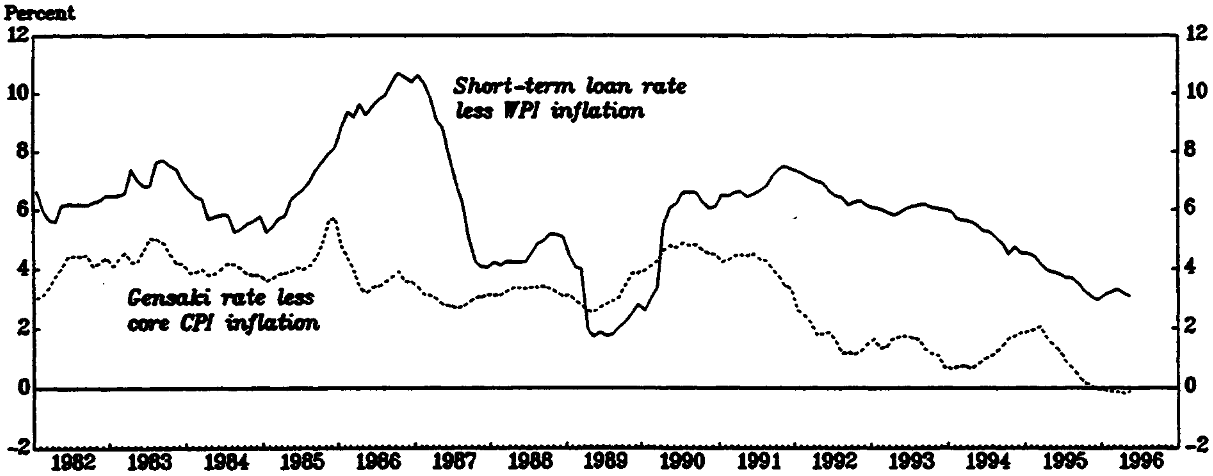
CHART 10

JAPAN

FACTORS AFFECTING SHORT-TERM REAL INTEREST RATES, 1982-95







Source: Bank of Japan, Economic Statistics Monthly; and staff estimates.
1/ Excluding fresh food, energy, and the effect of the rise in consumption taxes in 1989.

1991 to about minus 1 percent in early 1996. 1/ Thus, real interest rates have declined by considerably less than the decline in nominal interest rates would suggest.

Another factor acting to moderate the effective easing in monetary conditions has been widening bank intermediation spreads. As indicated in Panel 2 of Chart 10, the gap between the average short-term bank loan rate and short-term market rates increased to about 2 percentage points in late 1995. 2/ Previous work on Japan has explored the extent to which the widening of intermediation spreads could be attributed to normal lags in the adjustment of average lending rates to market rates versus other factors. 3/ It was claimed that the widening spreads in 1990 and 1991 could be attributed to banks' efforts to raise their operating profits to offset losses on nonperforming loans and to prepare to meet BIS capital-adequacy ratios. Using the same framework, it is shown that the effect of these factors declined through late 1994. While there was a modest rise in the forecast error in the first half of 1995, by early 1996 the spreads had returned to levels that could be explained by "normal" cyclical factors (Chart 10, Panel 2). In contrast, the *Tankan* index shows that businesses perceive that banks' have become increasingly willing to lend since the onset of the recession, particularly to large manufacturers (Chart 11).

In addition, the appreciation of the yen between mid-1992 and mid-1995 played a key role in offsetting the effect of lower interest rates on monetary conditions. The extent to which the contractionary effect on

---

1/ The true offset is likely greater, given indications that the CPI may overstate current inflation.

2/ A similar widening is observed in the spread on overall bank loans, and in the spread between average new loans and market interest rates.

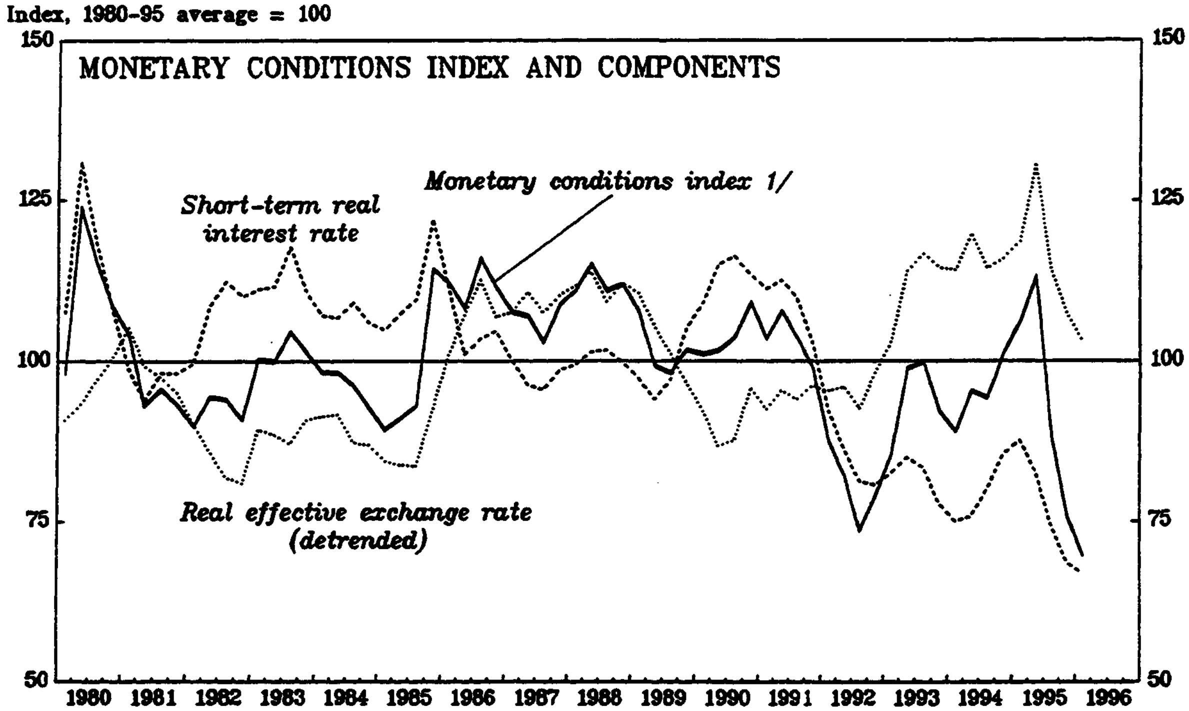
3/ In Chapter III of "Japan--Recent Economic Developments" (SM/94/185), an equation was estimated relating the average short-term lending rate to the call money rate and the ODR. Using quarterly data for 1980-89, the results indicated that the average lending rate responds strongly to changes in the ODR in the short-run, and is determined over the longer term by past levels of the call rate. The equation was resimulated for 1990-96. The results, presented in Panel 2 of Chart 10, show that the forecast error increased through early 1991 and then declined through late 1994. After widening again through mid-1995, the forecast error has narrowed.

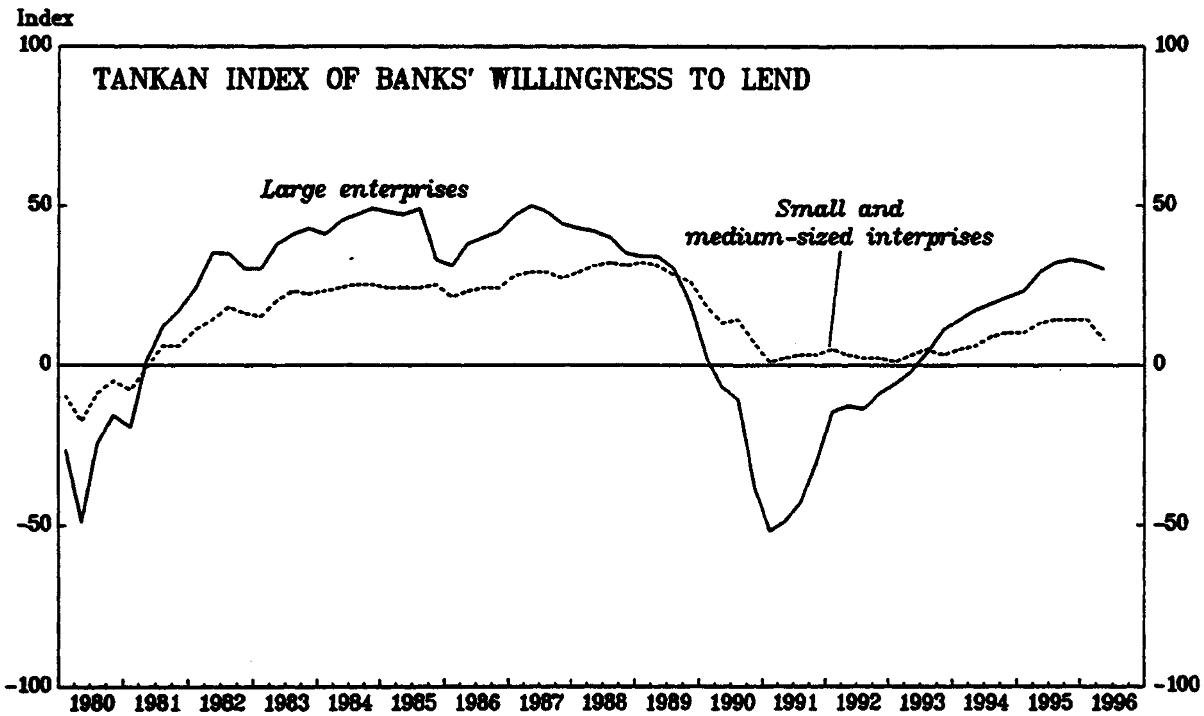
CHART 11

JAPAN

ALTERNATIVE MEASURES OF MONETARY CONDITIONS, 1980-96

(Percent)





Source: Nikkei Telecom; and staff estimates.
1/ An increase indicates a tightening of monetary conditions.

external demand of a rise in the yen has countered the stimulative impact of lower interest rates on domestic demand can be assessed by using the staff's monetary conditions index (MCI) (Chart 11). 1/ Empirical work suggests that a 1 percentage point rise in the real interest rate reduces aggregate demand by 1 percent over time, as does a 10 percent appreciation of the real exchange rate. Chart 11 indicates that monetary conditions eased from mid-1991 to mid-1992, reflecting a drop in real interest rates and a broadly stable real exchange rate. From mid-1992 through mid-1995, the MCI tightened sharply--by around 4 percentage points in terms of aggregate demand--reflecting the effect of the yen. The fall in the yen since mid-1995 has reinforced the easing in interest rates, resulting in the easiest monetary conditions since the onset of the recession.

2. Monetary aggregates

Growth in broadly defined measures of money and liquidity has stabilized, or in some cases, picked up from the trough in late 1992 (see following tabulation and Chart 12). While growth in broad money (M3) has continued to be stable in the range of 3 1/2 to 4 1/2 percent since 1992, declines in interest rates have led to shifts in deposits to more liquid categories and cash. In the case of M2+CDs, the aggregate most closely watched by the BOJ, growth increased steadily from late 1992, levelling off at around 3 percent in 1995. Combined with declines in interest rates from early 1995, the effect on financial wealth of the recovery in equity prices since mid-1995 may have further contributed to the rise in demand for liquid assets. As a result, growth in M1 has accelerated sharply, from an average rate of around 5 percent in early 1995, to over 15 percent recently. The shift in deposits from the banking sector to the postal savings system has continued unabated since 1991, with the share of postal savings deposits to bank deposits reaching around 45 percent recently (Chart 12, Panel 3). 2/

On the asset side, growth in domestic credit and bank lending fell through mid-1994, before stagnating in 1994 (Chart 12). Since late 1994, however, growth in domestic credit and bank lending has risen steadily by around 2 1/2 percentage points, stabilizing at around 2 percent in late 1995. While growth in domestic credit has picked up substantially, banks have continued to match increases in deposit liabilities, in part, with decreases in short-term foreign liabilities.

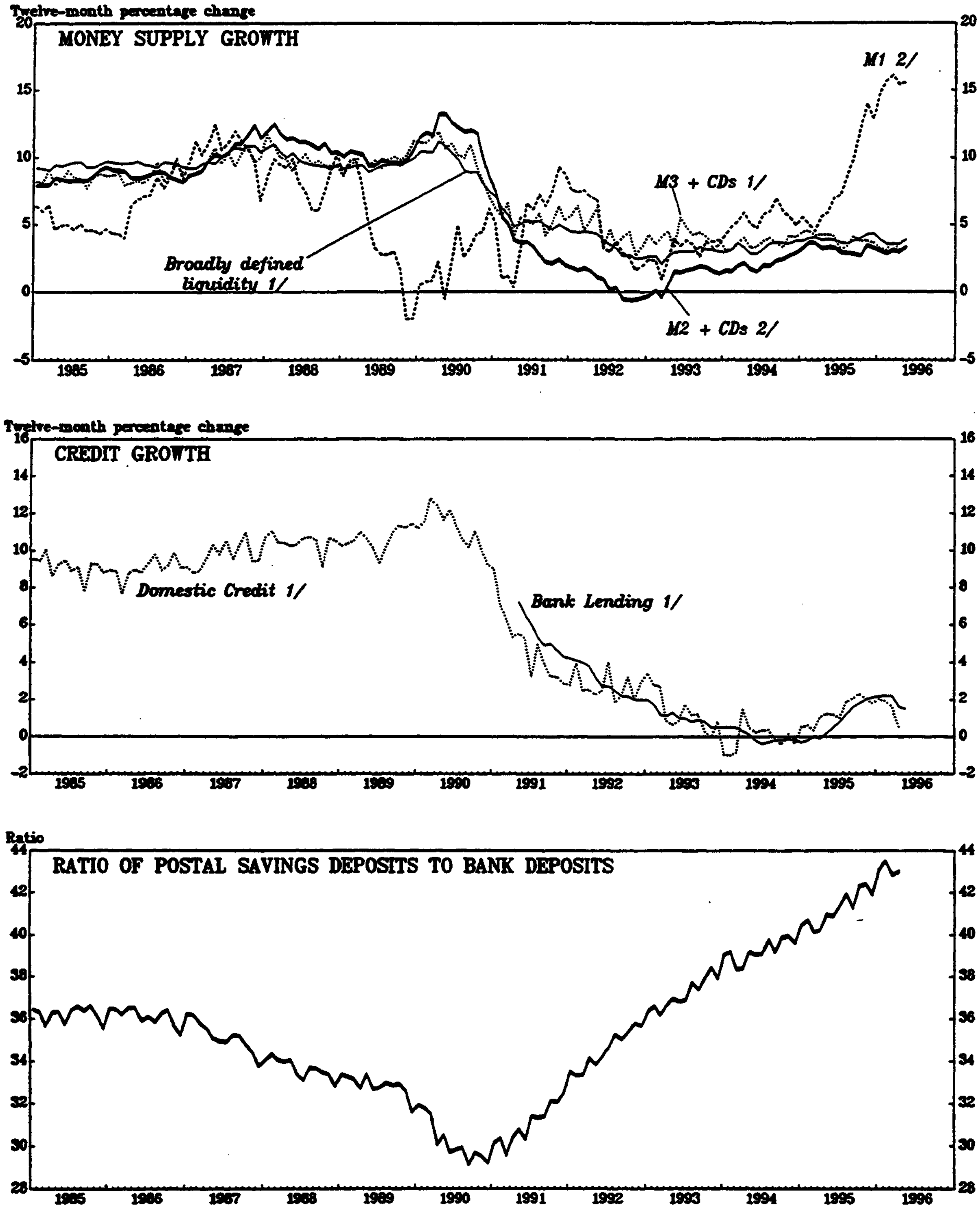
1/ The background paper, "The Monetary Conditions Index: A Reexamination" explores extensions to previous MCI analysis. A broader index, the "financial conditions index" (FCI) is constructed that includes the impact on aggregate demand of changes in equity prices and fiscal policy.

2/ The postal savings system is examined in greater detail in Chapter V of the background papers.

CHART 12

JAPAN

MONEY, CREDIT AND POSTAL SAVINGS, 1985-96



Source: Bank of Japan, Economic Statistics Monthly; and staff calculations.
1/ End-period.
2/ Period average.

	1980-86 Average	1987-90 Average	1991	1992	1993	1994	1995	1996 Q1
			(Percent change over the previous year)					
M1 1/	4.6	6.4	5.2	4.5	3.0	5.4	8.2	15.5
M2 + CDs 1/	8.4	10.8	3.6	0.6	1.1	2.1	3.2	3.0
M3 2/	9.0	9.4	5.3	3.4	3.9	4.0	3.6	3.6
Postal savings 1/	11.4	6.1	7.0	12.4	8.9	7.8	7.9	8.0
Broad liquidity 1/	10.0	9.7	5.3	3.5	2.9	3.3	3.9	3.7
Domestic credit 2/	8.7	10.2	2.9	2.9	0.8	-0.4	1.8	1.6
Bank lending	10.7	10.2	4.3	2.0	0.5	-0.2	2.1	2.2

1/ Period-average data.
2/ End-period data.

V. External Developments

1. Current account

Having declined steadily during the late 1980s, Japan's current account surplus rose sharply in 1991-92, both in nominal terms and as a proportion of GDP (Table 9 and Chart 13). 1/ In 1993 the surplus increased further in nominal terms, reaching a record high of ¥14.7 trillion ($132 billion), though it remained relatively stable as a proportion of GDP at 3 percent. During 1994-95, the surplus began to decline, with this process accelerating sharply during 1995. The surplus continued to drop rapidly in 1996, falling to 1 1/4 percent of GDP in the first quarter--well below the peak of 4 1/4 percent reached in 1986.

As discussed in Chapter VI of the Background Papers, historical movements in Japan's external surplus are well explained by movements in the yen, cyclical factors affecting domestic and external activity, and changes in world oil and commodity prices. The marked decline in the surplus in the late 1980s followed the sharp appreciation of the yen in 1985-87 which (with a lag) checked export volume growth, while encouraging imports (Charts 13 and 14). The decline was given added impetus by the extraordinary growth of domestic demand during the ensuing "bubble" period, leading to a rapid

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1/ Starting this year, Japanese balance of payments statistics have been compiled in yen according to the fifth edition of the IMF's Balance of Payments Manual. Historical data on this basis have been constructed going back to 1991.

