CONFIDENTIAL

Prime Minister

A.J.C. 18/3

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000 17 March 1982

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MS 19/3.

M Scholar Esq
No.10 Downing Street

Dear Michael,

ANGLO-GERMAN CONSULTATIONS: EC - JAPAN RELATIONS

The Chancellor has noted that, whereas the French Government share our view of the need for the Community to get fairly tough with the Japanese about their macro-economic and trading policies, the German Government are more doubtful. He therefore proposes to raise the matter with Herr Matthofer on Friday, and to give him the attached note.

There could well be advantage in the Prime Minister's touching on the subject if there is time during her talks with Chancellor Schmidt. The Chancellor has it in mind to propose this at the Prime Minister's briefing meeting tomorrow.

Copies of this letter to go to Brian Fall at the FCO, John Rhodes at DOT, and David Wright in the Cabinet Office.

Yours ever,

John Kerr.

J O KERR
Principal Private Secretary

EC/JAPAN RELATIONS

Japan has survived the second oil price shock more successfully than other industrial countries - with higher output growth, and lower unemployment and inflation. GDP growth has averaged 4 per cent in each of the past two years, compared with only 1 per cent in other major economies. Unemployment is about 2 per cent compared to 8 per cent in other OECD countries. Inflation was 3.3 per cent in the twelve months to the end of January, and has been virtually nil since October.

2. The recovery, however, has been biased heavily towards external demand. Net external demand has accounted for about three-quarters of Japan's GDP growth in the past two years, and, despite the deceleration of export growth in past months, it is expected to contribute significantly again this year. Indeed since 1974 the contribution of the external sector to growth in Japan has been far more than was necessary to compensate for the effect on Japanese import costs of the two oil price increases. It is right that we should consider the implications of this situation both for our own economies and for the general equilibrium of the world economy and the health of the open trading system.

3. The emergence of large Japanese surpluses is not a new problem. It has occurred at roughly the same point in previous cycles, contributing significantly to trade and exchange rate tensions in the world.

4. We must of course acknowledge the efficiency of the Japanese economy, and must in turn continue our own adjustment efforts. But Japan's success has been built to a significant extent upon a relatively closed non-market economic system, supported by macro-economic and exchange rate policies which give undue weight to external rather than domestic demand.

5. We are by now all familiar with the barriers to imports into Japan - both formal and informal - which have resulted in imports being only a sixth of GDP compared with almost double that, for example, in Germany and the UK. Imports of raw materials, fuels and food into Japan are, as a proportion of GDP, broadly in line with those of the

/UK and Germany.

UK and Germany. But imports of manufactures into Japan account for only 3 per cent of GDP compared to 10 per cent in other major economies.

6. We are also all familiar with the way in which Japan's tightly-controlled industrial strategy, involving government, industry and banks, results in a narrow concentration of export products with disruptive effects in particular markets in other countries. In addition to the impact of the excess of their exports over manufactured imports, the speed of attack on particular markets creates havoc in individual sectors.

7. Underlying all these difficulties is the high level of Japanese savings which are not matched by domestic private investment or public borrowing. The Government's present stringent fiscal policy should be seen in this light. A recent Commission paper shows that Japan's budget deficit is expected to be reduced to about 2 per cent of GDP - below the average for the Community or for the United States. With inflation now reduced to 3 to 4 per cent and a current account surplus, the Government is seeking further economies to balance the current budget by 1984. Yet personal savings account for 18 per cent of incomes in Japan compared to about 8 per cent in the other major economies. Japan's scope for fiscal manoeuvre, therefore, should now be larger - not smaller - than that of other countries. The excess of savings over investment is producing the current external surplus to which the rest of us are having such difficulty adjusting.

8. The Japanese are at the same time pursuing a policy of accommodating monetary growth and low interest rates. Monetary growth (M2) has been about 10-11 per cent over the past year and three-month interest rates have been reduced to 6½ per cent, well below those in other countries. A major effect of this, however, has been to prevent the yen appreciating to reflect fully the underlying strength of Japan's competitive position and the emerging current surplus. On the contrary the yen's effective rate has fallen by about 8 per cent since February 1981.

9. As a result of pressure from overseas the Japanese have recently introduced a number of trade liberalisation measures. Though welcome,

/these rather limited

these rather limited steps will not by themselves restrain the growth of the surpluses which pose problems for their trading partners. In these circumstances it is appropriate that Community governments should consider whether, while maintaining pressure on the trade front, it would not also be appropriate to encourage the Japanese to alter the mix of their macro-economic policies.

10. It is no part of our thinking that we should urge net expansionary measures on the Japanese at a time when we are concerned to consolidate the gains that we have made in the world as a whole in reducing inflation. But we should ask the Japanese to pay more attention to the structural aspects of their situation which, if reinforced by their policies, tend to make them an uncomfortable partner in the open trading system and so encourage protectionism. This should lead them to cut back less in the fiscal field where they are effectively increasing taxation and to rein back their relaxed monetary stance so that the yen can rise to reflect its true strength. This would help to restore a better balance in the international economy as a whole.

11. It would also be entirely consistent with our approach to the United States, whose policies are also threatening to disrupt the world economy but from the opposite direction. The present mix of Japanese and U.S. fiscal and monetary policy is a powerful threat to the open trading system because of the bilateral imbalance and protectionist pressures it is likely to generate.