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No. 1

THE POTENTIAL OF THE JAPANESE SURPLUS FOR
WORLD ECONOMIC DEVELOPMENT

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WORLD INSTITUTE FOR DEVELOPMENT ECONOMICS RESEARCH

The Potential of the Japanese Surplus for World Economic Development

Report of a Study Group of the World Institute for
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**THE POTENTIAL OF THE JAPANESE SURPLUS FOR
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Realizing the Potential of the Japanese Surplus for World Economic Development

A SEVEN-POINT PLAN.

EXECUTIVE SUMMARY

1. The international community should find methods to sustain higher growth in Japan in order to offset the decline in the momentum of the U.S. and counter any tendency towards world deflation.

2. While a part of the required policies would involve stepping up Japanese investment geared to her domestic market, there are real difficulties in absorbing domestically a rate of savings as high as 27 per cent of GNP.

3. For Japan's growth momentum to be sustained, therefore, there is a need for her to continue to rely to a substantial extent on export-led growth and to maintain a significant current account surplus in her balance of payments, in order to enable her to continue to "export" her excess savings abroad.

4. Japan's large current account surplus and her finding a large export market was primarily due to her comparative advantage in her export sectors, but she was also helped by the vast U.S. budget, and consequently, trade deficit.

5. Any reduction in the U.S. budget and trade deficit would tend to shrink, in the absence of offsetting policies, the external market for Japan, and reduce her economic growth and hence in the world economy. One such offsetting policy measure would be to enhance the import capacity of developing countries. This can be accomplished by re-directing the Japanese surplus to finance the deficits of the developing countries. This means that excess Japanese savings which cannot be absorbed domestically or in the U.S. can find a home in financing productive capital formation in the developing countries.

6. There is a need, therefore, for evolving mechanisms for financial intermediation of Japan's surplus towards this end.

7. Once this principle is accepted, the specific financial instruments and mechanisms can be worked out. They range from the notion of a Japanese Marshall Plan for the developing countries as has been recently proposed, to mechanisms for promoting Japanese investment in developing countries and increased lending by the Japanese international banks. Since the intermediation mechanisms have to enable private Japanese savings to find an outlet in developing countries, there may be a need for the Japanese government to promote this process either by subsidising the interest rate on loans to developing countries or by providing some collateral to Japanese private savings institutions to make investment in developing countries attractive.

The considerable reduction in recent years in Japan's fiscal deficit in relation to GNP and in her interest rates should permit this to happen with relative ease in the coming years. In this context the Japanese government could take the initiative of contributing one-tenth of one per cent (0.1 per cent) of her GNP to set up an international fund, while simultaneously inviting other industrial countries to join the fund by making a similar contribution. The fund would permit concessions and incentives of the sort mentioned above which would mobilize private capital flows to developing countries that are a substantial multiple of the resources available from the fund.

The Potential of the Japanese Surplus for World Economic Development

REPORT

The successes and failures of the developed market economies – their periods of boom and recession – are largely accounted for by the kinds of market conditions they face. Japan has been a consistent success story in recent decades because she could seek out a large international market to utilize her productive potential. It is the expanding export market that has fuelled a GNP growth rate in Japan that has consistently been at double the average rate of growth of key industrial countries in recent years; over the period 1980–85, Japan grew at 4.3 per cent while the average growth of industrial countries was only 2.2 per cent. The world economy slowed down in 1985 mainly because the U.S. growth rate lost its momentum with a decline of her growth rate from 6.6 per cent in 1984 to only 2.3 per cent in 1985. Had the Japanese economy not grown, even in 1985 at 4.2 per cent, the world economy would have slackened further.

The medium term scenarios of the OECD and IMF project a continuing slow growth of the world economy because the U.S. is not expected to grow beyond 3 per cent as she begins to correct her fiscal deficit. The projections of world economic growth would have been larger if they allowed for a continuing Japanese growth at 4 to 5 per cent. Instead, Japan is projected to grow at a little over 3 per cent during the years 1986–87. A high rate of growth of Japan is necessary for a high rate of growth of the world economy. The international community should find methods to sustain higher growth in Japan in order to offset the decline in the growth momentum of the U.S. Since export growth has been the main source of Japanese growth, this implies sustaining the momentum of high export in Japan. Even if this appears temporarily as a market loss for some countries like the U.S., in the long run, a growing world economy would allow for expansion of their markets. This would be the more so, if Japanese export growth is attended by a recycling of her export surplus to finance the import-surplus of the developing countries for products from industrial countries.