Table 9. Japan: Current Account Summary, 1991-96

(100 Billions of yen)

	1991	1992	1993	1994	1995	1995 I	1995 II	1995 III	1995 IV	1996 I
Current account balance 1/	91.8	142.3	146.7	133.4	103.9	29.6	27.8	24.2	22.2	18.4
Trade balance 2/	129.2	157.8	154.8	147.3	123.4	33.0	31.9	29.8	28.7	23.7
Exports	414.7	420.8	391.6	393.5	402.6	99.9	97.8	99.9	105.0	109.8
Imports	285.4	263.1	236.8	246.2	279.2	66.9	65.9	70.1	76.3	86.1
Services 3/	-56.3	-55.7	-47.8	-49.0	-53.9	-12.8	-12.4	-13.9	-14.8	-15.9
Travel	-27.6	-29.4	-25.8	-27.8	-31.6	-7.3	-6.7	-8.9	-8.7	-8.7
Receipts	4.6	4.5	3.9	3.6	3.0	0.6	0.6	0.8	1.0	0.9
Payments	32.2	34.0	29.8	31.3	34.6	7.9	7.3	9.7	9.7	9.6
Transportation	-11.9	-11.0	-11.0	-11.6	-12.6	-3.1	-3.0	-3.5	-3.0	-3.6
Receipts	23.6	23.4	21.0	20.7	21.2	5.0	4.4	5.6	6.1	5.6
Payments	35.6	34.4	32.1	32.3	33.8	8.1	7.4	9.1	9.1	9.3
Other	-16.8	-15.3	-11.0	-9.6	-9.7	-2.4	-2.8	-1.5	-3.1	-3.8
Receipts	32.1	34.2	34.2	35.3	37.3	9.3	7.7	9.8	10.5	11.7
Payments	48.8	49.5	45.2	44.9	47.0	11.6	10.5	11.3	13.6	15.5
Income 3/	35.0	45.1	45.3	41.3	41.6	11.3	9.6	10.5	10.2	13.6
Investment	36.0	46.1	46.2	42.0	42.2	11.4	9.7	10.6	10.5	13.6
Labor	-1.1	-1.0	-0.9	-0.7	-0.6	-0.1	-0.2	-0.1	-0.2	0.0
Net transfers 3/	-16.1	-4.8	-5.7	-6.2	-7.3	-1.9	-1.3	-2.1	-1.9	-3.0
Public	-14.6	-2.6	-2.7	-2.9	-3.1	-0.9	-0.4	-0.7	-1.1	-0.7
Private	-1.6	-2.2	-3.0	-3.3	-4.1	-1.0	-0.9	-1.4	-0.8	-2.3
Memorandum items:										
Current account, SA 4/	80.6	141.2	147.4	132.9	104.1	28.1	25.6	27.3	23.2	16.4
Current account, NSA 3/	91.8	142.3	146.7	133.4	103.9	29.3	25.9	25.6	23.1	20.1
Current account/GDP	2.0	3.0	3.1	2.8	2.2	2.4	2.1	2.3	1.9	1.3
BOP/customs-clearance ratio										
Exports	97.9	97.8	97.4	97.2	96.9	96.0	98.0	98.8	95.3	99.9
Imports	89.5	89.1	88.3	87.6	88.5	86.2	90.2	90.2	87.4	93.2
Average exchange rate (¥/$)	134.7	126.7	111.2	102.2	94.1	96.3	84.4	94.1	101.5	105.8

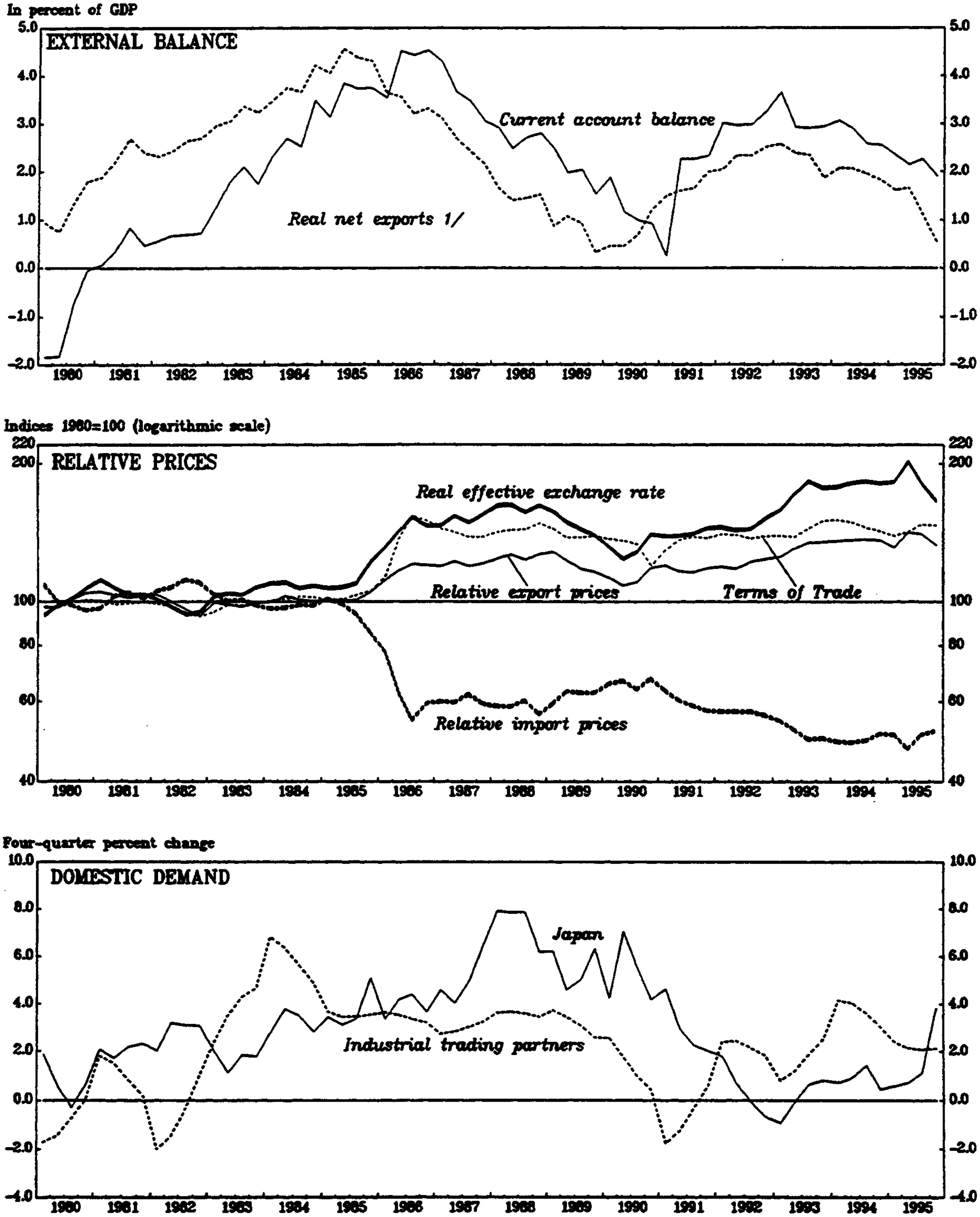
Sources: Bank of Japan, Balance of Payments Monthly; and staff estimates.

1/ Sum of the seasonally adjusted trade balance and the seasonally unadjusted invisibles balance.
2/ Seasonally adjusted.
3/ Seasonally unadjusted.
4/ Official seasonally adjusted current account.

CHART 13

JAPAN

EXTERNAL BALANCE AND ITS DETERMINANTS, 1980-95



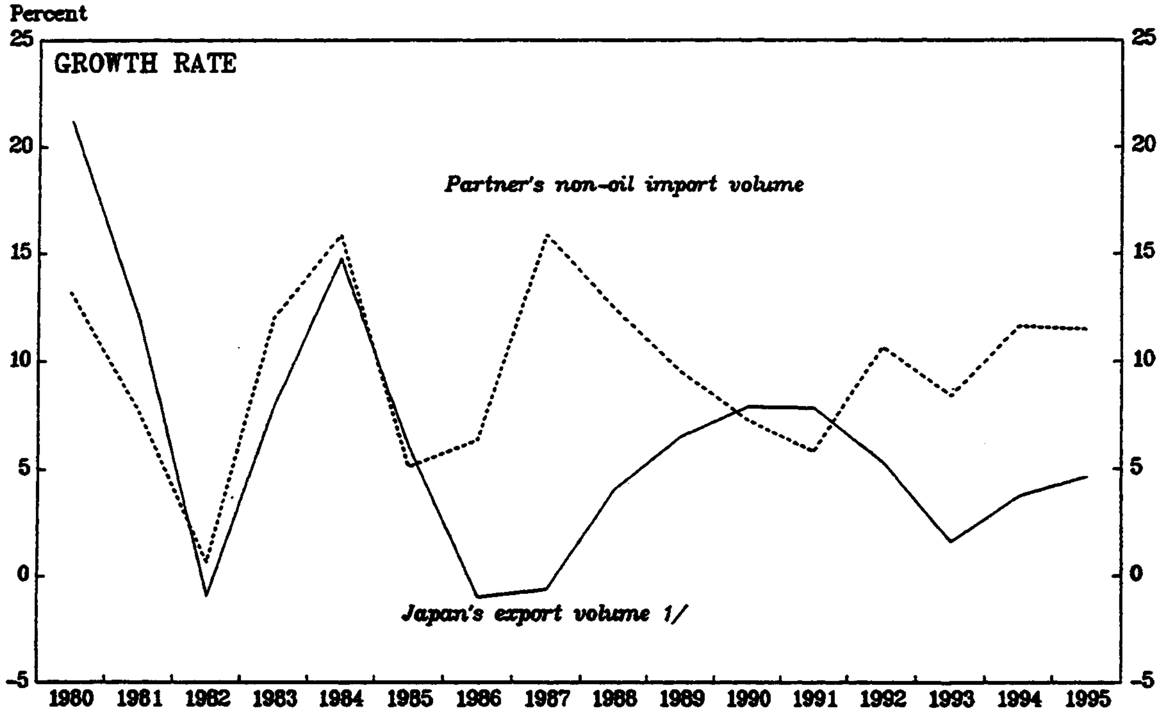
Sources: Economic Planning Agency, National Income Accounts; Bank of Japan, Balance of Payments Monthly; and staff estimates.

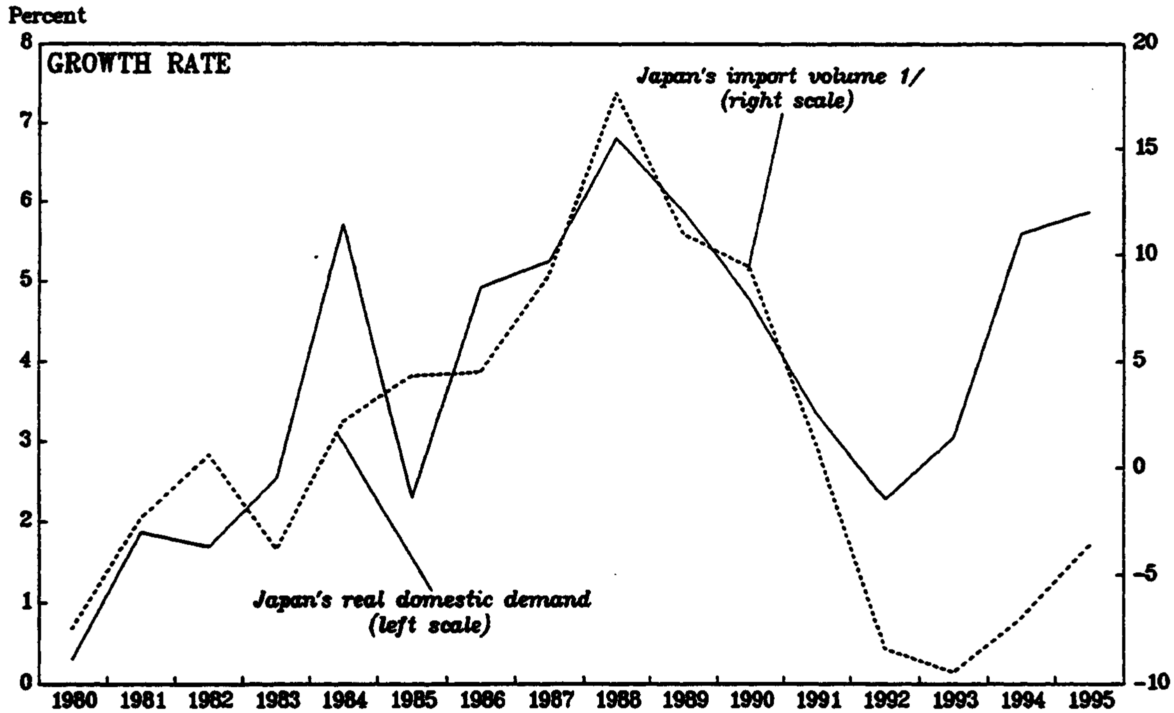
1/ Real net exports of goods and services on a national accounts basis.

CHART 14

JAPAN

TRADE DEVELOPMENTS, 1980-95





Sources: Economic Planning Agency, National Income Accounts; Bank of Japan, Balance of Payments Monthly; and staff estimates.

1/ Value deflated by Bank of Japan price index.

expansion of import volumes. Special factors--in particular large transfer payments related to the crisis in the Middle East in 1990-91--also contributed to the decline in the surplus. The increase in the external surplus during 1991-1993 was caused by differences in cyclical positions--a recession in Japan and a recovery in partner countries, valuation ("J-curve") effects from the yen's appreciation, and a combination of other factors such as lower commodity prices and increased overseas investment income from the accumulation of past surpluses.

The subsequent decline in the surplus during 1994-1995 was associated with a recovery in domestic demand growth, while the yen remained at a relatively appreciated level through mid-1995. The sharp decline in the surplus since mid-1995 is attributable to a variety of factors which acted in concert: (i) the lagged effects of the yen's appreciation through mid-1995 on trade volumes; (ii) J-curve effects from the yen's depreciation since mid-1995; (iii) the further recovery of domestic demand; (iv) a slowing of foreign demand; (v) increases in world oil and commodity prices; and (vi) an acceleration of "structural changes" in trade flows.

While historical movements in Japan's external surplus are well explained by movements in relative prices and income, structural changes in Japanese trade flows have played an important role in the more recent past. These changes encompass a variety of factors, including: the continued relocation of Japanese manufacturing facilities abroad, which have reduced exports from Japan and increased imports from Japanese enterprises abroad; inroads made by foreign manufacturers into the Japanese distribution system, spurred by the large appreciation of the yen through mid-1995 which widened price differentials between Japan and abroad, and increased the incentives for foreign manufacturers to incur the substantial fixed costs of investing in the Japanese distribution system; and shifts in Japanese consumer preferences, partly as a result of the recession, toward lower-priced (imported) goods.

a. Merchandise trade

Merchandise exports rose by 2 1/2 percent in yen terms in 1995, after falling substantially in 1993 by 6 1/2 percent and rising modestly in 1994 by 1/2 a percent (Table 10). Customs clearance data suggest that the increase in 1995 was accounted for by a decline in unit values of 3/4 percent and an increase in export volumes of 3 1/4 percent. Customs data, however, likely understate volume growth. The reason is that in recent years there appears to have been a compositional shift to higher value products--since 1989 the changes in the unit value of exports

Table 10. Japan: Merchandise Trade Prices and Volumes, 1987-96 1/

(Percentage change; Yen basis)

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996 Q1
Exports	-5.6	1.9	11.4	9.6	2.2	1.5	-6.5	0.7	2.6	-1.5
Prices										
Customs clearance unit value	-6.2	-3.3	6.5	3.9	-0.3	-0.0	-4.7	-1.0	-0.7	0.3
Bank of Japan price index	-5.0	-2.3	4.5	2.1	-5.4	-3.6	-8.0	-2.8	-2.2	1.4
Difference	-1.1	-0.9	2.1	1.8	5.1	3.6	3.3	1.8	1.5	-1.1
Volume										
Value deflated by customs-clearance unit value	0.6	5.3	4.6	5.5	2.4	1.6	-2.0	1.7	3.2	-1.9
Value deflated by Bank of Japan price index	-0.6	4.3	6.7	7.3	8.0	5.3	1.6	3.6	4.9	-2.9
Imports	0.9	10.4	20.7	16.8	-5.8	-7.4	-9.1	4.8	12.3	3.2
Prices										
Customs clearance unit value	-7.9	-6.3	11.8	10.7	-9.1	-6.9	-12.3	-8.0	-0.3	6.0
Bank of Japan price index	-8.2	-4.6	7.6	8.7	-8.2	-6.1	-10.4	-5.5	-0.1	3.2
Difference	0.2	-1.7	4.2	2.1	-0.9	-0.8	-2.0	-2.4	-0.2	2.8
Volume										
Value deflated by customs-clearance unit value	9.6	17.9	8.0	5.5	3.7	-0.6	3.6	13.8	12.5	-2.6
Value deflated by Bank of Japan price index	9.8	15.8	12.2	7.5	2.6	-1.4	1.3	10.9	12.3	0.0
Terms of trade										
Based on unit values	1.9	3.3	-4.7	-6.2	9.7	7.4	8.7	7.6	-0.4	-5.3
Based on Bank of Japan price indices	3.4	2.4	-2.9	-6.0	3.1	2.7	2.6	2.9	-2.1	-1.7
Difference	-1.5	0.9	-1.8	-0.2	6.7	4.7	6.1	4.7	1.7	-3.6
Export/import volume										
Based on unit values	-8.2	-10.7	-3.2	-0.0	-1.2	2.2	-5.4	-10.6	-8.3	0.8
Based on Bank of Japan price indices	-9.5	-9.9	-4.9	-0.2	5.2	6.9	0.2	-6.6	-6.7	-2.9
Difference	1.3	-0.8	1.8	0.2	-6.4	-4.7	-5.6	-4.1	-1.6	3.7
Memorandum items:										
World non-oil import volume 2/	15.8	12.5	9.5	7.2	5.8	10.6	8.4	11.6	11.5	2.0
Relative export prices (Japan/world) 3/	1.7	3.5	-0.8	-5.7	10.0	6.5	11.5	6.6	1.8	-1.7
Real domestic demand	5.0	7.4	5.5	5.2	3.0	0.4	0.1	0.9	1.6	3.4
Import price/wholesale price 4/	-4.1	-4.0	10.1	8.6	-9.9	-6.1	-11.8	-5.8	0.8	9.6

Sources: Staff estimates derived from The Summary Report on Trade of Japan, Japan Tariff Association; and WEO.

1/ Annual price and volume figures are constructed as priod averages of underlying monthly data.
2/ Data for trading partners weighted using Japan's export shares.
3/ Japan's export price based on customs-clearance unit value, world export price based on weights using Japan's export shares.
4/ Japan's import price based on customs-clearance unit value.

calculated from customs-clearance data has persistently exceeded that in the fixed-weight export price index published by the Bank of Japan. 1/

Using the Bank of Japan index to deflate nominal exports yields a volume increase of 5 percent in 1995. Export volumes were subject to conflicting effects during the year. During the first half, export volume growth was depressed by the effects of both past and continued yen appreciation, which increased relative Japanese export prices by almost 30 percent between 1990 and mid-1995 (Chart 13, second panel). During the latter half of the year, as the yen declined sharply, relative Japanese export prices fell by 12 percent, which tended to boost export volumes. The depreciation of the yen coincided, however, with a slowing in partner country activity, depressing exports. Export prices (measured by the Bank of Japan index), continuing their sustained decline since 1991, fell by 2 1/4 percent during 1995. The decline was, however, concentrated in the first half of the year, and during the second half of the year, as the yen fell, export prices rose. 2/

Following sustained declines in the value of imports between 1991-93, and relatively modest growth of 5 percent in 1994, merchandise imports on a customs clearance basis rose by 12 percent in 1995. The increase was accounted for entirely by an increase in import volumes (measured using the fixed-weight Bank of Japan index), while the (average) appreciation of the exchange rate over the year offset substantial increases in foreign (dollar) prices, and yen import prices were unchanged. 3/ The strong growth in

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1/ There are a number of measurement issues in interpreting the differences in trade prices measured by unit values and by fixed-weight indices. Unit values are calculated as Fisher indices, whereas the fixed-weight series are Laspeyres indices. The fixed-weight export price index uses data for 184 items, compared with 1,650 in the unit value. Since unit values are based on prices in customs declarations, and fixed-weight indices use contract data, there is also a timing difference. Finally, the exchange rates incorporated in the two indices are slightly different. Thus, the interpretation that the differences in the two series of trade prices represent a compositional shift, while plausible, is not conclusive.

