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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/32

10:00 a.m., February 29, 1984

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	J.-C. Obame, Temporary
J. de Groote	H. G. Schneider
B. de Maulde	X. Blandin
	J. Delgadillo, Temporary
R. D. Erb	M. K. Bush
M. Finaish	T. Alhaimus
T. Hirao	T. Yamashita
J. E. Ismael	Jaafar A.
R. K. Joyce	
A. Kafka	C. Robalino
G. Laske	
	C. P. Caranicas
	A. S. Jayawardena
Y. A. Nimatallah	J. E. Suraisry
J. J. Polak	T. de Vries
	K. G. Morrell
G. Salehkhou	O. Kabbaj
F. Sangare	E. I. M. Mtei
M. A. Senior	
J. Tvedt	
N. Wicks	T. A. Clark
Zhang Z.	Wang E.

L. Van Houtven, Secretary
J. C. Corr, Assistant

Also Present

Asian Department: Tun Thin, Director; P. R. Narvekar, Deputy Director; U. Baumgartner, J. T. Boorman, D. A. Citrin, R. J. Hides, S. Kashiwagi, I. Otani, S. M. Schadler. European Department: P. B. de Fontenay, H. B. Junz, S. M. Thakur. Exchange and Trade Relations Department: C. D. Finch, Director; W. A. Beveridge, Deputy Director; S. Mookerjee, Deputy Director; S. Eken, M. Guitian, J. P. Lipsky. Fiscal Affairs Department: R. A. Feldman, W. R. Mahler, Jr. IMF Institute: H. Ujikane, Participant. Legal Department: G. P. Nicoletopoulos, Director; A. O. Liuksila. Research Department: W. C. Hood, Economic Counsellor and Director; J. Artus, M. D. Knight. Secretary's Department: A. P. Bhagwat. Treasurer's Department: D. Williams, Deputy Treasurer. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; A. M. Jul, T. M. Reichmann. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: S. R. Abiad, C. J. Batliwalla, K. A. Hansen, H.-S. Lee, W. Moerke, G. E. L. Nguyen, Y. Okubo, I. R. Panday, D. I. S. Shaw, D. C. Templeman. Assistants to Executive Directors: J. R. N. Almeida, R. L. Bernardo, J. Bulloch, M. B. Chatah, G. Ercel, V. Govindarajan, N. U. Haque, J. M. Jones, H. Kobayashi, M. J. Kooymans, G. W. K. Pickering, M. Rasyid, J. Reddy, A. A. Scholten, Shao Z., S. Sornyanyontr, Wang C. Y., A. Yasseri.

1. BRAZIL - REPORT BY STAFF

The staff representative from the Western Hemisphere Department stated that a recent staff mission to Brazil had focused on three tasks: the 1983 Article IV consultation, the review of the program under the extended arrangement with Brazil, and the circumstances regarding a waiver of certain performance criteria that had not been observed at the end of December 1983. With regard to the consultation and the review, the staff papers would be circulated to Executive Directors in due course, together with the authorities' letter of intent, for Executive Board discussion in April or early May. The Executive Board's consideration of the possible waiver was tentatively scheduled for the following week.

The Brazilian authorities were determined to maintain control of the economic situation and to keep to the program agreed under the extended arrangement, the staff representative continued. They intended to adhere to the original monetary targets agreed in November 1983, including the programmed expansion of 50 percent in the monetary base during 1984. Similarly, they intended to increase the money supply by the agreed 50 percent. The staff had discussed monetary policy in detail and had reached understandings with the authorities on mechanisms to monitor monetary developments closely. Although there had been deviations from the agreed path for the monetary base, they were in the process of being corrected, and the authorities were confident that by the end of March they would achieve the original target of an expansion of 2 percent in the monetary base for the first quarter of 1984 as a whole. The authorities had also recently taken measures allowing them to pursue a more active interest rate policy; as a result, interest rates were rising.

With regard to fiscal policy, the staff representative remarked, the mechanisms set up in 1983 to monitor public sector budgetary developments appeared to be working effectively. The authorities were confident that they would be able to reach the target of a surplus in the operational budget for 1984 as a whole.