The high export growth of Japan has led to an increasing current account surplus as imports did not grow at the same pace. Although there may be good arguments for increasing Japanese imports, they do not call for an appreciation of the Yen, as these imports are mainly determined by structural factors and not very responsive to price changes. The exchange rate of the Yen should be guided mainly by the consideration of maintaining a high rate of growth in exports, while the problem of sustaining the current

account surplus should be dealt with by appropriate financial mechanisms.

The current account balance of payments for 1985 of the major actors in the world economy shows that the key deficits are in the United States (US\$120 billion) and in the developing countries (US\$45 billion), which together, add up to US\$165 billion. The surpluses are mainly those of Japan (US\$50 billion) and Germany (US\$15 billion). In fact, Japan has run a substantial current account surplus in recent years and this is expected to grow even larger in the next two years, particularly as a result of the decline in oil prices. A large part of the world's surpluses now go to financing the very large U.S. deficit, while the developing countries' deficit, excluding official transfers, is less than half the level of approximately US\$100 billion that they reached in the early '80s and reflects the severe cutbacks in import capacity and economic activity since then. To compensate for the recessionary effects of the expected reduction in the U.S. budget deficit, it is necessary to sustain growth in other parts of the world economy. One measure to offset these recessionary effects would be to enhance import capacity in developing countries which can be accomplished by re-directing the Japanese surplus away from the U.S. to finance the deficits of the developing countries.

Undoubtedly, surpluses and deficits are to a large extent reflections of the relative strength in international competitiveness among nations. Japan has outperformed its trade competitors, and this has sharply brought into focus the almost paradoxically interdependent aspects of the international payments system. Japan's large current account surplus and her finding a large market could not have materialized without the vast U.S. budget and consequently, trade deficit which largely sustained Japan's export market. **Obversely**, without structurally large Japanese domestic savings attracted to the United States through higher U.S. interest rates, and until a year ago by an appreciating dollar, the large budget and trade deficits of the U.S. simply could not have been sustained. These conditions have been changing in the last few months. Any reduction in the U.S. budget (and trade) deficit would tend to shrink the external market for Japan without appropriate counter-acting policies and, if that happens, the lower level of economic activity in Japan would have its chain reaction in depressing world trade and growth further. The present international financial system, closely linked to U.S. national policy, has no way of dealing with such negative chain reactions unless Japan and Germany take some initiative in these matters. In its absence, the world economy will continue to be exceptionally recession prone.

An inward-looking Japanese policy, as is currently counselled by many, would rely increasingly on its domestic market. The transition from a successful regime of export-led growth to a domestic market-oriented growth regime is beset with so many difficulties that inward looking policies are likely to doom Japan to a future of lower growth and higher unemployment. Although it is necessary and desirable to raise domestic investment and expenditure on housing and other public goods, it is very difficult to imagine that a highly industrialized economy like Japan would be able to absorb all its 27 per cent rate of private savings in relation to GNP by increasing the rate of domestic investment and reducing the current account surplus. In a very real sense, the current account surplus in Japan is structural, reflecting the high rate of private savings that cannot be absorbed by domestic investment. The Japanese surplus on current account has increased from 2.1 per cent of GNP in 1983 to 3 per cent in 1984 and to 3.6 per cent in 1985. Even if

domestic consumption is stimulated by special incentives, it is unlikely that the private rate of savings would come down significantly in the medium term as Japanese savings behaviour is determined largely by long-term demographic and sociological factors. Similarly, it is unlikely that, with all the stimulus to domestic investment activity, the savings/investment gap can be reduced drastically, and the current account surplus, as a percentage of GNP, can be brought lower than 2.5 per cent to 3 per cent in the next few years, without bringing down the Japanese rate of economic growth.