2/ This is consistent with the empirical evidence that Japanese exporters price-to-market in the short run, while over the long run there is a tendency for export prices to decline secularly relative to domestic costs in the overall manufacturing sector. See Chapter VI of the background papers.

3/ The change in the customs clearance import unit value has systematically fallen short of the change in the fixed-weight import price index published by the Bank of Japan during 1991-1995, with substantial differences in 1993 and 1994. This suggests a shift in the composition of imports toward lower-value items. This contrasts with developments in 1989-90 when there was a substantial difference in the other direction, possibly reflecting a compositional shift in imports toward luxury goods in the final years of the "bubble" period.

import volumes during 1995 was led by the growth of imports of manufactures which grew by over 20 percent, while volumes of other components of imports--food, raw materials and mineral fuel--grew more modestly by 1-2 percent. The factors behind the continued strong growth of manufactured import volumes have already been noted above--the decline in the relative price of imports (of manufactures by over 30 percent between 1990 and mid-1995); the outsourcing of Japanese manufacturing; changes in the distribution system; and the recovery in domestic demand. The relatively unchanged level of aggregate import prices for the year as a whole masks the sharp movements during the year, with import prices falling sharply as the yen appreciated during the second quarter of the year, and then recovering during the latter half of the year as it depreciated.

b. Regional trade flows

Southeast Asia has continued to grow in importance as a destination for Japan's exports and as a source for its imports. The growth of Japan's exports to Southeast Asia has consistently outpaced the overall increase in exports owing to continued strong growth in the region and the relocation and outsourcing of Japanese manufacturing facilities to the region, which has boosted exports of capital and intermediate goods (Table 11). The relocation of Japanese manufacturing subsidiaries to Southeast Asia has boosted the steady growth of imports from the region. Traditionally, Japan has had trade surpluses with the Southeast Asian countries as a group, and with export growth outpacing import growth, this surplus continued to increase. During 1995, reversing the established pattern, import growth from the region exceeded the growth of exports to the region. The outsourcing of production has had conflicting effects on the trade balance. On the one hand, there was an 'export-inducing' effect as the relocation of manufacturing facilities abroad boosted exports of capital and intermediate goods. On the other hand, as production facilities abroad came on line, there was an increase in imports of finished goods. The sharp increase in imports from Southeast Asia in 1995, which exceeded the growth of exports, suggests that the latter effect has begun to dominate. The combined surplus with these countries, at ¥7.9 trillion in 1995, has, for the fourth consecutive year, continued to represent Japan's largest bilateral regional surplus.

After rising gradually during 1991-1994 to reach a peak of ¥5.6 trillion in 1994, the surplus with the United States fell sharply in 1995 to ¥4.3 trillion. The increase in the bilateral surplus during 1991-94 was driven largely by differences in cyclical positions--a recovery in the United States and a downturn in Japan. The sharp fall-off in the surplus during 1995 reflected both a notable decline in exports, which fell by 6 percent, and a steep increase in imports, which rose by 10 percent. While the recovery of activity in Japan during 1995 played a role in increasing imports and reducing the surplus, other factors, particularly the outsourcing of Japanese automobiles and autoparts production following the frictions in the sector last summer, appear to have played a role in

Table 11. Japan: Regional Trade Flows, 1990-1996

(In 100 billions of yen; customs clearance basis)

	1990	1991	1992	1993	1994	1995	1996 Q1
United States							
Exports	130.6	123.2	121.2	117.4	120.4	113.3	29.6
(percent change)	(1.9)	(-5.6)	(-1.6)	(-3.2)	(2.6)	(-5.8)	(0.7)
Imports	75.9	71.9	66.2	61.6	64.2	70.8	20.9
(percent change)	(14.4)	(-5.2)	(-7.9)	(-6.9)	(4.2)	(10.1)	(25.7)
Balance	54.7	51.3	55.0	55.7	56.1	42.6	8.7
Europen Union							
Exports	77.3	79.7	79.2	63.2	58.9	66.0	17.5
(percent change)	(17.6)	(3.0)	(-0.6)	(-20.2)	(-6.8)	(12.0)	(6.4)
Imports	50.7	42.8	39.6	33.6	36.2	45.8	12.7
(percent change)	(31.0)	(-15.5)	(-7.5)	(-15.2)	(7.8)	(26.4)	(15.7)
Balance	26.6	36.9	39.6	29.6	22.7	20.2	4.8
Other industrial countries							
Exports	35.8	33.8	32.2	27.2	26.1	20.0	5.1
(percent change)	(1.5)	(-5.6)	(-4.6)	(-15.7)	(-3.8)	(-23.7)	(-2.6)
Imports	45.7	42.3	38.2	33.9	35.0	33.5	8.7
(percent change)	(8.7)	(-7.4)	(-9.8)	(-11.2)	(3.4)	(-4.4)	(6.6)
Balance	-9.9	-8.5	-5.9	-6.7	-8.9	-13.6	-3.6
Southeast Asia							
Exports	119.4	129.6	132.2	130.6	141.5	159.1	40.9
(percent change)	(18.0)	(8.5)	(2.0)	(-1.2)	(8.4)	(12.4)	(10.7)
Imports	78.7	79.3	72.9	67.5	69.4	79.8	23.0
(percent change)	(8.3)	(0.7)	(-8.1)	(-7.4)	(2.9)	(15.0)	(23.8)
Balance	40.7	50.3	59.3	63.1	72.1	79.2	17.9
Other developing countries							
Exports	51.4	57.3	65.3	63.8	58.1	57.0	14.5
(percent change)	(7.5)	(11.3)	(14.0)	(-2.3)	(-8.9)	(-1.9)	(2.1)
Imports	87.6	82.7	78.4	71.7	76.1	85.6	24.0
(percent change)	(25.0)	(-5.6)	(-5.2)	(-8.6)	(6.2)	(12.5)	(14.5)
Balance	-36.1	-25.4	-13.1	-7.9	-18.0	-28.6	-9.5
Total							
Exports	414.6	423.6	430.1	402.0	405.0	415.3	107.6
(percent change)	(9.6)	(2.2)	(1.5)	(-6.5)	(0.7)	(2.6)	(5.3)
Imports	338.6	319.0	295.3	268.3	281.0	315.5	89.3
(percent change)	(16.8)	(-5.8)	(-7.4)	(-9.1)	(4.8)	(12.3)	(18.6)
Balance	76.0	104.6	134.8	133.8	123.9	99.8	18.3

Source: Bank of Japan, Balance of Payments Montyhly.

reducing exports and increasing imports. The share of Japan's total surplus represented by trade with the United States has declined from 72 percent in 1990 to around 43 percent recently. The United States remains Japan's single most important trading partner, with a share in exports of 27 percent and in imports of 22 percent in 1995.

Japan's trade surplus with the European Union, which peaked in 1992, continued to decline in 1995. In contrast to 1993-94, however, both exports and imports rose in 1995. With imports rising much more robustly than exports, however, the bilateral surplus continued to decline.

c. Services and income accounts

The services deficit narrowed steadily until 1993, as payments for travel and 'other' services declined, and then widened again (Table 9). The widening of the services deficit since 1993 reflected increased payments for travel, as increasing numbers of Japanese travelled abroad, encouraged by the strong yen, the beginning of economic recovery at home, and the opening of the Kansai airport. 1/

The surplus on investment income, reflecting returns on the continued accumulation of net foreign assets from the surplus on the current account, has grown over the years. Reflecting variations in the rates of return and exchange rate changes, however, the surplus has fluctuated. After rising sharply from ¥3.6 trillion in 1991 to ¥4.6 trillion in 1992, it remained relatively steady in 1993, then fell in 1994 and remained at this level in 1995. During 1995 an increase in the dollar value of investment income was offset by the appreciation of the yen during the year, leaving the yen value of the surplus unchanged.

2. Capital account

a. Overview of capital flows

After peaking in 1992 at ¥12.9 trillion, net outflows of capital from Japan declined steadily during the following years, and the deficit on the capital and financial account fell to ¥6.3 trillion in 1995 (Table 12). 2/ While outflows from Japanese residents continued, and some categories of outflows increased, these were offset by substantial portfolio and other

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1/ The opening up of the Kansai airport appears to have alleviated a bottleneck on foreign travel, as the only previous major international airport, Narita, had been running at or above capacity.

2/ Starting this year, statistics on Japanese capital and financial account transactions have been compiled according to the fifth edition of the IMF's Balance of Payments Manual. The financial account, which covers the majority of such transactions, is comprised of: direct investment flows; portfolio investment flows; and 'other' investment flows.

Table 12. Japan: Capital and Financial Account Summary, 1991-96

(100 Billions of Yen, not seasonally adjusted)

	1991	1992	1993	1994	1995	1995 I	1995 II	1995 III	1995 IV	1996 I
CURRENT ACCOUNT BALANCE	91.8	142.3	146.7	133.4	103.9	29.3	25.9	25.6	23.1	20.1
CAPITAL AND FINANCIAL ACCOUNT	-92.7	-129.2	-117.0	-89.9	-62.8	-26.8	-17.2	6.2	-24.9	15.3
Capital account	-1.6	-1.6	-1.6	-1.9	-2.1	-1.0	-0.1	-0.6	-0.4	-1.7
Total credit	--	--	--	--	0.0	0.0	--	--	--	0.3
Total debit	1.6	1.6	1.6	1.9	2.2	1.0	0.1	0.6	0.4	2.0
Financial Account	-91.0	-127.5	-115.4	-88.0	-60.6	-25.8	-17.1	6.8	-24.5	17.0
Direct investment	-40.9	-18.4	-15.2	-17.6	-21.2	-5.3	-5.1	-2.8	-7.9	-6.0
Direct investment abroad	-42.6	-21.9	-15.5	-18.5	-21.3	-5.3	-5.2	-2.8	-8.0	-5.9
Equity capital	-36.7	-22.4	-16.7	-16.9	-22.1	-5.6	-4.2	-4.6	-7.7	-5.1
Other capital	-5.9	0.4	1.2	-1.6	0.8	0.3	-1.0	1.9	-0.3	-0.7
Direct investment in Japan	1.7	3.5	0.2	0.9	0.0	-0.0	0.1	-0.1	0.1	-0.1
Equity capital	1.3	2.8	0.1	0.7	0.3	-0.1	0.1	0.1	0.2	-0.0
Other capital	0.4	0.7	0.2	0.2	-0.3	0.0	-0.0	-0.2	-0.1	-0.3
Portfolio investment	60.2	-33.4	-77.6	-23.7	-30.8	10.2	-31.9	-5.9	-3.2	-18.9
Assets	-109.9	-43.4	-69.6	-92.0	-80.0	7.9	-35.6	-22.0	-30.4	-14.8
Equity securities	-4.9	3.9	-16.4	-14.1	0.1	3.8	-1.4	1.1	-3.4	4.5
Debt securities	-105.0	-47.3	-53.1	-77.9	-80.1	4.1	-34.2	-23.1	-27.0	-19.4
Bond and notes	-95.4	-45.9	-40.0	-70.0	-84.8	-5.8	-33.6	-22.3	-23.1	-14.6
Money market instrument	-9.5	-0.6	-12.5	-8.3	5.8	9.7	-0.3	-0.3	-3.2	-0.6
Financial deriv.	-0.1	-0.8	-0.5	0.4	-1.1	0.3	-0.3	-0.5	-0.6	-4.2
Liabilities	170.1	10.0	-8.1	68.4	49.3	2.3	3.8	16.0	27.2	-4.1
Equity securities	62.7	11.4	21.9	52.0	48.1	3.5	5.3	25.9	13.4	26.3
Debt securities	107.5	-1.4	-30.0	16.4	1.2	-1.2	-1.5	-9.9	13.8	-30.4
Bond and notes	92.6	-0.6	-34.6	-13.7	-9.2	7.5	-6.2	-12.1	1.6	-13.0
Money market instrument	16.6	1.7	5.2	30.4	18.9	-8.6	7.9	3.2	16.4	-20.7
Financial derivatives	-1.7	-2.5	-0.6	-0.2	-8.5	-0.2	-3.2	-0.9	-4.2	3.3
Other investment	-110.4	-75.7	-22.5	-46.7	-8.6	-30.7	19.9	15.6	-13.4	41.9
Assets	37.3	60.8	18.3	-36.2	-97.9	-24.5	-9.6	-32.9	-30.9	41.3
Trade credits	3.3	5.1	5.8	2.7	2.3	0.1	0.6	-0.5	2.2	1.7
Loans	22.7	74.2	33.2	-10.5	-156.3	-7.9	-34.4	-54.0	-60.0	20.7
Currency & deposits	7.4	-19.0	-16.6	-26.9	37.6	-21.3	21.3	9.9	27.6	18.2
Other assets	3.9	0.5	-4.0	-1.5	18.6	4.6	2.9	11.7	-0.7	0.7
Liabilities	-147.7	-136.5	-40.9	-10.5	89.3	-6.1	29.5	48.5	17.5	0.6
Trade credits	-0.8	0.3	-1.0	-1.6	-0.3	0.5	-0.5	0.3	-0.6	-0.1
Loans	-29.2	-93.6	-11.5	-5.0	97.6	7.1	12.5	53.8	24.0	-5.0
Currency & deposits	-107.9	-47.1	-34.4	-2.0	-0.3	-22.1	26.2	-4.2	-0.2	-1.0
Other assets	-9.8	3.8	6.0	-2.0	-7.7	8.4	-8.8	-1.5	-5.8	6.7
NET ERRORS AND OMISSIONS	-10.5	-12.4	0.3	-17.6	13.1	12.4	4.3	-8.7	5.1	-12.2
RESERVE ASSETS	11.4	-0.8	-30.0	-25.9	-54.2	-14.8	-13.0	-23.1	-3.3	-23.2

Source: Bank of Japan, Balance of Payments Monthly.

investment inflows into Japan from foreign residents. The recorded declines in capital outflows between 1993-95 coincided with considerable exchange market pressures for yen appreciation and, as the Bank of Japan intervened on the foreign exchange market, reserve assets rose during 1993-95 by a cumulative ¥11 trillion ($110 billion).

Outward direct investment declined sharply in 1992 following the bursting of the asset price bubble and, as domestic business conditions and corporate profitability declined, fell further in 1993. As economic activity began to recover, corporate profitability picked up, and the yen rose substantially through mid-1995, outward direct investment flows recovered during 1994-95. Data on a notification basis indicate that the declines in Japanese foreign direct investment in the early 1990s were concentrated in nonmanufacturing (Table 13). The subsequent pickup has been spread somewhat evenly between manufacturing and nonmanufacturing. While the United States remains by far the most important host country for Japanese foreign direct investments, its share has fluctuated. After falling from 48 percent in 1989 to 41 percent in 1992, the share rose to 45 percent during the first half of 1995. The share of Asia, on the other hand, has increased rapidly, rising from 12 percent in 1989 to 23 percent during the first half of 1995. Inward direct investment into Japan has continued to remain very modest, and even these modest levels have declined in recent years.

The portfolio investment account registered a net inflow of ¥6 trillion in 1991 following substantial purchases of Japanese equities and debt securities by foreign residents in the aftermath of the collapse of the asset price bubble (Table 12). With a drop-off in such purchases during the following year, the balance on the portfolio account reverted to a net deficit position in 1992. Net outflows of capital for portfolio investment then accelerated in 1993 as purchases of foreign bonds by Japanese residents rose. Net outflows through portfolio investment then slowed during 1994-95 despite robust outflows from Japanese residents, particularly for purchases of foreign bonds, as foreign residents purchased substantial amounts of Japanese equities and money market instruments.

The 'other investment' account, dominated by movements in bank loans and currency and deposits, persistently registered net outflows during 1991-95. The overall balance on the account, however, and even more so the underlying components, displayed sharp swings during the period. Net outflows on the account fell from ¥11 trillion in 1991 to ¥2.2 trillion in 1993, then rose to ¥4.7 trillion in 1994, before falling back again to ¥9 trillion in 1995. On the asset side, on net, Japanese residents (banks) reduced their loans extended abroad during 1991-93, then increased them modestly in 1994, and then very sharply in 1995--by ¥15.6 trillion. The increase during 1995 was concentrated in the latter half of the year, and conforms with reports that Japanese banks increased lending to their foreign subsidiaries following the imposition of the 'Japan premium' on borrowing by Japanese banks in international interbank markets. On the liability side, foreign residents (banks) reduced their loans to Japanese residents (banks)

Table 13. Japan: Direct Investment by Sector and by Region, FY 1989-FY 1995 1st Half 1/

Fiscal Years	1989	1990	1991	1992	1993	1994	1995 1st Half
				(In billions of U.S. dollars)			
Total	67.5	56.9	41.6	34.1	36.0	41.1	21.7
North America	33.9	27.2	18.8	14.6	15.3	17.8	10.2
(United States)	(32.5)	(26.1)	(18.0)	(13.8)	(14.7)	(17.3)	(9.8)
Europe	14.8	14.3	9.4	7.1	7.9	6.2	2.6
Asia	8.2	7.1	5.9	6.4	6.6	9.7	5.0
Other	10.6	8.3	7.5	6.0	6.0	7.2	3.9
Manufacturing	16.3	15.5	12.3	10.1	11.1	13.8	6.5
United States	8.9	6.4	5.6	3.8	4.0	4.6	1.9
Europe	3.1	4.6	2.7	2.1	2.0	1.9	0.6
Asia	3.2	3.1	3.0	3.0	3.7	5.2	3.2
Nonmanufacturing	51.3	41.4	29.3	24.1	24.9	26.9	14.9
United States	24.3	12.4	12.4	10.0	10.7	12.7	7.9
Europe	11.7	9.7	6.7	5.0	5.9	4.4	2.0
Asia	5.0	4.1	2.9	3.4	2.9	4.2	1.5
				(In percent)			
Memorandum items:							
Shares of total							
United States	48.1	45.9	43.3	40.5	40.9	42.1	45.2
Europe	21.9	25.1	22.6	20.8	22.0	15.1	12.0
Asia	12.1	12.5	14.2	18.8	18.4	23.6	23.0

Source: Ministry of Finance, Zaisei Kinyu Tokei Geppo; and data provided by the Japanese authorities.

1/ On a notified basis, excluding direct real estate purchases (but not investment in the real estate industry).

during 1991-94. In 1995, however, there was a sharp turnaround, with such loans increasing by ¥9.8 trillion.