Among the areas of concern discussed with the authorities were the strong pressures in the economy to resist the planned tightening of monetary and fiscal policy, the staff representative remarked. There was, for example, pressure to obtain more credit than warranted under the 50 percent expansion target. The consequences of further increases in interest rates were also a matter of concern. On the fiscal side, there were pressures from states and municipalities to exceed the budget limits agreed for the state enterprises, and to expand housing construction. In addition, the social security system, which was running a deficit, was creating a difficult situation.

A major concern, affecting all areas of policy, was inflation, the staff representative went on. Inflation remained subject to cost-push pressures, primarily from agriculture, and those pressures would not subside before the new harvest. The almost full indexation of the economy and the variability of monetary policy in recent months were also creating problems. It was expected that if monetary policy remained tight for several months and if the new harvest were good, which appeared likely, there could be a break in inflation in April or May. Because the results on the inflation front to date had not been encouraging, the staff had agreed with the authorities that their overall policy stance would have to be reassessed if a break in inflation did not occur as soon as expected. It was generally agreed that the tight monetary and fiscal policies should produce such a break, but it was difficult to say when it might occur. Only one of the performance criteria in the program, the overall public sector borrowing requirement (PSBR), was directly affected by inflation; in view of the poor results so far, the PSBR limit would have to be revised upward to about 12 percent for all of 1984. However, that limit still represented a significant decline from the increase of 18 percent in 1983.

There had been an unexpected, but welcome, outcome with regard to the current account of the balance of payments in 1983, the staff representative noted. "Other service payments" had turned out to be about $1 billion less than expected, so that the current account deficit for 1983 had turned out to be about $6.2 billion rather than the approximately $7.3 billion expected earlier. However, because of shortfalls from parts of the 1983 financing package relating to trade credits and interbank facilities of about the same amount, the overall balance of payments had turned out as expected. In order to reduce the risk of further unanticipated shortfalls, the authorities had agreed to aim at a target of about $5 billion for the current account deficit for 1984 rather than the original $6 billion.

The request for a waiver of certain performance criteria not met at the end of December 1983 arose from the fact that there had been a delay in the disbursement of the new money facility of Phase 2 of the commercial banks' financial package, the staff representative commented. It had been expected that $3.5 billion of that facility would have been disbursed in December 1983, with a further disbursement of $1.5 billion in the first quarter of 1984. However, in the event, no money had been disbursed in December, and $3 billion was to be disbursed in March. As a result, the waiver was intended to adjust the December and March ceilings to allow for the different pattern of disbursements and to waive compliance with two other performance criteria arising from the delay in disbursements, namely, the elimination of payments arrears by December 31, 1983, and the elimination of the centralized allocation system for foreign exchange by the same date. Neither of the latter two actions could have been taken earlier in the absence of the necessary foreign exchange. The authorities now intended to eliminate all arrears and the centralized allocation system by March 28, 1984.

With regard to debt that might become eligible for rescheduling under the Paris Club, the staff representative noted, the authorities intended to establish as soon as possible a definitive list of the loans eligible for rescheduling and to pay all remaining arrears on loans not included in that list. In cases of doubt, the authorities stood ready to pay any debts that the appropriate trading agency certified were not included under the Paris Club. The Paris Club had already agreed that all bilateral agreements should be finalized by June 30, 1984. The Brazilian authorities expected that the process would be more rapid and that they would be able to clear up all doubtful cases in April or early May.

The elimination of the centralized system for foreign exchange allocation was a difficult issue for the authorities, the staff representative observed, because there continued to be uncertainty about the extent of demand for foreign exchange in the economy and about the extent to which foreign companies would take advantage of the elimination of the system to advance their remittances of profit and dividends. There was also a question whether the authorities' cashflow position would permit full liberalization of the allocation system. However, the authorities had decided to go ahead despite the risks, and to eliminate the centralized foreign exchange allocation system by the end of March. In those circumstances, the situation would be restored to what had been agreed under the program, and no further modification would be required.