The other option open to Japan is to build on the strength of its international position (Japan accounts for one-tenth of the world's GDP) and to take an initiative in co-ordinating international economic policies for the mutual benefit of nations engaged in world trade which other surplus countries, notably Germany, could be encouraged to join. The purpose would be to maintain the exports growth and hence the GNP growth of Japan as a stimulus to the growth of the world economy, and adopt measures to allow the current account surplus of Japan to finance the deficits of other growing economies. This can be initiated through evolving mechanisms for financial intermediation of the Japanese surplus. As mentioned before, when the American deficit decreases and creates deflationary pressures in the world market, Japan could partly counter this pressure by diverting its surplus through financial intermediation to the developing countries. This would increase the latter's international purchasing power, and in turn would expand the external market of Japan and other industrial countries.

Conditions are now favourable for Japan to take this initiative in two different ways. First, the Japanese banking system has been developing its international capabilities through the last decade and a half at a rapid rate. Since 1981, Japan has accumulated current payments surpluses exceeding US\$160 billion, of which less than \$10 billion has been added to Japanese reserves while the rest has been increasingly recycled through Japanese banks and securities firms. Today, Japan owns the largest share of 25 per cent of the **total** of international banking assets. Japan has now displaced American banks into second place with the latter accounting for 18 per cent. So financial infrastructural facilities are sufficiently developed in Japan to facilitate the diversion of surplus savings to the developing world. A necessary condition, however, for starting new lending by the international banks would be to solve the problems of outstanding debt of the developing countries through measures such as the extension of maturities and lowering of interest rates. An example of such a measure is the Hattori Plan to establish an International Solidarity Bank, replacing hard commercial loans by loans on more reasonable terms, and this principle can be extended also to other cases. The implementation of the Hattori Plan would be complementary to the initiatives under the Baker Plan.

Secondly, mechanisms can be created to channel Japanese capital directly to developing countries, with the support of the Japanese government, by mobilizing Japanese private savings for portfolio and equity investment in these countries. If the principle is accepted, the specific nature of the financial instruments and intermediation mechanisms can be worked out. From the broad and humane philosophy of the proposal for a Japanese Marshall Plan for the developing countries, to the specifics of the financial instruments required for diverting the Japanese surplus to the Third World, there exists a wide spectrum of options and combinations to be elaborated. Looking at the nature of Japanese capital outflows and foreign investment,

it would appear that the main motivating force is capital security, and not so much the market rate of return. Any recycling mechanism which has the guarantee of an international institution such as the IMF or the World Bank, or the major industrial countries, would at least partly meet the requirement.

The international institutions and the developing countries have to play a major role in providing guarantees as well as ensuring fair returns on the investment of the Japanese surplus. But it may also be necessary for the Japanese government to play an active part in this process of recycling either in the form of subsidising the interest rates or giving special incentives for investment income earned in developing countries or in providing some collateral to Japanese private savings institutions to make investment in these countries attractive. The fiscal implication of such a role of the Japanese government may not be substantial. It may be noted that the fiscal deficit as a percentage of GNP in Japan has been brought down considerably in recent years. With such a high rate of private savings as in Japan, the fiscal deficit of the public sector has very little crowding out effect and some subsidisation by the government of private equity or portfolio investment in developing countries may play a catalytic role in mobilizing resources with a very large impact on the developing countries and the world economy. In this context, a beginning can be made by creating an international fund for promoting private capital flows from the developed to the developing countries. This should cover all kinds of private capital, including direct and portfolio investment as well as bank lending, and should be used directly or indirectly through the governments of the countries concerned, for providing interest subsidies, concessional treatment of investment income and other possible incentives. A number of feasible schemes can be worked out which would make the mobilization of actual capital flows to developing countries a substantial multiple of the resources available from this fund. What is required, however, is the political will of the industrial countries who should agree to provide additional funds for this purpose over and above their official development assistance and contributions to multilateral institutions. The Japanese government could take the initiative of contributing one-tenth of one per cent (0.1 per cent) of her GNP to set up such an international fund, while simultaneously inviting other industrial countries to join the fund by making a similar contribution.