During 1989-91, as the yen depreciated, the Bank of Japan intervened to support the yen, and reserves fell by ¥1.1 trillion in 1991. Intervention to counter the rapid appreciation of the yen since 1993 prompted successive increases in official reserve assets of ¥3 trillion ($27 billion) in 1993, ¥2.6 trillion ($25 billion) in 1994, ¥5.4 trillion ($58 billion) in 1995, and a further ¥2.3 trillion ($22 billion) in the first quarter of 1996. This brought the stock of official reserves to an historic high--exceeding $210 billion at the end of June 1996.

In the first quarter of 1996, the capital and financial account registered a substantial net inflow. While portfolio investment outflows accelerated, led by sales of Japanese bonds and money market instruments by foreign residents, these were more than offset by 'other investment' inflows, as Japanese residents (banks) reduced loans extended abroad.

b. Capital account liberalization, 1995-96

Partly in response to the appreciation of the yen, over the past year several measures were adopted to deregulate and encourage capital outflows from Japan.

In August 1995 several measures were adopted to increase the incentives for Japanese institutional investors to invest abroad. First, Japanese insurance companies, which had been barred from making loans abroad denominated in foreign currencies, were allowed to do so. Second, they were allowed to lend overseas in yen without, as before, having to syndicate at least half of the value of the credit to other participants. Third, Japanese institutional investors were given access to the primary market for Euroyen bonds launched by nonresident corporate issuers. Previously, in order to protect the Japanese bond market, where yields have been lower, a "seasoning" period of 90 days had been imposed during which only foreign residents could buy the issues. Fourth, accounting restrictions for foreign bonds were made equivalent to those for Japanese government bonds. Previously, Japanese institutional investors had been required to value holdings of foreign bonds, particularly U.S. treasury issues, at cost on their balance sheets, whereas Japanese government bonds could be valued at cost or market value. Fifth, banks with authorized foreign exchange operations were allowed to trade more freely in foreign currency bonds, which they had previously been required to treat as long-term holdings.

In February 1996 measures were announced to liberalize the management and investment of pension funds which had implications for capital flows. For domestic pension funds the restriction that 50 percent of their assets be invested in fixed-income assets such as Japanese government bonds, and no more than 30 percent in stocks, 30 percent in foreign currency denominated securities, and 20 percent in real estate was lifted. In addition, the proportion of corporate pension funds which could be managed by investment

advisory companies--including foreign investment advisory companies operating in Japan--was increased from 33 percent to 50 percent.

Measures were also adopted in February 1996 that directly impacted on potential capital flows. These included: a relaxation of restrictions on foreign currencies held by domestic entities; an easing of the 'two-step' loans system, under which Japanese banks lent money overseas; the lifting of restrictions on yen interest-rate swap trading between Japanese securities houses and nonresidents; a liberalization of settlements of foreign currency denominated transactions among domestic entities which were previously required to be channeled through authorized foreign exchange banks.

c. Flow of funds to developing countries

Over the past decade, Japan has taken several initiatives to stimulate the flow of financial resources to developing countries, with the most recent being the "Funds for Development" initiative for 1993-97, with a target of $120 billion. The program consists of $70 billion in untied official development assistance (ODA) funds (yen loans and subscriptions and contributions to multilateral lending institutions) and $50 billion in non-ODA untied funds (including loans from the Export-Import Bank of Japan and international trade insurance).

In recent years, Japan's total net financial flows to developing countries have fluctuated around $20 billion annually (Table 14). About half of the total has been accounted for by ODA, taking the form of contributions to the multilateral financial institutions and bilateral loans, grants, and technical assistance. Other official loans, including loans by the Export-Import Bank of Japan, have been about 10 percent of the total. The remaining part has originated from the private sector, including loans from commercial banks, direct investment, and commercial bank cofinancing with the Export-Import Bank and with multilateral development institutions.

In response to declines in domestic interest rates, in mid-1995 Japan reduced interest rates on new official loans to developing countries. The changes in interest rates were linked to the borrower's status of development. While interest rates on loans to the least-developed countries remained unchanged at 1 percent, those for low-income countries were lowered from 2.6 to 2.3 percent, those for lower-middle, and upper-middle-income countries were each lowered from 3 percent to 2.7 percent, and for those to high-income countries from 5 to 4 percent. 1/ Loans for environmental projects received an additional 0.2 percentage point subsidy.

1/ The least developed countries were identified as Bangladesh and Nepal, the low-income countries were defined as having per capita income of less than $695, lower-middle-income as $696-1,345, upper-middle-income as $1,346-2,785, and high-income as $2,786 or more.

Table 14. Japan: Net Flow of Financial Resources to Developing Countries and Multilateral Agencies, 1989-94 1/

	1989	1990	1991	1992	1993	1994
			(In billions of U.S. dollars)			
ODA	9.0	9.1	11.0	11.2	11.3	13.2
Bilateral	6.8	6.8	8.9	8.4	8.0	9.6
Multilateral	2.2	2.3	2.1	2.8	3.2	3.7
Other official flows	1.5	3.4	2.6	3.3	3.8	3.2
Private flows	13.5	6.2	11.1	1.5	0.6	11.8
Grants by private voluntary agencies	0.1	0.1	0.2	0.2	0.2	0.2
Total resource flows	24.1	18.7	24.7	16.2	15.9	28.5
			(In percent)			
ODA	0.31	0.31	0.32	0.30	0.27	0.29
Total resource flows	0.83	0.63	0.74	0.44	0.40	0.62

Source: Data provided by the Japanese authorities.

1/ Calendar years, Development Assistance Committee basis.

Japan remains the world's largest provider of nonmilitary aid, accounting for over 20 percent of the total official development assistance supplied by the members of the OECD in 1995. Japan's net disbursements of ODA, after remaining relatively stable at around $11 billion during 1991-93, rose to $13 billion during 1994, while the ODA-to-GNP ratio dropped from a peak of 0.32 percent in 1991 to 0.29 percent in 1994. The FY 1996 ODA budget provides for a 3.5 percent increase (in yen terms) over FY 1995. The target for 1993-97 has been set at $70-75 billion, enhancing Japan's position as the largest donor but implying little change in the ODA-to-GNP ratio; the present ratio is well below the United Nations target of 0.7 percent.

Japan's ODA is well diversified regionally. While Asia receives the bulk of Japan's bilateral aid--with China, India, Indonesia, the Philippines, and Thailand accounting for over 40 percent of the total--Africa, the Middle East, and Latin America are also major recipient areas. Japan is now the leading donor in over 30 countries, not only in Asia but also in parts of Africa. The allocation of Japan's aid is governed by an ODA Charter that was adopted in 1992. The Charter outlines four principles that mandate more stringent conditions for foreign aid. They stipulate that Japan must pay close attention to: environmental concerns; restraint in military expenditures and weapons development; democratization and human rights; and the fostering of market-oriented economies.

3. Exchange rate developments

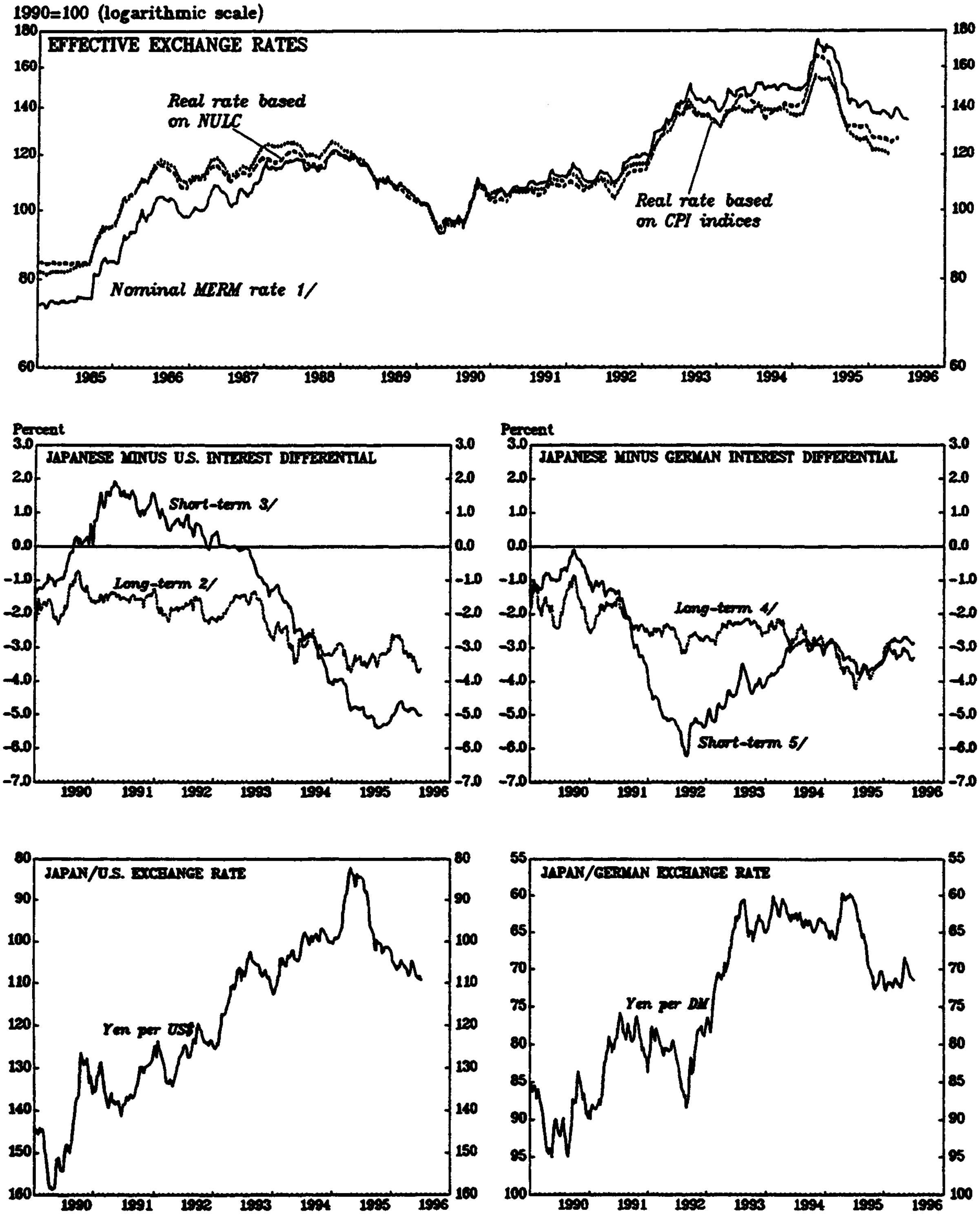
Having depreciated between late 1988 and early 1990, the yen appreciated persistently through mid-1995 (Chart 15). The real effective appreciation (based on consumer price indices) was initially moderate, averaging 5 1/2 percent annually in 1991-92, then accelerated sharply to 18 percent in 1993. After appreciating modestly by a further 4 percent in 1994, the yen strengthened rapidly in the spring of 1995, shooting up by 6 percent in March and another 7 percent in April. From the trough in 1990 to the peak in April 1995, there was a cumulative increase in the real effective value of the yen of 67 percent, taking it to 33 percent above the previous peak in 1988. Starting in July 1995 the yen underwent a rapid reversal, and by September it had fallen below its level at the beginning of the year. After depreciating modestly through the rest of 1995, it fell by a further 4 percent in January 1996, and has continued to depreciate modestly since, falling by a further 2 percent by the beginning of June. By the beginning of June 1996 the yen had fallen, on a real effective basis, from its peak in April 1995, by 22 percent.

Movements of the real effective exchange rate have been driven almost entirely by movements in the nominal effective rate. These in turn have reflected movements in the important bilateral exchange rates of the yen vis-à-vis the U.S. dollar and the deutsche mark. While the movements of the exchange value of the yen against the two currencies have been broadly similar since 1990, there have been some notable differences (Chart 15, bottom two panels). In the most recent period the sharp appreciation and

CHART 15

JAPAN

EXCHANGE RATES AND INTEREST RATE DIFFERENTIALS, 1985-96



Sources: IMF, Information Notice System; and Nikkei Telecom.

1/ Based on IMF MERM rate.

2/ Japan: ten-year government bond rate; United States: ten-year government bond rate.

3/ Japan: three-month CD rate; United States: three-month CD rate.

4/ Japan: ten-year government bond rate; Germany: ten-year government bond rate.

5/ Japan: three-month CD rate; Germany: three-month interbank rate.

subsequent depreciation of the yen during 1995 was much more pronounced against the U.S. dollar than against the deutsche mark.

Several factors have been ascribed important roles in explaining the appreciation of the yen from 1991 to mid-1995: the recession in Japan; the relative stance of monetary policies; portfolio effects reflecting changes in the willingness of Japanese investors to hold foreign exchange assets; and trade frictions and negotiations between the United States and Japan. 1/ While it is likely that they all played some role in affecting the massive appreciation of the yen during this period it is difficult to reconcile the role of most of these factors with the speed and magnitude of the appreciation. With regards to the subsequent depreciation of the yen starting in July 1995, three factors appear to have played key roles. First, the lowering of Japanese call money rates in July 1995, followed by the September cut in the official discount rate, and the continued relatively easy stance of monetary policy since, played a critical role. Second, markets appeared to gradually become convinced of the intent and resolve of the G-7 following their announcement in late April 1995 that there should be an "orderly reversal" of earlier exchange rate movements. Finally, the announcement in early August 1995 of measures to promote capital outflows from Japan, which was supported with aggressive coordinated exchange market intervention, appeared to take markets by surprise, and helped propel the yen down.

VI. Developments in Trade and Structural Policies

1. Trade policy

Over the past year there continued to be significant developments regarding both the multilateral trading environment and bilateral trade issues. While trade frictions with partner countries, particularly the United States, subsided following the resolution of the dispute in the automobiles and parts sector last summer, disputes and discussions in various other areas continued.

a. Multilateral trade issues

Japan has continued to implement its commitments under the Uruguay Round agreement (Table 15). The agreement is affecting, and will continue to affect, Japan's trade in a number of ways: market access for agricultural and industrial goods to Japan is improving; Japanese exporters face a more liberal trading environment; and multilateral trading rules have been extended to new areas, particularly services.

1/ Chapter I of the supplement to last year's Recent Economic Developments paper (SM/95/163) provides a discussion of movements in the yen between 1990 and mid-1995 from a long-run perspective.

Table 15. Japan: Outline of Tariff Changes Under the Uruguay Round

1. Number of Items (Harmonized System 9-digit system)

	Offer
Agricultural products	about 1,500
Wood products	about 140
Fishery products	about 250
Industrial products	about 6,700
Total	about 8,500

2. Tariff Reductions (in percent)

	From agreement base 1/	From applied rate 2/
Agricultural products	36	...
Wood products	50	30
Fishery products	33	29
Industrial products	61	33

3. Average Tariff Rates (in percent) 3/

	Base Rate	Applied Rate in 1993	Applied Rate in 1995	Post Uruguay Round in 2000
Agricultural products	14.5	11.9	11.5	9.3
Wood products	2.0	1.4	1.3	1.0
Fishery products	6.1	5.7	5.4	4.1
Industrial products	3.8	2.2	2.1	1.5

Source: Data provided by the Japanese authorities.

1/ Offer rate relative to the base rate (in 1986-88).
2/ Offer rate relative to the applied rate (in 1993).
3/ Simple average for agricultural products and a trade-weighted average (in 1988) for other products. Newly tariffied products are excluded from agricultural products in the calculation.

In agriculture, the main changes resulting from the Uruguay Round agreement concern market access. 1/ Japan's commitments consist of three elements. First, all agricultural products (except rice) that were previously subject to quotas (27 products on a 4-digit Harmonized System basis, including wheat, barley, dairy products, beans, peanuts, starches, raw silk, and pork), are to be tariffied. Second, tariffs for all agricultural products except rice are to be cut by an average of 36 percent during the 6-year implementation period. This implies a reduction in tariffs from 14.5 to 9.3 percent on a simple average basis (excluding the products to be newly tariffied) (Table 15). Third, while rice was exempted from tariffication, Japan committed to provide minimum access equivalent to 4 percent of domestic consumption in 1995, rising to 8 percent by 2000.

For industrial goods, Japan committed to lowering its tariffs by 61 percent over the six-year implementation period, bringing industrial duties to an average level of 1.5 percent (Table 15)--among the lowest in the world. Duties will be eliminated altogether on 10 product groups (pharmaceuticals, construction equipment, medical equipment, steel, beer, furniture, farm equipment, whiskeys and brandies, pulp and paper, and toys). In line with the Uruguay Round agreement, Japan aims to eliminate all voluntary export restraints (VER) during the four-year period allowed for phasing out grey-area measures, except that on exports of automobiles to the European Union, which is to be eliminated upon expiry in 1999. 2/ Beyond industrial and agricultural goods, Japan committed to a one-half cut in tariffs on wood products and a one-third cut in tariffs on fisheries.

As part of the "initial actions" towards the Asia-Pacific Economic Cooperation (APEC) forum's goal of free trade in the region by 2020, Japan announced in November 1995 a plan to accelerate tariff reduction commitments under the Uruguay round on 697 items. The items included textiles, chemicals, steel and non-ferrous metals. Tariff rates originally scheduled to be applied in January 1998 on these items were applied in April 1996. It is estimated that imports of approximately $10 billion, primarily sourced from the APEC region, would be affected by the accelerated tariff reductions.

In services, Japan's commitments cover more than 100 sectors, including banking, securities, insurance, transport, construction, telecommunications, distribution, legal services, and accounting. While most of Japan's commitments were a codification of existing policies, there were important additional commitments, especially in financial services (pension funds and insurance).

1/ A more detailed review of Japan's commitments in agriculture in the Uruguay round agreement are reviewed in a chapter of the supplement to last year's paper (SM/95/163).

2/ The VER for auto exports to the United States, which had been in effect for 13 years, expired on April 1, 1994.

b. Bilateral trade issues with the United States

A key goal of the Framework Agreement, announced in July 1993, was to increase access and sales of competitive foreign goods and services through market-opening and macroeconomic measures. The framework talks covered structural and sectoral issues as well as macroeconomic policies. For its part, Japan pledged to pursue strong and sustainable domestic demand-led growth and increase market access, with a view to achieving, over the medium term, a "highly significant" decrease in its current account surplus and a significant increase in its imports of goods and services.

There were initially four priority areas in the sectoral and structural discussions under the Framework Agreement--government procurement, particularly in the areas of medical equipment and telecommunications; automobiles and parts; insurance; and the promotion of competition and competitiveness. The assessment of the implementation of measures and policies were to be based on sets of "objective criteria," either qualitative or quantitative, or both, as appropriate. Progress under the agreement, scheduled to be in force initially for two years, was to be reviewed at biannual meetings of the heads of the two governments. A major hindrance to resolution of the sectoral issues was the interpretation of what constituted "objective criteria", with the Japanese contending on several occasions that many of the U.S. demands were tantamount to numerical targets for imports and managed trade.