Another area creating problems for the authorities was the elimination of the multiple currency practice arising from a contribution quota on coffee exports, the staff representative from the Western Hemisphere Department added. The practice should have been eliminated by December 31, 1983, but it had turned out that the political and economic ramifications of such a move were more serious than the authorities could contemplate at present. Nevertheless, they had decided to proceed with the elimination and intended to announce publicly that the contribution quota would be removed by January 2, 1985. They also intended to set up a study group of all interested parties to report on the issue by April 30, 1984. Thus, the commitment by the authorities was essentially the same as had been made a year earlier, but it was now being made in a more public fashion. The scope of the proposed waiver would also cover the extension to petroleum imports of the import surcharge currently affecting nonpetroleum imports. Action in that regard had been suggested for fiscal reasons by the staff. The surcharge on all imports would be eliminated during 1985.

The Chairman remarked that it was important that Brazil should be able to draw on the Fund's resources no later than March 15, 1984 to underpin the total financing package. In order for the Treasurer to prepare the drawing, the Executive Board would need to take a decision on the waiver by March 9 at the latest. A staff paper on the waiver would be circulated on March 2, with arrangements made for a special delivery to Executive Directors, if necessary. The paper on the review under the arrangement and on the performance criteria until the end of the third quarter of 1984 would be circulated in the usual way.

Mr. Kafka said that in addition to the reason mentioned by the Chairman, there were two other reasons why the waiver should be approved by the Executive Board as soon as possible. Because of the abolition of centralized exchange control, it would be important for the authorities to have as much cash in hand as possible at as early an opportunity as possible. After Brazil had drawn the first $3 billion from the "jumbo loan," the drawing of the next tranche of the loans from the commercial banks was dependent on prior drawing from the Fund of the next tranche under the extended arrangement. Second, Brazil was entering a period of unprecedented austerity; it would be important for the Brazilian public to be aware that the Fund was being as supportive as possible.

Mr. Caranicas asked if the staff had prepared a written statement and, if so, whether such a statement could be circulated to Executive Directors.

The Chairman replied that the staff had not yet prepared a written statement. The informal report by the staff representative from the Western Hemisphere Department contained the major elements of the paper that would be circulated to Executive Directors by the end of the week. If, before then, Directors needed clarification of the information presented, the staff would be ready to assist.

2. JAPAN - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Japan (SM/84/32, 1/30/84; and Sup. 1, 2/13/84). They also had before them a report on recent economic developments in Japan (SM/84/41, 2/9/84; and Sup. 1, 2/14/84).

The staff representative from the Asian Department said that in the first paragraph on page 17 of SM/84/32, referring to the market-opening measures of May 1982 and January 1983, the reduction from 7.7 percent to 4.5 percent in the average tariff related to all imports affected by the market-opening measures and not, as the wording currently implied, to all dutiable imports. On page 6a of the same document, in the lower panel of Chart 5, the exchange rate measurement on the right scale was expressed in yen per U.S. dollar, not U.S. dollars per yen.

Mr. Hirao made the following statement:

> In my statement, I propose to touch on three topics: developments during the current fiscal year, the outlook for the coming year, and some further observations on policy aspects.
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> Developments during fiscal year 1983/84
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> Developments during 1983/84 have been characterized by emerging signs of moderate recovery after three years of adjustment. The real growth rate, reversing the declining trend since 1980/81, is now expected to be about 3.4 percent. During the first half of 1983/84, which ended last September, about one half of the growth was accounted for by the external sector. In the second half, however, growth is expected to be largely the result of an increase in domestic demand. Underlying the strengthening of Japan's economic activity were the global economic recovery, improvement in the terms of trade due to the oil price decline, completion of the inventory adjustment, and continued price stability. Private

consumption, which slowed through the first half of 1983, picked up in the third quarter. Plant and equipment investment by large corporations showed signs of recovery after a period of sluggishness which commenced in late 1982. Investment by small and medium-sized corporations is also reviving after a long spell of inactivity. Private residential investment, which was temporarily weak until about mid-year, has been edging upward.