A number of agreements were reached. In end-September 1994 agreements were reached on the procurement of telecommunications and medical equipment by the Japanese government and its agencies, on foreign access to the Japanese insurance market, and an "understanding" on increased foreign access to the Japanese flat-glass market that was later made more specific. In January 1995, agreement was reached providing greater foreign access to Japan's financial services market. Finally, in the automobiles and automobile parts sector, against the backdrop of a U.S. deadline to impose punitive tariffs on the imports of luxury models of Japanese cars, and the filing of a complaint by Japan against the imposition of such sanctions with the WTO, an agreement was reached in June 1995. These agreements are described in detail in last year's Recent Economic Developments paper. 1/

During the summer of 1995, Japan refused to grant approval of additional new routes for U.S. air-cargo carriers through Japan to other Asian destinations. The U.S. government argued that under the existing bilateral aviation treaty, the approval of new routes should have been automatic. The government of Japan argued that the aviation accord, signed in 1952, before Japan had its own international airlines, was biased in favor of U.S. carriers, and needed to be renegotiated. In the event, an accord was reached in April this year that expanded the number of carriers, flights, and cities served by both Japanese and U.S. air-cargo companies.

1/ See "Japan--Recent Economic Developments," (SM/95/163).

While numerous agreements have been reached in recent years, disputes have arisen in interpreting past accords and in new areas. These include: the pace of liberalization of the insurance sector in Japan; renewal of the bilateral 1991 semiconductor accord; and foreign access to the domestic photographic film market.

The disagreement in the insurance sector regards the interpretation of the 1994 accord on the pace of liberalization and deregulation of the so called "third sector" (an area between life and casualty insurance, including hospitalization and injury), where American firms have played an important role. The accord stated that certain steps for deregulation of the "third" sector should only take place after the primary life and non-life insurance markets were sufficiently deregulated. On April 1, 1996, Japan implemented the revised Insurance Business Law, allowing life and non-life insurance companies to enter each other's spheres through the establishment of subsidiaries. The United States contends that allowing subsidiaries of the major Japanese insurance suppliers into the "third" sector at this point in time would violate the 1994 bilateral agreement. Japan maintains that in the accord it had promised to avoid radical changes in the third sector, but not to prohibit entry of Japanese firms into the sector. Moreover, it has argued that the new insurance law represented substantial and meaningful deregulation of the life and non-life insurance sectors, satisfying the precondition for liberalization of the "third" sector. Discussions are continuing.

The United States has sought to renew the 1991 semiconductors agreement, which expires on July 31, 1996. The agreement set an important precedent, in that the "expectation" in the agreement that the market share of foreign firms in the Japanese market would exceed 20 percent by the end of 1992 came to be interpreted as a numerical target for the expansion of imports into Japan. While the United States has stated that specific numerical targets for foreign suppliers in the domestic market were no longer necessary in a new agreement, renewal of the agreement was important for ensuring continued access for foreign firms to the domestic market. Japan has argued that the agreement was intended as a temporary measure, its objectives had been fully achieved with dramatically improved market access and increased market shares for foreign firms, and there was no reason to extend or renew the agreement. Japan has argued further that increases in cross-border and joint production had rendered the notion of identifying the nationality of purchased semiconductors by the capital affiliation of the manufacturer meaningless. Moreover, with the substantial relocation of Japanese production facilities abroad over the past five years, renewal of the agreement, which would measure market access by the capital affiliation of the manufacturer, could represent discrimination against Japanese manufacturers who had relocated abroad. Such discrimination would be inconsistent with WTO most-favored-nation and national-treatment principles. Japan has called for private sector arrangements to maintain the cooperation that has been established in the sector under the previous agreement. Discussions are continuing at both the governmental and industry level.

In May 1995, Kodak filed a petition with the U.S. government's trade representative under Section 301 of the U.S. Trade Act, alleging that Fuji film had engaged in practices that had impeded Kodak's entry into the Japanese consumer photographic film and paper market. The Japanese government has maintained that Kodak's access to the domestic Japanese market should not be discussed at the government level, but rather should be investigated by Japan's Fair Trade Commission (JFTC). In February, 1996, the JFTC announced that it would conduct a survey on transactions between firms in the consumer color photographic film and photographic paper markets. On June 13, the United States filed a complaint with the WTO against Japan's trade practices in the consumer film and paper market. Japan is to respond shortly.

c. Bilateral trade issues with the European Union

There are a number of trade issues between Japan and the European Union (EU). The main Japanese concern involves protectionist pressures and discriminatory standards in the EU. Several EU members still maintain quantitative import restrictions against Japan; these are expected to be eliminated under the Single Market Program. On automobiles, there is an arrangement to monitor Japan's automobile exports to the EU market (both for overall exports and for exports to individual member countries). The monitoring agreement is to expire in 1999.

For their part, EU members have been concerned about possible discrimination against them resulting from U.S.-Japan bilateral agreements. Japan has emphasized that all benefits from bilateral agreements reached would be provided on a most-favored-nation basis. In response to an EU initiative, a Trade Assessment Mechanism was established in January 1993. Under this mechanism, experts from both sides have engaged in a product-by-product analysis to compare how EU exports were performing in the Japanese market, and vice versa.

The EU, subsequently followed by the United States and Canada, have alleged that the system of Japanese alcohol taxes resulted in effective discrimination against imports, and filed suit with the WTO. After discussions failed, a WTO dispute settlement panel took up the matter, ruling in May of this year that the Japanese system of liquor taxes did indeed discriminate against imported liquors. Japan is considering appealing the ruling.

2. Structural policies

Structural reform has been a high priority of the Japanese Government in recent years. Major policy initiatives in the early 1990s included: an overhaul of land taxes in 1991; reforms in the distribution system in

1990-91; and further measures to liberalize financial markets. 1/ More recently, structural reform plans have emphasized the promotion of broadbased deregulation and market opening, with a view to improving market access, reducing price differentials from those abroad, and raising consumer welfare.

The basic policy intentions for deregulation and structural reform in recent years were developed by two advisory groups. The recommendations of the first group, the Maekawa report, issued in 1986, were ambitious and wider-ranging. Many of these recommendations did not materialize, however, in part because mechanisms were lacking to ensure that measures were implemented in a timely manner. The latest reform efforts are based on the work of the Advisory Group for Economic Structural Reform, set up in September 1993. While the bulk of the group's recommendations, issued in December 1993 as the Hiraiwa report, were devoted to structural reform, they covered a wide range of other issues, including the creation of a domestic demand-led economy, making the economy more outward oriented, reforming the fiscal structure, and activating money and capital markets.

With the basic policy intent having been announced in the Maekawa and Hiraiwa reports, the formulation of specific deregulation measures has been through a series of announced packages of measures. In 1993, the Hosokawa government endorsed a 102-item program. In February 1994, the Hata government announced a package of 800 measures. In June 1994, the Murayama government announced a 280-item package. In March 1995, the government unveiled the 5-year Deregulation Action Program (DAP) covering 1,091 items. Subsequently, as part of a package of emergency measures announced April 15 in response to the rapid appreciation of the yen, the government promised to speed up the implementation of the DAP to 3 years. In March this year the government announced the latest deregulation package of 1,797 measures.

The measures announced in the various packages have sometimes overlapped, and differed widely in scope. While some items have been very specific, others have only designated areas for further review. The structural reform agenda has been closely linked to developments in trade relations with other countries, particularly the United States and the European Union. Individual government ministries have been responsible for proposing specific items for deregulation. Despite the government's goal of "freedom from regulation in principle, with regulation as the exception", according to the Management and Coordination Agency, the number of government regulations continued to grow steadily from around 10,000 in 1984 to almost 11,500 in 1993. The number of regulations has declined only over the last two to three years, falling to 10,760 regulations by March 1995. Until recently, an institutional mechanism for monitoring the overall deregulation process had been lacking. As part of the DAP, an Administrative Reform Committee, comprised of academics, businessmen, and

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1/ A discussion of structural reforms up to 1991 is presented in Section VIII of "Japan--The Recent Past and Longer-Term Prospects" (SM/91/135).

other non-governmental representatives was established with the mandate of setting the agenda for deregulation, and making recommendations directly to the Prime Minister. Progress on deregulation is now reviewed annually through a government White Paper.

Major deregulation measures adopted during 1994 spanned various areas. In the distribution sector, rules on hours of operation of large retail stores were eased, as mandatory closing times were extended from 7 to 8 p.m., and large stores (over 10,000 square meters) were permitted to acquire liquor licenses. In the telecommunications sector, sales of cellular phones, which were previously only allowed to be leased, were permitted, and international satellite communications were opened to foreign firms. In the transportation sector, trucking and domestic air fares were deregulated. In the construction sector, foreign inspection data on imported construction materials were accepted. In the energy sector, gas charges to large-lot users were deregulated. In the financial sector, interest rates on demand deposits were liberalized and commercial banks were allowed to participate in the securities business through subsidiaries.

Measures announced and adopted during 1995 and 1996 include: the abolition of the Oil Products Import Control Law, which restricted imports to companies with refineries and storage facilities; the alignment of the system of standards, certification, and labelling with international norms; simplification and computerization of import inspection procedures to allow imports to clear customs faster; containers used on ships were permitted to be used on trucks; elimination of the requirement of certified garage inspections of automobiles prior to official inspection; a reduction of restrictions on imported building materials; and the relaxation of pension-fund management rules. Several measures have been announced that are scheduled to be implemented in March-April 1997. In the telecommunications sector, service rates for cellular phones are to be deregulated and government control over the facilities of common carriers is to be abolished. Foreign exchange rules are to be changed to allow firms to net cross-border inward and outward payments for calculating commissions. Rules for licensing job-placement agencies are to be simplified. The minimum number of taxis and trucks required to be owned by a transportation company is to be reduced.

A number of important items that have been the subject of public debate remain to be resolved: further liberalization or abolition of the Large-Scale Retail Store Law; the ban on holding companies; the breakup of Nippon Telephone and Telegraph; measures to improve land use; and the removal of restrictions on temporary employment agencies.

The potential long-term gains from deregulation and structural reform in the form of higher productivity growth, lower costs, and job creation are likely to be substantial for Japan. The Economic Council, an advisory body to the Prime Minister, in its recently issued draft economic plan, estimated that comprehensive and wide-ranging reforms would add 1 1/4 percentage points per year to the growth potential of the Japanese economy over the

period 1996-2001, and lower the unemployment rate by 1 percentage point by 2001. The plan identified 10 sectors where cost-cutting reforms were likely to have the most impact: cargo distribution; energy; wholesale and retail distribution; telecommunications; financial services; passenger transport services; agricultural production; import procedures and standards certification; public works; and housing construction. The plan also identified seven "most promising growth" sectors, all in services, with the greatest potential for employment creation: information and telecommunications; corporate services; human resource development; healthcare and welfare; leisure activities; quality housing; and environmental services. The tremendous scope for productivity increases in Japan's nontradable sectors is illustrated by the productivity "gaps" between Japan and the United States, which have been estimated to range from 30 percent in the retail sector to 80 percent in agriculture. 1/

VII. Banking Sector Developments

Japanese financial institutions continue to face considerable asset-quality problems, arising both from the bursting of the bubble in land and equity prices since 1990 and the prolonged downturn in activity. Concerns about the fragility of the financial sector, however, intensified in late 1995, following the string of failures of smaller institutions in the summer and the Daiwa Bank scandal in October. These developments strengthened the authorities' determination to tackle the problems in the financial sector. Following years of limiting disclosure about the magnitude of problem loans in the hope that banks would earn their way out of difficulties, several initiatives were announced: detailed estimates of problem loans were released by the Ministry of Finance (MOF); and plans were announced for liquidating the *jusen* (housing loan companies), establishing a system to dispose of failed institutions, rebuilding the funds of the Deposit Insurance Corporation (DIC) and improving bank supervision and disclosure. These steps, together with banks' record high operating profits and aggressive write-offs in FY 1995, have contributed to an important improvement in confidence.

1. Size of the problem

In November 1995, the Ministry of Finance released detailed figures on problem loans in the financial sector based on a survey of individual institutions. 2/ These figures, revised as of end-March 1996, place

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1/ For a discussion of sectoral productivity differentials between Japan and other industrial countries see Chapter VII of the supplement to last year's Recent Economic Developments paper (SM/95/163, Supplement 1).

2/ Problem loans include nonperforming loans (loans to borrowers that have legally been declared bankrupt and loans on which interest has not been paid for 180 days) and restructured loans (loans on which interest rates have been reduced to below the official discount rate prevailing at the time).

total problem loans at ¥34.8 trillion (about 7 percent of GDP), of which ¥8.3 trillion is considered to be unrecoverable. 1/

	Major Banks	Regional Banks	Cooperative Institutions	Total
		(In trillions of yen)		
Problem loans	21.9	6.6	6.3	34.8
(In percent of GDP)	(4.5)	(1.4)	(1.3)	(7.1)
(In percent of assets)	(2.9)	(2.4)	(2.4)	(2.7)
Specific reserves	9.1	2.4	1.1	12.5
Net operating profit				
(Average of FY 1990-94)	2.7	1.4	1.1	5.1
(FY 1995)	4.8	2.0	1.7	8.4

The official figures exclude: (i) ¥1.8 trillion in problem loans of several credit cooperatives and a Regional II bank that failed recently; (ii) the exposure of the agricultural cooperatives to the *jusen*, amounting to ¥5.5 trillion; (iii) recapitalized loans and loans that have been restructured at above the official discount rate; and (iv) banks' contingent liabilities on the sales of nonperforming loans to an asset liquidation company, the Cooperative Credit Purchasing Company (CCPC). 2/ Private estimates are therefore considerably higher placing total problem loans in the range of ¥60-70 trillion, at

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1/ The calculation of unrecoverable loans assumes that the estimated collateral coverage on nonperforming and restructured loans (excluding loans to the *jusen*) is 35 percent, that only half the restructured loans will become nonperforming, and that specific reserves (excluding those for the *jusen*) amounts to ¥8.3 trillion.

2/ The CCPC is an asset liquidation company established by banks in January 1993 to take over their nonperforming loans at a discount and enable them to immediately write off the losses for tax purposes, based on Japan's corporate tax laws (see SM/95/163 for a description of the CCPC). To date, the CCPC has played an important role in facilitating the write-down of problem loans, although it has not been as successful in liquidating the collateral associated with these loans. Until the collateral is sold, the banks retain contingent liabilities. As of end-March 1996, ¥12.1 trillion in loans had been sold to the CCPC by financial institutions at an average discount of 59 percent, while the CCPC had sold only ¥0.4 trillion of the total collateral (Table 16). The remaining assets of the CPCC, amounting to ¥4 1/2 trillion and financed by bank loans, may not be fully recoverable, in which case banks will incur losses on their loans to the CPCC equivalent to the price received by the banks on the sale of the loans less the value of recoveries by the CPCC.

Table 16. Japan: Business Results of Cooperative Credit Purchasing Company (CCPC), 1992-96

(In billions of yen)

	Number of transactions	Face Value	Price	Discount (in percent)	Value of recoveries
FY 1992	229	681.7	452.1	33.7	--
FY 1993	1,891	3,838.3	1,778.9	53.6	30.2
FY 1994	3,077	4,038.0	1,591.0	60.6	141.5
FY 1995	3,154	3,577.5	1,182.0	70.0	260.9
1995					
April	99	113.2	42.9	62.1	9.7
May	16	21.6	6.8	68.5	17.2
June	31	44.9	16.0	64.4	11.8
July	103	67.7	30.8	54.5	12.7
August	86	148.7	45.1	69.5	17.9
September	996	940.3	358.5	61.9	33.0
October	39	42.6	17.8	58.2	13.5
November	31	43.6	12.5	71.3	16.5
December	173	308.4	75.6	75.5	39.1
1996					
January	131	136.7	52.3	61.8	28.7
February	270	213.1	71.9	66.3	14.6
March	1,179	1,496.7	451.8	69.8	46.2
Total	8,351	12,135.5	5,004.0	58.8	432.6

Source: Data provided by the Japanese authorities.

end-March 1995. 1/

While the absolute scale of the problem is clearly important, the pace of its resolution depends on the distribution of problem loans across institutions, the banks' coverage against losses (including, the values of the collateral and loan-loss provisions), and the strategy adopted to dispose of nonperforming loans.

2. Resolving the problems of the major banks

The pace of write-offs has been rather slow in recent years, as the resolution of the major banks' difficulties has relied primarily on banks' generating sufficient operating profits to write off nonperforming loans. To boost loan-loss provisions, banks have also realized capital gains on their hidden reserves (unrealized profits on investment securities). In addition, banks have been permitted to make tax-deductible loan-loss provisions by selling their nonperforming loans to the CCPC, although they retain certain contingent liabilities on these loans. FY 1995 therefore marks a significant step forward toward restoring the health of banks' balance sheets: 17 of the 21 major banks have announced aggressive loan-loss provisions and write-offs--exceeding their net business profits and capital gains on the sale of equity--resulting in significant charges against their Tier 1 capital.

a. The major banks' FY 1995 results

Net business profits (*gyomu-juneki*) of the major banks soared to ¥4.8 trillion in FY 1995, increasing by over 70 percent relative to the previous year (Table 17). The increase was attributable to the rise in net interest revenue and a surge in gains on the sale of investment bonds. Net interest revenue rose by over 20 percent from FY 1994, while noninterest revenues jumped by 75 percent, primarily due to the increase in net profits on investment bonds (which jumped by over 850 percent from the previous year). Among the other components of noninterest revenues, fees and commissions rose by 9 percent, while revenues from bond dealings and general and administrative expenses were almost unchanged, and profits on foreign exchange transactions declined.

Banks realized a high level of net capital gains on their hidden reserves, amounting to ¥3.1 trillion. Most of the stocks sold by banks were subsequently repurchased, thereby raising the book value of the banks' equity investments and increasing the exposure of their balance sheets to

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1/ These estimates are comparable to the official figures in that they both refer only to problem loans of deposit-taking institutions. Some of these problem loans relate to lending to troubled nonbank financial sector institutions, including finance companies, leasing companies, consumer credit agencies, etc. In addition, however, some market analysts believe that potentially serious asset quality problems exist at nonbanks beyond those included in the problem loans of deposit-taking institutions.

Table 17. Japan: Indicators of Banking Performance, 1992-96

(In billions of yen, except where indicated)

	March 1992	March 1993	March 1994	March 1995	March 1996
21 Major banks					
Nonperforming loans	7,900.0	12,774.6	13,575.9	12,543.3	13,110.7
Restructured loans	...	...	...	...	8,757.0
Specific loan loss reserves	1,044.2	1,866.0	3,022.4	4,297.5	9,069.4
Hidden reserves	16,754.9	17,430.0	20,325.6	8,640.1	16,611.0
Total loans	397,464.5	390,761.4	387,916.1	351,942.1	391,852.0
Risk-weighted capital ratio (in percent)	8.27	9.32	9.71	8.93	8.83
Net business profits	2,432.3	3,223.5	3,155.6	2,768.1	4,771.1
Adjusted net business profits 1/	2,610.3	3,092.0	2,724.9	2,662.0	3,755.0
Of which: Net interest income	5,213.1	5,909.3	5,580.6	5,515.7	6,684.1
Net gains/losses on equities	795.3	27.0	1,800.9	3,067.8	3,145.8
Loan loss provisions and write-offs 2/	550.3	1,321.4	3,538.7	4,815.7	10,818.7
Net income	940.9	506.0	447.8	(120.5)	(3,565.0)
City banks					
Nonperforming loans	5,214.0	8,454.9	8,947.3	8,114.6	8,035.0
Restructured loans	...	...	...	...	4,382.0
Specific loan loss reserves	835.9	1,459.0	2,102.1	2,956.1	5,548.7
Hidden reserves	10,575.5	10,845.4	13,024.9	5,464.5	10,991.5
Total loans	274,757.6	269,616.0	271,142.0	266,564.4	278,051.0
Risk-weighted capital ratio (in percent)	8.19	9.26	9.68	8.88	8.72
Net business profits	1,922.7	2,516.8	2,382.3	2,058.9	3,500.0
Adjusted net business profits 1/	2,167.9	2,512.4	2,179.7	2,026.8	2,812.2
Of which: Net interest income	4,145.8	4,658.3	4,439.6	4,304.1	5,203.3
Net gains/losses on equities	359.3	-109.1	1,068.7	1,962.7	1,760.9
Loan loss provisions and write-offs 2/	437.3	1,011.6	2,490.0	3,319.3	6,392.2
Net income	647.4	367.7	318.3	(69.9)	(1,751.7)
Long-term credit banks					
Nonperforming loans	1,106.0	1,850.2	1,887.5	1,915.3	2,062.7
Restructured loans	...	...	...	...	1,371.0
Specific loan loss reserves	123.1	231.0	493.4	716.1	1,257.2
Hidden reserves	3,350.5	3,643.7	3,908.6	1,899.7	2,520.9
Total loans	56,374.9	54,548.8	53,169.0	51,565.5	52,654.0
Risk-weighted capital ratio (in percent)	8.31	8.98	9.25	8.77	8.44
Net business profits	292.6	401.1	367.6	268.0	618.1
Adjusted net business profits 1/	270.9	336.5	175.6	163.9	340.3
Of which: Net interest income	470.7	526.3	341.2	259.5	386.0
Net gains/losses on equities	205.1	66.3	413.4	642.0	988.6
Loan loss provisions and write-offs 2/	49.0	197.3	546.9	592.5	1,921.6
Net income	161.5	70.4	68.1	58.3	(409.5)
Trust banks					
Nonperforming loans	1580.0	2,469.5	2,711.6	2,499.4	3,013.0
Restructured loans	...	...	...	...	3,004.0
Specific loan loss reserves	85.2	175.0	426.9	625.3	2,263.5
Hidden reserves	2,828.9	2,940.6	3,392.4	1,278.9	3,098.6
Total loans	66,332.0	66,596.6	63,605.1	63,879.3	61,147.0
Risk-weighted capital ratio (in percent)	8.66	10.01	10.47	9.39	9.85
Net business profits	217.6	305.6	405.7	441.2	653.0
Adjusted net business profits 1/	171.5	243.0	369.6	477.3	602.5
Of which: Net interest income	596.6	724.7	799.8	952.1	1,094.8
Net gains/losses on equities	231.9	69.8	318.8	463.0	396.3
Loan loss provisions and write-offs 2/	64.0	112.5	501.8	903.9	2,504.9
Net income	132.0	67.8	61.4	(109.5)	(1,403.8)
Memorandum item:					
Nikkei 225 index	19,346	18,591	19,112	16,139	20,406

Sources: Bloomberg; IBCA; Ministry of Finance; and IMF staff estimates.

1/ Adjusted to exclude investment bond profits and losses.
2/ Specific provisions and write-offs against non-developing country loans plus losses on loans sold to the Cooperative Credit Purchasing Company (CCPC).

the stock market. 1/ However, with the Nikkei stock price index rising to 21,406 at end-FY 1995 from 16,139 at end-FY 1994, banks' hidden reserves jumped to ¥16.6 trillion from ¥8.6 trillion over the same period.

The dominant feature of the FY 1995 results was the banks' sizable loan-loss charges, amounting to Y10.8 trillion. 2/ This included: specific provisions of ¥5.6 trillion, of which *jusen* loans accounted for ¥2.8 trillion; losses on loan sales to the CCPC of ¥1 trillion; losses on support to affiliates of ¥2.6 trillion; and direct write-offs of ¥1.4 trillion. Part of these charges was covered by net business profits and capital gains on the sale of equity, which together totalled ¥7.9. As a result, the major banks recorded an aggregate net loss of ¥3.5 trillion. On a consolidated basis, the net loss was ¥1.5 trillion, which was charged against Tier 1 capital. 3/

b. Capital adequacy of the major banks

With the major banks recording net losses, their average risk-weighted Tier 1 capital ratio fell to 4.6 percent at end-FY 1995, down from 5.2 percent at end-FY 1994. The decline in Tier 1 capital was mitigated by the use of deferred tax accounting, which permitted banks to realize tax relief on non tax-deductible loan-loss provisions (in particular, on *jusen* loans). With the rise in equity prices boosting banks' hidden reserves, the major banks' average Tier 2 capital ratio increased to 4.5 percent at end-FY 1995, from 3.8 percent at end-FY 1994. Of Tier 2 capital, the share of hidden reserves increased, while that of subordinated debt declined. In all, banks' total capital ratios rose to 9.1 percent at end-FY 1995 from 8.9 percent at end-FY 1994 (Table 17).

Following large loan-loss charges, the major banks are planning to issue preferred shares to further restore the health of their balance sheets. Concerns remain, however, that a rush by banks to equity markets would trigger a sharp decline in prices.

1/ If banks realize capital gains on their securities holdings and subsequently repurchase them at a higher price, their reported income becomes more dependent on stock market variations as they would suffer valuation losses if the market falls below cost. It is estimated that the level of the Nikkei stock price index at which banks hidden reserves would disappear has increased from 12,957 at end-FY 1994 to 14,929 at end-FY 1995.

2/ Banks' non-LDC loan-loss charges include loan-loss provisions, losses on loan sales to the CCPC and direct write-offs against profits.

3/ The difference in the net loss on an unconsolidated and consolidated basis is primarily attributable to the adoption of deferred tax accounting in the consolidated accounts.

3. Turning points in Japanese banking policy

a. Recent bank failures

Since December 1994, the Japanese authorities have announced the closure of several credit cooperatives and two regional banks, including Hyogo Bank, the country's largest Regional II bank. These closures signify a departure from past practices, where failed banks were either merged or taken over by other banks. In all cases, depositors have been protected, but shareholders have had to write off their claims on the failed banks. Most significantly, public funds have been injected in a number of instances to resolve certain failed institutions. The lack of a concrete framework for winding up failed institutions, including a rationale for the use of public money and a loss-sharing rule, has meant, however, that the authorities responded to each situation *de novo*: public money was used in winding up selective credit cooperatives; and commercial banks were called on to contribute to each resolution on a different basis. The closures have involved the extensive use of DIC funds, and Bank of Japan (BOJ) loans under Article 25 have been extended in several cases. 1/

The decision to liquidate Tokyo Kyowa and Anzen Credit Cooperatives in December 1994 and transfer the viable assets to a newly created bridge bank, Tokyo Kyodo, was important in a number of respects: (i) the precedent was established for using public funds to resolve failed banks; (ii) equity in the failed institutions was written down to zero; (iii) a bridge bank was set up that could be used to resolve further failed cooperatives; and (iv) all commercial banks, including those that had no relationship with the failed cooperatives, were called upon to contribute to the operation. Many of the principles outlined above were applied in closing Cosmo Credit Cooperative on July 31, 1995, following a run on deposits. In contrast, however, only those banks that had lent money to Cosmo and its parent company were asked to provide assistance to the liquidation. On August 30, 1995, the closures of Kizu Credit Cooperative and Hyogo Bank (including its nonbank affiliates) were announced. While Kizu was liquidated along the lines of other credit cooperatives, the operations of Hyogo Bank were transferred to Midori Bank, a newly established bank with the capital subscriptions by many of the major banks, Regional II banks, insurance companies and some businesses in the Kobe area; existing shareholders' capital was used to cover part of the unrecoverable assets. Similarly, in March, the resolution plan for Taiheiyo Bank, a Regional II bank, called for operations to be transferred to a newly created bank, with assistance being provided by four related banks.

1/ Under Article 25 of the Bank of Japan Law, and subject to the approval of the MOF, the BOJ may take any action considered necessary to maintain the stability of the financial system.

The lack of full disclosure of nonperforming loans, together with the absence of a transparent framework for disposing of failed institutions, contributed to increasing concerns about the fragility of the Japanese financial sector in late 1995. In response, several initiatives were announced: plans were announced for rebuilding the funds of the DIC, establishing a framework for resolving failed institutions, improving bank supervision, and liquidating the *jusen*. These steps, together with the record high operating profits of banks in the first half of FY 1995, contributed to a significant improvement in confidence in early 1996. Indeed, the announcement of the closure of Taiheiyo Bank in late March, and two smaller institutions in April, passed without significant market reaction.

b. Framework for resolving failed institutions

The Financial System Stabilization Committee (FSSC), which was set up in July 1995 to formulate a strategy for resolving the nonperforming loan problem, issued its final report at the end of December. These recommendations were formalized in three bills (outlined below) that have recently been passed by the Diet.

(i) Deposit insurance

The FSSC defined a key role to be played by the DIC in future resolutions, including: (i) paying off depositors; and (ii) paying other financial institutions an amount equivalent to the deposit insurance payment or the purchasing price for deposits to the take-over banks in the form of new deposits. As such, modifications to the Deposit Insurance Law were needed. These modifications involve raising deposit insurance premiums fourfold--from 0.012 percent of insured deposits--to rebuild the funds of the DIC, and levying a special "tax" on financial institutions, equal to three times the existing insurance premium, to establish "special accounts" for financing the disposal of failed institutions beyond the pay-off costs; the "special accounts" for ordinary financial institutions and for credit cooperatives are to be treated separately. 1/ These hikes are expected to raise the DIC's annual premium income to ¥450 billion, from ¥65 billion, generating a total income of around ¥2 1/2 trillion over the next five years.

(ii) Public funds

The authorities acknowledge that public funds will likely be needed to wind up several credit cooperatives. There are 370 credit cooperatives in Japan with total assets of about ¥28 trillion. While the distribution of losses among these institutions is unknown, past loss rates in the financial sector suggest that significant funds could be needed to resolve their difficulties.

Public money can be provided to wind up financial institutions, depending on the situation, either via direct budgetary outlays by the central or local governments or via the Bank of Japan (BOJ). Passage of the bills legislates the use of public funds by the central government or the Bank of Japan to resolve problems at credit cooperatives if there is a shortage of funds at the time of closing the "special accounts" after five years. In addition, a notable provision of the law is that the government can guarantee the borrowing of the "Special Account for Credit Cooperatives," which opens the door to the systematic use of public funds.

1/ At end-FY 1995, the resources of the DIC stood at ¥385 billion. In addition, as bridging finance to cover the gap between disbursements and the inflow of premium income, the borrowing limit for the DIC's General Account from the BOJ has been raised from ¥500 billion to ¥1 trillion, and its Special Account has also been authorized to borrow up to ¥1 trillion from the BOJ and private financial institutions.

In addition, under Article 25 of the Bank of Japan Law, and subject to the approval of the MOF, the BOJ may take any action considered necessary to maintain the stability of the financial system. This would include extending unsecured loans or making capital injections, provided that certain BOJ conditions are met, including that such lending does not jeopardize the soundness of the BOJ's balance sheet. The BOJ's own capital currently amounts to around ¥2 1/2 trillion, while the net income of the BOJ is around ¥500 billion per annum (Table 18).

(iii) Institutional structure

To facilitate the disposal of failed financial institutions, the FSSC recommended that the supervisory authorities be authorized to apply for the initiation of corporate reorganization or bankruptcy procedures. In addition, the FSSC called for the establishment of the Resolution and Collection Bank (RCB), an institution similar to the Resolution Trust Corporation set up in the United States to restructure insolvent savings and loans in the late 1980s, to: (i) take over failed institutions and handle their liquidation after deposit repayment and loan collection, in cases where other institutions cannot be found to take over the failed institutions; (ii) serve as a bridge bank until a take-over institution can be found; and (iii) collect those nonperforming loans that are not transferred to take-over institutions. The plan is that Tokyo Kyodo Bank is to be reorganized for this purpose.

c. Measures to enhance banking inspection and supervision

Measures to improve banking inspection and supervision have also been announced, some of which are contained in the set of bills that passed the Diet on June 18. To strengthen internal management controls, financial institutions will be expected to follow guidelines on in-house inspections and risk management, appropriate vacation policy is to be applied, and in-house reporting is to be made more rigorous. To enhance supervision, a system of "Prompt Corrective Action" is to be introduced whereby the MOF will take actions, including issuing management-improvement orders, if financial institutions fail to meet specified objective criteria (e.g., capital adequacy ratios). In addition, there is to be greater coordination between the local and national supervisory authorities to strengthen the supervision of credit cooperatives and other cooperative financial institutions that have been less strictly supervised in the past. Finally, overseas branches also will be subject to more frequent scrutiny by the Ministry and the Bank of Japan, and the authorities have announced plans to strengthen the exchange of information with foreign supervisory authorities, in accordance with the Basle Concordat.

Also included are proposals to modernize accounting standards with the adoption of mark-to-market accounting in the books of financial

Table 18. Japan: Bank of Japan's Accounts, FY 1992-FY 1995

(In billions of yen)

	FY 1992	FY 1993	FY 1994	FY 1995
Total revenues	3,485.2	2,732.1	1,939.8	2,322.5
Total expenses	1,181.7	974.5	894.9	1,610.8
Of which:				
Transferred to allowance for losses	132.2	114.1	8.3	779.9
Net income	2,303.5	1,757.6	1,044.8	711.8
Appropriations of net income:				
Transfers to legal reserve	115.2	87.9	52.2	35.6
Transfers to general reserve	76.3	17.6	10.4	7.1
Dividends	0.004	0.005	0.005	0.005
Payments to Japanese government	2,112.1	1,652.2	982.1	669.0
Total capital 1/	2,719.5	2,624.4	2,532.0	2,016.4
Of which:				
Legal reserve	906.8	1,005.3	1,065.8	1,131.1
General reserve	840.2	859.9	872.0	885.1
Specific reserve	0.0	0.0	0.0	0.0
Equity	0.1	0.1	0.1	0.1
Net income	972.3	759.0	593.9	0.0

Source: Bank of Japan, Annual Review, various issues.

1/ End of year.

institutions, namely securities and derivatives transactions for trading purposes. Finally, disclosure requirements for all classes of financial institutions are to be made more rigorous to promote market discipline. Regional banks have already disclosed their nonperforming loans, while *shinkin* banks, labor credit associations and credit cooperatives are to disclose their nonperforming loans by March 1998. Disclosure requirements will, however, not be made uniform across institutions.

d. The *jusen* issue

A plan to liquidate the seven insolvent *jusen* was approved by the Cabinet in December 1995, following intense negotiation among the principal creditors. 1/ The plan specifies that the immediate losses associated with an estimated ¥6.4 trillion of unrecoverable assets are to be distributed among founding banks, other financial institutions, and agricultural cooperatives as shown in the tabulation below.

	Loans	Losses	Losses/Loans
	(In trillions of yen)		(In percent)
Founding banks	3.5	3.5	100
Other financial institutions	3.8	1.7	45
Agricultural cooperatives	5.5	0.5	10

In addition, ¥680 billion has been earmarked in the FY 1996 Budget to cover the balance of the losses. The remaining *jusen* assets, amounting to about ¥6.8 trillion, are to be transferred to a loan-collecting firm, the Jusen Resolution Corporation (JRC). 2/ The founding banks, lender banks, and agricultural cooperatives are to extend low-interest financing to the JRC. Public money will be used to cover half of the possible future losses incurred by the JRC; the financial institutions concerned contributed about ¥1 trillion to the DIC account for the Special Fund for the Stabilization of the Financial System in July, and the investment income generated from this Special Fund will be used to cover half of the JRC's future losses. 3/

1/ There are eight *jusen*, of which seven are insolvent. The *jusen*, partially owned by banks (founding banks), insurance companies and securities firms, were originally established to finance housing loans. During the second half of the 1980s, however, these institutions increased their borrowing from their shareholders, other financial institutions (lender banks) and the agricultural cooperatives to finance their rapidly expanding lending to real estate developers.

2/ The JRC was formally established as the Housing Loan Administration Corporation on July 26, 1996.

3/ In addition, in July 1996, the BOJ made a capital contribution of ¥100 billion to the Jusen account at the DIC, on the condition that the contribution would finance the capital subscription of the JRC. By law, this will be paid back in full to the BOJ when the JRC is wound up in 15 years.

While the FY 1996 Budget was enacted in May, including the ¥680 billion, implementation of the *jusen* plan remained contingent on the passage of further bills. In the event, these bills were passed on June 18. Beyond that, the authorities consider that, of the remaining ¥6.8 trillion in *jusen* assets, ¥3.5 trillion represent "normal assets", ¥2.1 trillion are "possibly recoverable" and ¥1.2 trillion are "difficult to recover." Private estimates are higher; many private analysts believe that in addition to the "difficult to recover" assets, all of the "possibly recoverable" assets and part of the "normal assets" will ultimately prove unrecoverable. With public money covering half of the future losses incurred by the JRC, analysts believe that around ¥2-3 trillion (about 1/2 percent of GDP) will likely be required. 1/

4. Future scenario

The authorities have stated that commercial banks will be expected to cope with their problem loans without public assistance, although recourse to deposit insurance assistance may be necessary. In contrast, public money will likely be needed to resolve several credit cooperatives.

For the major banks, the ultimate losses on their nonperforming loans could amount to about ¥17 trillion, of which ¥9.1 trillion is covered by special reserves. 2/ This would leave a net loss of around ¥8 trillion. Assuming banks' operating profits returned to the average level in recent years of about ¥2 1/2 trillion, 3/ that there is no further accumulation of problem loans, and that all profits are used to write down problem loans, most of the major banks appear to be capable of fully writing off problem loans over the next three years. Given the uneven distribution of problem loans among the banks, some--in particular, the trust banks--may require considerably longer to write down their problem loans. For others, this write-off period may be almost complete, following the large write-offs in FY 1995.

Based on similar assumptions, the Regional I banks--with unrecoverable loans of around ¥3 1/2 trillion, specific reserves of ¥1.7 trillion, and annual operating profits at ¥1 trillion--can be expected to write off their

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1/ This includes the ¥685 billion of immediate losses, and half of the estimated second-stage losses.

2/ This calculation assumes an average loss rate of 70 percent on the banks' total problem loans. It also assumes that the major banks will cover about ¥1 1/2 trillion of the "secondary" losses associated with liquidating the *jusen*.

3/ Banks' operating profits (*gyomu-juneki*) were boosted in FY 1995 by one-time capital gains on bond holdings and widening spreads, due to falling interest rates. With stable or possibly rising interest rates in FY 1996, banks' operating profits are expected to decline.

problem loans in around 2 years. In addition, it is believed that public funds will be needed to wind up several credit cooperatives. Private sector estimates suggest that ¥2-3 trillion could be needed to liquidate the *jusen*, and that an even larger amount is ultimately likely to be needed to fully resolve problems at credit cooperatives. 1/

1/ The estimate also assumes--as has been repeatedly stated by the authorities--that commercial banks will be expected to deal with their problem loans without public assistance.