Price movements have been stable, with the consumer price index increasing by 2 percent and the wholesale price index falling by 2.3 percent in 1983/84. The external current account surplus is expected to reach about $23 billion, compared with $9 billion for the previous fiscal year. About half of the increase in the surplus is accounted for by the decline in the payments for fuel, which reflected both a lower world price and conservation efforts.

In order to enhance domestic demand, the Government continued to front-load the public works program. Furthermore, in October 1983 it adopted a comprehensive package of economic measures that included an increase in public works expenditures amounting to ¥ 1.9 trillion, an income and resident tax reduction totaling ¥ 1.2 trillion (spread over two years), and specific steps to support activities of small and medium-sized corporations. Measures aimed at market opening and import promotion, etc., were also part of the package. The flexible and timely implementation of fiscal policy has further strengthened the case for sustained economic recovery during the fiscal year.

Monetary policy has been under severe constraints because of foreign exchange considerations. The 0.5 percentage point reduction in the official discount rate announced concurrently with the economic package was the first since December 1981. The subsequent stable movements of the yen in the exchange markets suggest that the dual objectives of the authorities to exert a favorable impact on corporate profits through lowering the level of interest rates while avoiding an adverse effect on the yen exchange rate have been achieved.

The outlook for fiscal year 1984/85

The basic policy stance for 1984/85 is the following:

- to remain flexible in conducting economic policies in order to achieve steady recovery based on the expansion of domestic private demand. For sustained growth over the medium term, it will be essential to regain vigor in the private sector. The Government is committed to continuing its efforts to provide an environment conducive to increased private investment.

- to secure price stability, which is the basis for economic well-being and balanced growth. The authorities will continue to monitor monetary aggregates closely while taking into account international monetary developments.

- to enforce administrative reforms in the public sector. Extensive reviews are being made on the appropriate role of the public sector, with a view to adapting its function to the future needs of society. To this end, further efforts will be made toward implementing greater efficiency and simplification.

- to continue the commitment to maintaining and furthering the free trade system. The Government is determined to make continued efforts to open further Japan's markets and to enhance imports. It is expected that a growth rate of about 4.1 percent--of which about 3.6 percent will be gained from an expansion in domestic demand--is expected to be achieved in 1984/85. Private consumption is forecast to grow by about 4.1 percent, reflecting the per cent increase in personal income as well as the effects of tax cuts. Private equipment investment started showing strong signs of recovery at the end of 1983, due to a rise in capacity utilization, improvements in corporate profits, and other factors. A strong recovery in investment is expected to take place during 1984/85 with a 5.1 percent growth rate, the highest in four years. Prices are expected to be stable in 1984/85, with the wholesale price index and the consumer price index expected to rise by 1 percent and 2.8 percent, respectively. As regards an external balance projection, which is particularly difficult to make, the current account is forecast to show a surplus of roughly the same order as in FY 1983/84, reflecting stabilized oil prices, the appreciation in 1983 of the effective value of the yen, and the expected buoyancy of domestic demand. With a net long-term capital outflow of about the same magnitude, the basic balance is expected to be near equilibrium.

Some further observations on policy aspects

Public finance has been in severe disequilibrium as a result of structural changes that took place during the 1970s, when growth in tax revenue decelerated while expenditure rose despite the slowdown in economic growth. Beginning in 1975/76, the fiscal balance has continuously deteriorated, regardless of business cycles. This suggests that a large part of the deficit is structural. In the past nine fiscal years, tax revenue covered on average approximately 63 percent of total expenditure. The fiscal deficit, in terms of GNP, has been about 5 percent.