Table 1. Japan: General Government Balances, FY 1987-FY 1994

Fiscal Years	1987	1988	1989	1990	1991	1992	1993	1994
				(In billions of yen)				
Saving 1/	23,785	30,511	34,409	43,098	44,652	34,529	31,155	24,106
Central government	810	2,761	1,974	7,114	6,328	-374	402	-3,301
Local government	12,675	15,202	18,847	20,121	20,596	18,351	15,346	12,756
Social security	10,300	12,548	13,588	15,862	17,729	16,553	15,407	14,651
Capital transfers 2/	442	377	432	-1,225	266	148	-328	-745
Central government	-4,001	-3,444	-3,440	-4,855	-3,403	-4,878	-8,115	-8,283
Local government	5,051	4,138	4,211	4,011	4,174	5,491	8,270	8,080
Social security	-607	-316	-339	-381	-505	-465	-484	-542
Gross fixed capital formation	18,451	18,701	20,226	21,914	23,910	28,033	31,158	30,558
Central government	3,297	3,090	3,139	3,298	3,530	4,355	5,297	4,855
Local government	15,074	15,538	17,010	18,534	20,293	23,558	25,707	25,565
Social security	80	74	77	83	87	120	155	138
Land acquisition	3,382	3,973	3,918	4,630	5,212	6,077	6,362	5,419
Central government	342	416	274	363	348	459	570	459
Local government	3,024	3,540	3,624	4,249	4,838	5,579	5,735	4,917
Social security	16	17	20	18	26	39	57	43
Balance	2,394	8,214	10,697	15,329	15,797	567	-6,694	-12,617
Central government	-6,830	-4,189	-4,879	-1,401	-952	-10,067	-13,580	-16,899
Local government	-373	261	2,423	1,349	-362	-5,295	-7,826	-9,647
Social security	9,596	12,141	13,154	15,381	17,111	15,928	14,712	13,928
				(In percent of GDP)				
Saving	6.7	8.1	8.6	9.8	9.6	7.3	6.5	5.0
Central government	0.2	0.7	0.5	1.6	1.4	-0.1	0.1	-0.7
Local government	3.6	4.0	4.7	4.6	4.4	3.9	3.2	2.7
Social security	2.9	3.3	3.4	3.6	3.8	3.5	3.2	3.1
Capital transfers	0.1	0.1	0.1	-0.3	0.1	--	-0.1	-0.2
Central government	-1.1	-0.9	-0.9	-1.1	-0.7	-1.0	-1.7	-1.7
Local government	1.4	1.1	1.0	0.9	0.9	1.2	1.7	1.7
Social security	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Gross fixed capital formation	5.2	5.0	5.0	5.0	5.2	5.9	6.5	6.4
Central government	0.9	0.8	0.8	0.8	0.8	0.9	1.1	1.0
Local government	4.3	4.1	4.2	4.2	4.4	5.0	5.4	5.3
Social security	--	--	--	--	--	--	--	--
Land acquisition	1.0	1.1	1.0	1.1	1.1	1.3	1.3	1.1
Central government	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Local government	0.9	0.9	0.9	1.0	1.0	1.2	1.2	1.0
Social security	--	--	--	--	--	--	--	--
Balance	0.7	2.2	2.7	3.5	3.4	0.1	-1.4	-2.6
Central government	-1.9	-1.1	-1.2	-0.3	-0.2	-2.1	-2.8	-3.5
Local government	-0.1	0.1	0.6	0.3	-0.1	-1.1	-1.6	-2.0
Social security	2.7	3.2	3.3	3.5	3.7	3.4	3.1	2.9

Source: Economic Planning Agency, Annual Report on National Accounts, 1996.

1/ Gross saving (includes capital consumption allowance).
2/ Includes capital transfers within the general government and with entities outside the general government.

Table 2. Japan: Public Sector Balances, FY 1987-FY 1994

Fiscal Years	1987	1988	1889	1990	1991	1992	1993	1994
				(In billions of yen)				
Saving 1/	24,518	31,881	39,744	47,147	47,203	37,060	32,206	25,201
General government	24,227	30,888	34,846	41,873	44,918	34,677	30,826	23,360
Public enterprises	291	993	5,141	6,005	3,485	2,383	1,379	1,841
Investment	27,933	28,474	30,260	33,382	36,473	43,133	47,545	46,219
General government	21,833	22,674	24,144	26,544	29,122	34,111	37,520	35,978
Gross fixed capital formation	18,451	18,701	20,226	21,914	23,910	28,033	31,158	30,558
Land acquisition	3,382	3,973	3,918	4,630	5,212	6,077	6,362	5,419
Public enterprises 2/	6,101	5,800	6,116	6,838	7,351	9,023	10,024	10,241
Balance	-3,416	3,407	9,726	14,497	11,931	-6,073	-15,339	-21,018
General government	2,394	8,214	10,702	15,329	15,797	567	-6,694	-12,617
Public enterprises	-5,809	-4,807	-975	-832	-3,866	-6,640	-8,645	-8,400
				(In percent of GDP)				
Saving 1/	6.9	8.5	9.9	10.9	10.4	7.8	6.8	5.3
General government	6.8	8.2	8.7	9.5	9.7	7.3	6.5	4.9
Public enterprises	0.1	0.3	1.3	1.4	0.8	0.5	0.3	0.4
Investment	7.9	7.6	7.5	7.6	7.9	9.1	10.0	9.7
General government	6.2	6.0	6.0	6.0	6.3	7.2	7.9	7.5
Gross fixed capital formation	5.2	5.0	5.0	5.0	5.2	5.9	6.5	6.4
Land acquisition	1.0	1.1	1.0	1.1	1.1	1.3	1.3	1.1
Public enterprises 2/	1.7	1.5	1.5	1.6	1.6	1.9	2.1	2.1
Balance	-1.0	0.9	2.4	3.3	2.6	-1.3	-3.2	-4.4
General government	0.7	2.2	2.7	3.5	3.4	0.1	-1.4	-2.6
Public enterprises	-1.6	-1.3	-0.2	-0.2	-0.8	-1.4	-1.8	-1.8

Source: Economic Planning Agency, Annual Report on National Accounts, 1996.

1/ Includes capital consumption allowances and capital transfers (net) of the general government. For public enterprises, data on capital transfers are not available.
2/ Includes inventory accumulation. Data on land acquisition are not available.

Japan--Rebasing of National Accounts Data

1. Introduction

In December 1995, the Economic Planning Agency released national accounts data rebased to 1990 prices. The main implication of the rebasing was to lower substantially the shares in real GDP of the components whose relative prices had fallen from 1985 to 1990, specifically exports, imports, and business fixed investment. Nevertheless, the rebasing had only minor effects on the historical growth rates of real GDP. This annex provides a brief overview of the implications of the rebasing.

2. Growth rates and contributions to growth

GDP growth rates were little affected by the rebasing to 1990 relative prices. As seen in Table 1 and Chart 1, growth collapsed in 1992, and was stagnant through the second quarter of 1995. 1/ While growth in 1993 is now measured at a positive 0.1 percent, compared to a negative 0.2 percent in 1985 prices, it registered 0.5 percent in 1994 using both series.

There was also a slight upward revision in the pace of recovery measured in 1990 prices. There are only four quarters of negative growth recorded in the seventeen quarters since the downturn began in the second quarter of 1991, compared to six quarters of negative growth measured in 1985 prices. Cumulative growth since the trough in the fourth quarter of 1993 stood at 1.2 percent through the second quarter of 1995 in the 1990-based data, compared to 0.7 percent under 1985 prices.

The rebasing of the national accounts data did not result in any significant change in the volatility of GDP over the last 25 years (Table 2). The standard deviation of quarterly growth in GDP remained at 0.9 percentage points, while the standard deviation for the four-quarter growth rate rose from 2.6 percentage points to 2.7 percentage points. Interestingly, however, the volatility of the components of GDP declined, especially the contribution to growth from net exports and, to a lesser extent, the growth contribution from inventories. This is consistent with an unchanged volatility of total GDP due to a decline in the negative correlation between net exports and total domestic demand. There was also very little difference in the average growth rates or their standard deviations for the components of domestic demand.

1/ The last data available using 1985 prices were for the second quarter of 1995.

Table 1. Japan: Growth Rates and Contributions to Growth, 1990-95

	1990	1991	1992	1993	1994	1994 III	1994 IV	1995 I	1995 II
1990 prices									
Growth rates									
Gross domestic product	5.1	4.0	1.1	0.1	0.5	0.6	-1.1	0.1	0.6
Domestic Demand	5.2	2.9	0.4	0.1	0.8	0.7	-0.9	0.3	0.6
Stockbuilding 1/	-0.2	0.2	-0.4	-0.1	-0.2	0.2	0.2	0.0	-0.1
Final Domestic demand	5.4	2.7	0.9	0.3	1.0	0.6	-1.1	0.3	0.7
Private consumption	4.4	2.5	2.1	1.2	1.8	1.5	-0.6	0.1	0.7
Public consumption	1.5	2.0	2.0	2.4	2.2	-0.1	-2.3	4.2	-1.2
Residential investment	4.8	-8.5	-6.5	2.4	9.2	2.2	-4.2	1.0	-6.7
Nonresidential investment	10.9	6.3	-5.6	-10.2	-6.0	-0.6	-0.3	0.5	2.8
Public investment	4.9	4.9	14.5	15.7	2.8	-3.8	-3.2	-3.4	3.2
Net exports 1/	-0.0	1.0	0.6	-0.0	-0.3	-0.1	-0.2	-0.2	0.1
Exports	6.9	5.4	4.9	1.3	4.6	0.7	1.9	-0.0	4.2
Imports	7.9	-4.7	-1.1	1.7	9.0	1.8	3.9	1.9	4.3
Contributions to growth									
Gross domestic product	5.1	4.0	1.1	0.1	0.5	0.6	-1.1	0.1	0.6
Domestic Demand	5.1	2.9	0.4	0.1	0.8	0.7	-0.9	0.3	0.6
Stockbuilding	-0.2	0.2	-0.4	-0.1	-0.2	0.2	0.2	0.0	-0.1
Final Domestic demand	5.3	2.7	0.9	0.3	1.0	0.6	-1.1	0.3	0.7
Private consumption	2.6	1.5	1.2	0.7	1.1	0.9	-0.3	0.1	0.4
Public consumption	0.1	0.2	0.2	0.2	0.2	-0.0	-0.2	0.4	-0.1
Residential investment	0.3	-0.5	-0.3	0.1	0.5	0.1	-0.2	0.1	-0.4
Nonresidential investment	2.0	1.2	-1.1	-1.9	-1.0	-0.1	-0.0	0.1	0.4
Public investment	0.3	0.3	1.0	1.2	0.2	-0.3	-0.3	-0.3	0.3
Net exports	-0.0	1.0	0.6	-0.0	-0.3	-0.1	-0.2	-0.2	0.1
Exports	0.7	0.6	0.5	0.1	0.5	0.1	0.2	-0.0	0.5
Imports	-0.8	0.5	0.1	-0.2	-0.8	-0.2	-0.4	-0.2	-0.4
1985 prices									
Growth rates									
Gross domestic product	4.8	4.3	1.1	-0.2	0.5	0.9	-1.0	-0.0	0.8
Domestic Demand	5.0	2.9	0.3	-0.0	0.9	1.0	-0.7	0.1	0.8
Stockbuilding 1/	-0.3	0.3	-0.5	-0.2	0.2	-0.0	0.0	-0.0	0.1
Final Domestic demand	5.3	2.6	0.8	0.1	0.7	1.1	-0.7	0.1	0.7
Private consumption	3.9	2.2	1.7	1.0	2.2	1.1	-0.6	0.1	0.8
Public consumption	1.9	1.6	2.7	1.7	2.8	1.5	0.1	2.2	-1.3
Residential investment	4.7	-8.2	-6.7	2.5	9.7	2.6	-5.4	1.5	-5.5
Nonresidential investment	11.4	6.6	-4.7	-9.3	-8.9	0.3	0.1	0.5	2.5
Public investment	4.5	4.7	15.3	16.5	5.0	0.7	-0.9	-3.2	2.3
Net exports 1/	-0.2	1.3	0.8	-0.2	-0.4	-0.1	-0.3	-0.1	-0.0
Exports	7.3	5.2	5.2	1.3	5.1	0.5	2.4	0.1	4.0
Imports	8.6	-4.1	-0.4	2.7	8.4	1.4	4.4	1.0	4.2
Contributions to growth									
Gross domestic product	4.8	4.3	1.1	-0.2	0.5	0.9	-1.0	-0.0	0.8
Domestic Demand	5.1	2.9	0.3	-0.0	0.9	1.0	-0.7	0.1	0.8
Stockbuilding	-0.3	0.3	-0.5	-0.2	0.2	-0.0	0.0	-0.0	0.1
Final Domestic demand	5.3	2.7	0.8	0.1	0.7	1.0	-0.7	0.1	0.7
Private consumption	2.3	1.3	1.0	0.6	1.3	0.7	-0.4	0.1	0.5
Public consumption	0.2	0.1	0.2	0.1	0.2	0.1	0.0	0.2	-0.1
Residential investment	0.3	-0.5	-0.3	0.1	0.5	0.1	-0.3	0.1	-0.3
Nonresidential investment	2.3	1.4	-1.0	-1.9	-1.7	0.0	0.0	0.1	0.4
Public investment	0.3	0.3	1.0	1.2	0.4	0.1	-0.1	-0.3	0.2
Net exports	-0.2	1.3	0.8	-0.2	-0.4	-0.1	-0.3	-0.1	-0.0
Exports	1.0	0.7	0.7	0.2	0.8	0.1	0.4	0.0	0.6
Imports	-1.2	0.6	0.1	-0.4	-1.2	-0.2	-0.7	-0.2	-0.7

Sources: EPA; and staff calculations.

1/ Contributions to growth.

Table 2. Japan: Analysis of GDP and its Major Components, 1970-95

(Growth rates and standard deviations)

	1990 Prices		1985 Prices	
	Mean Growth	Standard Deviation	Mean Growth	Standard Deviation
Quarterly growth				
Gross domestic product	0.93	0.93	0.94	0.91
Total domestic demand 1/	0.89	1.06	0.92	1.07
Final domestic demand 1/	0.90	1.18	0.92	1.20
Inventories 1/	-0.01	0.47	-0.01	0.57
Net exports 1/	0.04	0.36	0.03	0.51
Correlations				
1990 prices				
	(1)	(2)	(3)	(4)
Gross domestic product (1)	1.00			
Total domestic demand (2)	0.94	1.00		
Final domestic demand (3)	0.90	0.92	1.00	
Net exports (4)	-0.17	-0.50	-0.36	1.00
1985 prices				
	(1)	(2)	(3)	(4)
Gross domestic product (1)	1.00			
Total domestic demand (2)	0.88	1.00		
Final domestic demand (3)	0.83	0.88	1.00	
Net exports (4)	-0.07	-0.54	-0.37	1.00

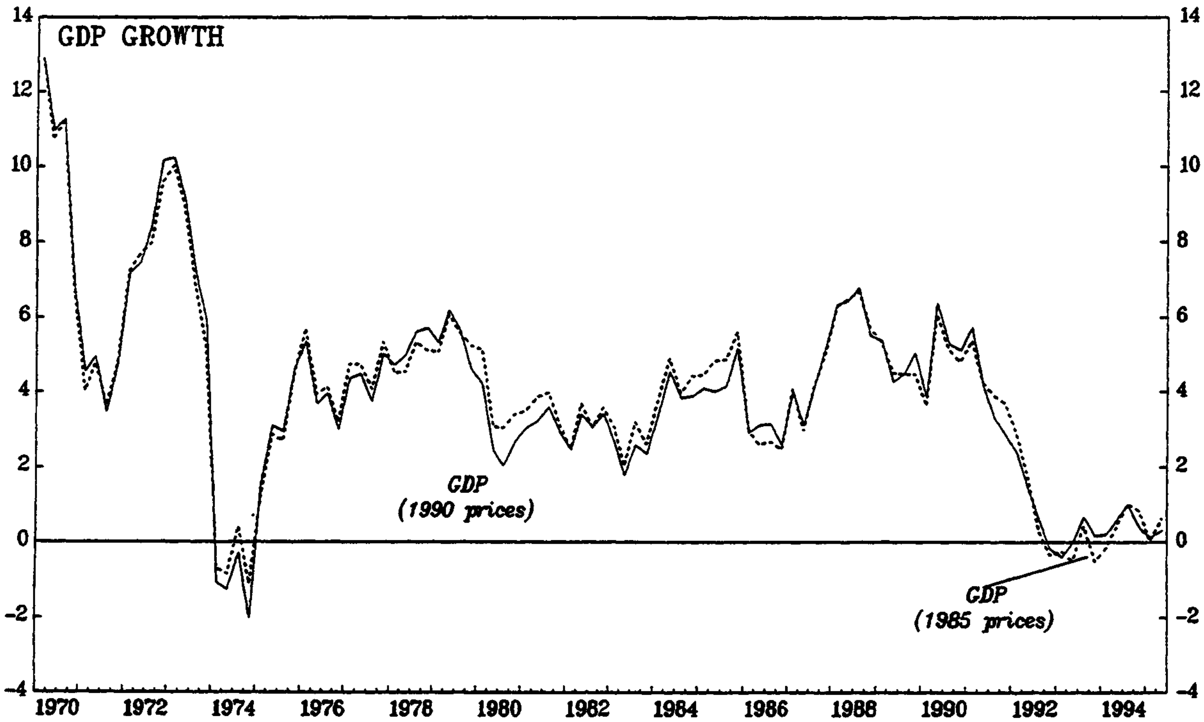
1/ Contribution to growth.