The persistence of structural deficits over the nine-year period has severely limited room for policy maneuver, almost to the point where there is virtually no scope for discretionary measures. This can be illustrated by the following exercise: given a nominal growth rate of 6.5 percent (assuming the average growth rate through 1990 to be 6-7 percent), an elasticity of tax revenue of 1.1, and the resulting tax revenue increase of about 7 percent, the tax revenue would grow by ¥ 2.2 trillion, on the basis of the actual tax revenue of ¥ 32 trillion in 1983/84. Again, given government bond issues in 1983/84 amounting to ¥ 13.3 trillion, and a coupon rate of 7.3 percent, interest payments would rise by about ¥ 1 trillion over the previous year. In addition, 32 percent of revenue from the three major taxes--corporate, individual income, and liquor--would be transferred to local governments (transfer tax), which roughly amounts to ¥ 0.6 trillion. Thus, of the ¥ 2.2 trillion increase in tax revenue, ¥ 1.6 trillion would automatically be outgoing. The remaining ¥ 0.6 trillion--equivalent to only 27 percent of the increase in tax revenue--would barely equal 2 percent of general expenditure (total government expenditure less interest payments and transfer taxes), which currently stands at about ¥ 32 trillion. With only a 2 percent margin in nominal terms, severe expenditure restraint would be needed just to meet legitimate increased demand for international development cooperation, social security payments, and other important expenditures, not to mention other discretionary expenditures.

Fiscal deficits associated with business cycles can be regarded as temporary and may disappear when the economy recovers. Deficits caused by a built-in stabilizer might be reversed. Structural deficits, however, cannot be expected to disappear automatically unless appropriate measures are taken. As demonstrated above, in a situation where imbalances have persisted for a long time, additional bond issues would be followed by a sizable increase in interest payments in the next fiscal year. Thus, even if the economy grew at a favorable pace, the fiscal position would not be able to meet the growing legitimate needs for additional expenditure, leaving a large unreduced fiscal deficit. Even if the Government were successful in containing general expenditure at "no growth," new bond issues of ¥ 12-13 trillion would be needed. The result would be snowballing interest payments that would further aggravate the structural deficit.

It is sometimes argued that fiscal stimulus can be expected to result in a larger automatic tax increase through stepped-up economic activity. In my view, this argument does not apply to the present state of the Japanese economy. A tentative estimate shows that an additional ¥ 1 trillion for public works would yield, including local taxes and fees, a cumulative revenue increase of about ¥ 0.76 trillion over three years. The net return to the Central Government's General Account would be far smaller because of the additional interest payments incurred on the ¥ 1 trillion bond issue. Thus, a stimulative fiscal policy would result in an increase in the deficit rather than a decrease.

As a result of continued fiscal imbalances, government bonds outstanding at the end of 1984/85 are expected to top ¥ 120 trillion--roughly 40 percent of GNP, or 45 percent if other long-term debt is included--the highest among major industrial countries. What is most disconcerting is that the outstanding amount has been rising sharply over the past nine years. In the present circumstances, where coupon rates on bonds exceed the nominal economic growth rate, debt service expenditure will increase at an accelerated pace. The share of interest payments in total expenditure--having increased from 2 percent in 1970/71 to 17 percent in 1983/84 and a projected 18 percent in 1984/85--the highest among major industrial countries, is increasing at a rapid rate. I believe this is the most serious factor undermining the flexibility of fiscal policy.

If the attainment of sustained economic growth over the medium term is to be the primary policy objective, it is essential to restore fiscal soundness. No economy can achieve sustained growth over a number of years with an unsound fiscal position. Japan should regain its ability to respond flexibly to the changing needs of the times. To this end, efforts should be made over time to reduce inefficient expenditures and misallocated fiscal resources. In particular, the debt service expenditure should be reduced, or at least contained. Accordingly, reducing fiscal deficits would be a most important step. The solution could be found in the following areas. First, efforts toward administrative reform should be enhanced. Second, certain public sector activities should be shifted to the private sector for more efficient performance. Third, the tax structure should be re-examined so as to close any fiscal gap remaining even after the first two efforts are fully exerted. If a credible program aimed at restoring fiscal soundness could be set in place and steadily implemented, it would enhance public confidence in the Government's ability to manage its economic affairs, and this in turn would help to achieve sustained growth led by private domestic demand.