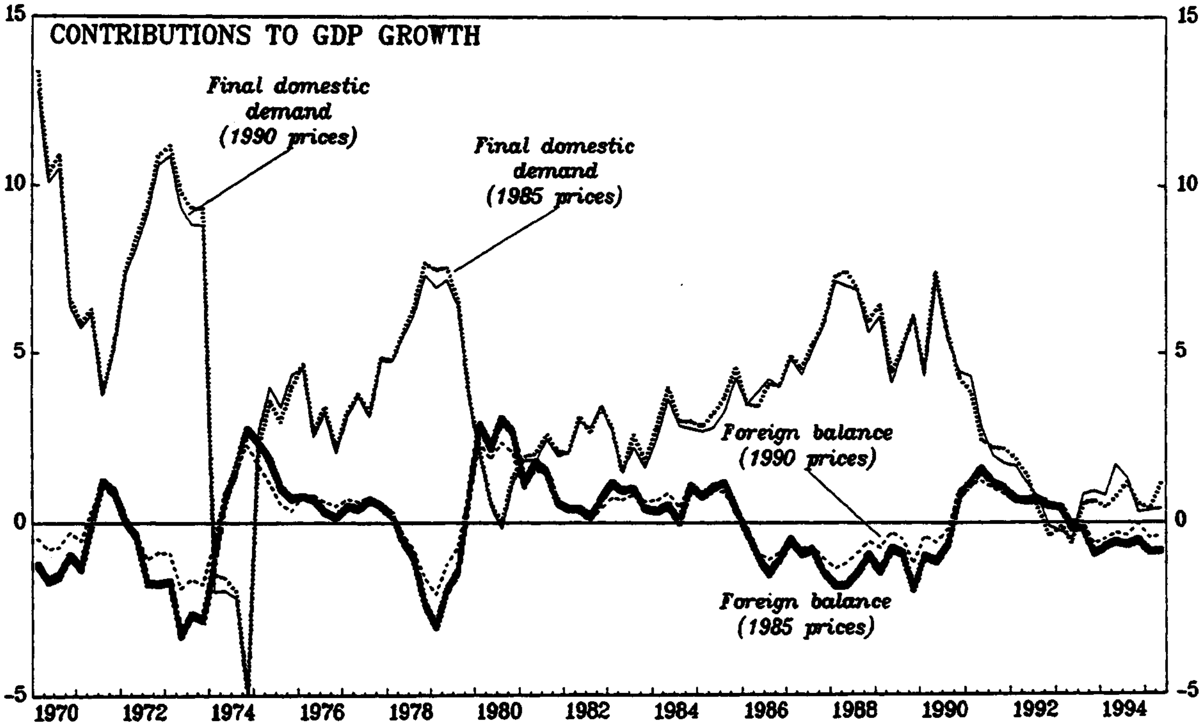
CHART 1

JAPAN

GROSS DOMESTIC PRODUCT AT 1985 AND 1990 CONSTANT PRICES, 1970-95

(Percentage change from previous year)





Source: EPA, National Income Accounts.

3. Component shares of GDP

While overall GDP growth was little affected by the rebasing, shifts in relative prices have significantly changed the shares of some of the components of aggregate demand (Chart 2). The biggest shift was in the share of imports, which fell by about 5 percentage points of GDP. The share of exports in GDP also fell, but only by about 3 1/2 percentage points. As a result, net exports accounted for almost 2 percent of GDP in 1990 prices in mid-1995 (similar to its nominal share), compared to a zero share when measured in 1985 prices.

The persistent decline in the prices of private business investment goods relative to the GDP deflator resulted in about a 2 percentage point drop in their share of GDP when measured in 1990 prices. In contrast, the share of public consumption in GDP rose by about 1/2 percentage point in 1990 prices. Smaller and less systematic revisions are seen in the shares of private consumption and residential and public investment as a result of the rebasing.

4. Implicit deflators

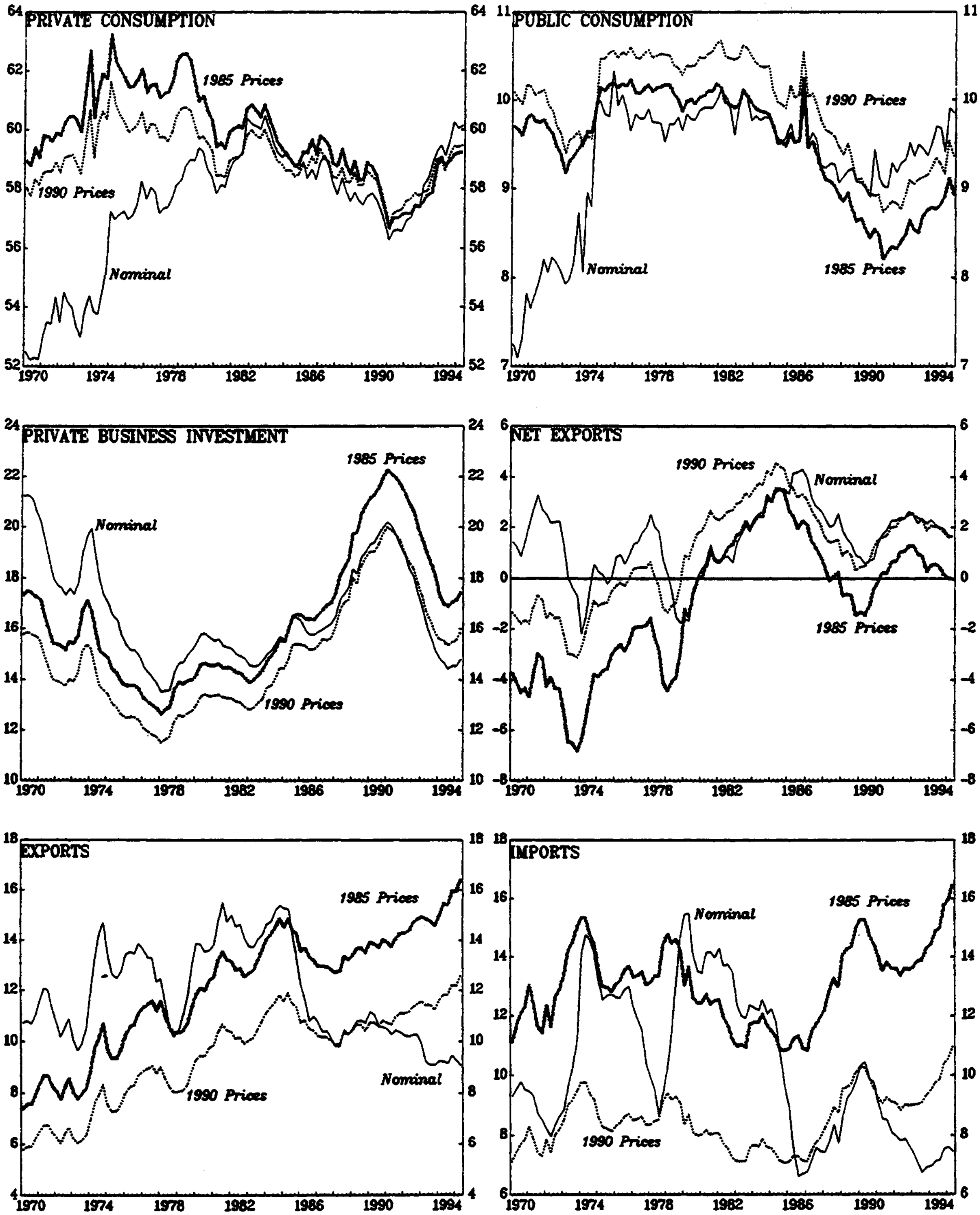
The changing composition of GDP between 1985 and 1990, as well as differing rates of inflation among the components, resulted in slight revisions in the GDP deflator. The largest occurred in public and private business investment, especially in 1994-95. The revision in the year-on-year change in the public investment deflator exceeded 5 percentage points during 1994:IV-1995:II, while private nonresidential investment inflation was revised down by about 4 percentage points in the middle two quarters of 1994. Other revisions were small by comparison. In total, the revisions in the year-on-year change in the GDP deflator exceeded 1 percentage point only two times since 1970 (in the fourth quarter of 1974 and the third quarter of 1980) and exceeded 1/2 percentage point 21 times in the 102 quarters since 1970.

CHART 2

JAPAN

GDP SHARES AT 1985 AND 1990 CONSTANT PRICES, 1970-95

(Percent of GDP)



Source: EPA, National Income Accounts.

Indicators of Government Debt Stock

Flow indicators of Japan's fiscal position have severely deteriorated since the onset of the downturn. In stock terms as well, the authorities have emphasized the high level of public debt as a constraint on fiscal action. On a national accounts basis though, debt indicators are mixed: the general government gross debt-to-GDP ratio is high, while the net debt-to-GDP ratio is low. As fiscal consolidation will be a high priority as the recovery becomes well established, increasing attention should be paid to debt stock developments as well as the flow concepts.

This annex discusses debt stock indicators for Japan. The following section describes the main measure used by the authorities, based on their budgetary accounts. Section 2 analyzes gross and net debt on a national accounts basis, including both developments over time and comparisons with other G-7 countries. The sectoral breakdown of the assets and liabilities of the general government is also examined in light of the large differences between gross and net debt. Section 3 proposes using net debt excluding social security assets as the most appropriate indicator to guide medium-term fiscal policy--the exclusion of social security assets is justified by the large unfunded liability in the social security sector.

1. Authorities' indicator of debt stock

In referring to the deterioration of the fiscal situation, the authorities use the outstanding balance of central government bonds as the main indicator of the debt stock. 1/ At the central government level, essentially all bonds are issued by the general account to finance its expenditures. Therefore, these outstanding government bonds represent direct borrowing of the general account. 2/ As a result of the continuing large fiscal deficits, that amount is officially projected to exceed ¥240 trillion (48 percent of GDP) at the end of FY 1996.

The outstanding balance of government bonds is a "gross" concept, because assets are not netted out. It is a subset of the central government gross debt on a national accounts basis. As the central government gross debt is projected to be ¥360 trillion at the end of FY 1996, the outstanding government bonds (¥240 trillion) constitute two thirds of total gross debt of the central government. 3/

1/ In flow terms, the authorities use the "bond-financing" ratio as well as the share of debt-service payments in general account expenditures.

2/ The general account also relies on "indirect" borrowing, such as the postponement of statutory payments to other government bodies.

3/ The remainder of the central government gross debt includes: liabilities of the general account in forms other than bonds; and liabilities of special accounts. One notable example is the debt of the former Japan National Railway Service that was taken over by the general account.

2. General government gross and net debt

Commonly used indicators of debt stocks include the ratios of the general government gross and net debt to GDP on a national accounts basis. The upper panel of Chart 1 shows the developments in these ratios over time, and their projected values through 2001. The net debt ratio declined rapidly during 1987-91, when the overall balance registered surpluses in the process of fiscal consolidation. During 1988-91, the gross debt ratio also declined, reflecting slower debt increases than GDP growth. 1/ As the focus of fiscal policy shifted from consolidation to demand support in 1992, both net and gross debt started rebounding, and, since then, they have increased rapidly. The increase is projected to continue over the medium term under currently announced policies.

Table 1 compares these indicators with those for other G-7 countries. The international comparison indicates that: Japan's gross debt is high and increasing rapidly; its net debt has been the lowest among the G-7 throughout the 1990s; and the differences between gross and net debt ratios are much larger for Japan than for any of the other G-7 countries.

The differences between gross and net debt are largely accounted for by the sizable social security assets. Table 2 shows the assets and liabilities of the general government as well as their breakdown into three subsectors in 1995. The liabilities of the central and local governments (about 90 percent of GDP)--which correspond to the general government gross debt--are offset by social security assets (about 45 percent of GDP) as well as by the assets of the central and local governments (about 35 percent), resulting in a net debt ratio of slightly above 10 percent of GDP. The lower panel of Chart 1 illustrates this relationship over time.

3. Net debt excluding social security assets

While net debt is an important indicator to gauge the sustainability of fiscal policy, an adjustment is required for Japan. Specifically, net debt is derived by deducting the asset holdings of three subsectors of the general government from gross liabilities. However, deducting social security assets is misleading in the case of Japan. The asset holdings of the social security fund cover part of the contingent liabilities of the social security system. The contingent liabilities are much larger in Japan than for other industrial countries, as population aging is projected to be the most rapid among the G-7. In Japan, the existing social security assets, even if they are currently sizable, are projected to be eroded over time, even with the full implementation of the ambitious 1994 pension reform plan. Offsetting the non-social security government debt by social security assets that are intended to finance part of the much larger future liability

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1/ In contrast, the level of outstanding government bonds has continuously increased during 1975-95, although its growth slowed in the late 1980s.

Table 1. Japan: Government Gross and Net Debt

(In percent of GDP)

	Gross Debt			Net Debt		
	1990	1995	2000	1990	1995	2000
Japan	69.8	89.0	100.1	9.5	10.8	21.0
United States	59.9	68.9	66.2	46.3	57.6	55.4
Germany	39.8	57.8	57.4	19.8	48.0	47.6
France	35.5	51.1	55.6	25.1	43.2	47.1
Italy	102.1	126.5	112.1	92.8	114.9	101.9
United Kingdom	34.4	49.0	45.4	27.2	42.5	38.9
Canada	72.7	98.0	92.7	44.0	67.2	65.0

Sources: For Japan, Economic Planning Agency, staff estimates and projections; and for other countries, October 1995 WEO.

Table 2. Japan: Public Sector Financial Assets and Liabilities, 1995

(In trillions of yen, unless otherwise indicated)

	Financial Assets	Financial Liabilities (Gross Debt)	Net Debt
General government	373.0 1/	425.0 1/	52.0
(In percent of GDP)	(77.6)	(88.4)	(10.8)
Central government	133.0	326.0	193.0
(In percent of GDP)	(27.7)	(67.8)	(40.1)
Local government	38.0	109.0	71.0
(In percent of GDP)	(7.9)	(22.7)	(14.8)
Social Security Fund	213.0	1.0	-212.0
(In percent of GDP)	(44.3)	(0.2)	(-44.1)
Memorandum item:			
Outstanding balance of government bonds as of end FY 1995		220.0	
(In percent of GDP)		(45.2)	

Sources: Economic Planning Agency; Ministry of Finance; and staff projections.

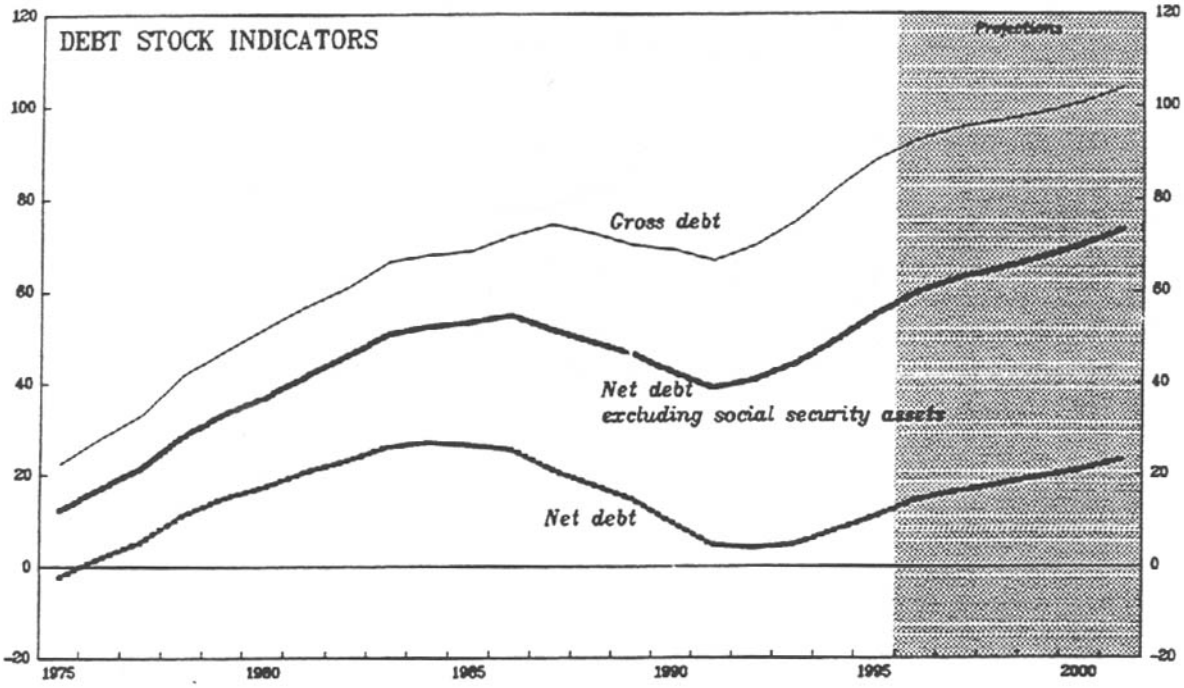
1/ Cross-holdings of assets and liabilities by subsectors are not netted out. The general government figure thus does not match the sum of three subsectors.

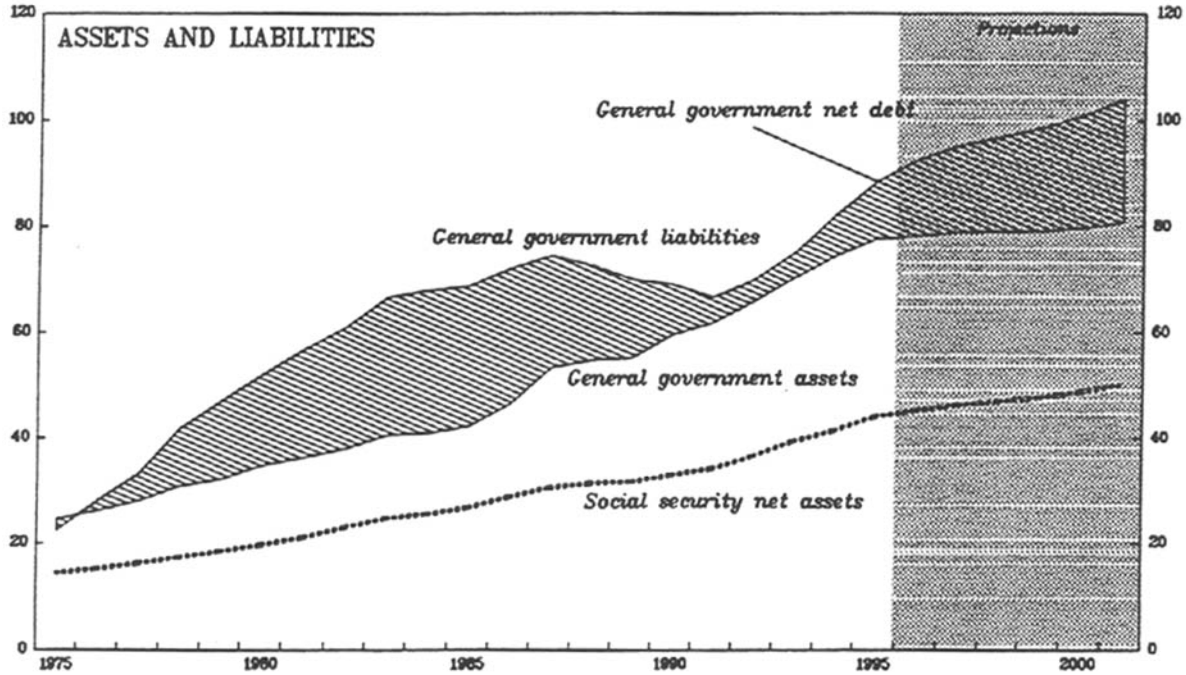
CHART 1

JAPAN

GENERAL GOVERNMENT DEBT STOCK, 1975-2001

(In percent of GDP)





Sources: Economic Planning Agency; and staff estimates and projections.

would thus result in a distorted picture of the fiscal situation. For the be treated separately from the rest of the general government. Net debt excluding social security assets would thus be the preferred indicator, consistent with the use of the general government balance excluding social security in flow analysis.

Developments in net debt ratio excluding social security are shown in the upper panel of Chart 1, together with gross and net debt. The ratio stood at around 40 percent of GDP in 1990, has risen rapidly to 55 percent of GDP in 1995, and is projected to reach 70 percent of GDP in 2000. These ratios are on the high side, compared with net debt ratios for other G-7 countries. Moreover, a projected sharp rise in net debt ratio for Japan, as opposed to declines in those ratios generally projected for other G-7 countries, underscores the severeness of Japan's fiscal challenges in the coming years.