The program for fiscal soundness should be effected steadily over the long run. Equally important is the implementation of policies as flexibly as possible so as to respond appropriately to the changing phases of business cycles. This has been clearly demonstrated by the flexible conduct of fiscal policy during the past three years. Fortunately, as already indicated, domestic private demand is expected to recover strongly in 1984/85, thereby virtually eliminating the need for discretionary stimulative measures.

The 1984/85 budget presented to the Diet thus reflects the firm commitment to pursue the goals of enhancing domestic economic growth within the framework of limited resources, improving the quality of public services, and implementing the measures contained in the March 1983 Report of the Ad Hoc Committee for Administrative Reform. One example is the proposed reform in the financing of local governments, which includes a ban on borrowing by local governments from the Trust Fund Bureau (see footnote 1 on page 41 of SM/84/41) to finance their deficit spending. Another is the proposed reduction in the medical benefits of principal participants from 100 percent to 90 percent of the actual costs, with a further cut in 1986/87 to 80 percent. This aims at restoring the soundness of medical insurance by stemming abuses of these resources. As regards the National Railway, which has been run with ever-growing deficits for many years, a reduction in the number of employees, restraint on investment outlays, and increased revenues are envisaged. Through these streamlining efforts, it would operate more efficiently, leading to a drastic cut in government subsidies. On the revenue side, income taxes will be reduced by about ¥ 870 billion in order to alleviate the wage earners' burden, which has been increased by fiscal drag over the years. Local resident taxes will also be cut by about ¥ 310 billion. At the same time, corporate income, liquor, and commodity taxes will be raised. In order to encourage investment in new equipment by small and medium-sized enterprises, a special amortization scheme is being proposed, with an option for a special tax credit.

With regard to the exchange rate of the yen last year, the following salient features could be observed. First, the average rate in terms of U.S. dollars in calendar year 1983 was ¥ 237.61, an appreciation of ¥ 11.65 over the 1982 average. Second, the movement in the rate was relatively stable in 1983. The yen moved within a range of ¥ 20.60 during the year, compared with a range of some ¥ 50-60 during the past few years. Third, market perception was influenced predominantly by interest rate differentials or by U.S. interest rate movements, and the movement in the exchange rate had a close correlation to interest rate differentials throughout the year, as clearly shown in Chart 5 of the staff report. Fourth, the yen appreciated considerably against major European currencies: by 16 percent against the deutsche mark, by 13 percent against the pound sterling, by 25 percent against the French franc, and by 11 percent against the Swiss franc.

A stronger yen would have benefited the economy through stabilizing prices, enhancing private consumption, and improving corporate profits. Structural shifts toward rising industries would also have been promoted. While it is the market that determines the exchange rate, the yen appreciated less than generally expected vis-à-vis the dollar, although it did appreciate considerably vis-à-vis European currencies. It thus has been hoped that there would be a decline in overseas interest rate levels.

During the last few years, my authorities have made strenuous efforts to advance further trade liberalization in the face of growing worldwide protectionist tendencies. They have adopted several packages of market-opening measures to reduce or eliminate tariffs and to simplify or ease import procedures, including various standards and certification systems. They also plan to advance the implementation of the tariff reductions agreed upon at the Tokyo Round multilateral trade negotiations. Furthermore, my authorities intend to encourage the initiation of a new round of multilateral trade negotiations, with a view to rolling back protectionist tendencies.

The authorities continue to promote the further liberalization of capital and money markets and to support the internationalization of the yen. Most interest rates at the short and long ends of money markets are determined by supply and demand. Interest rates on foreign currency deposits and certificates of deposit have been liberalized. Further liberalization will be pursued in such a way that the existing financial system would evolve into a more internationally integrated one, without causing serious friction in the process.

The promotion of development cooperation is an important objective of the Government. It intends to increase capital subscriptions to international organizations, aid to developing countries, and other development assistance. In the proposed 1984/85 budget, official development assistance (ODA) is projected to increase by 9.7 percent, against a background of severe budgetary restraint, with no growth in general expenditures.

Mr. Erb commented that the Japanese case was unusual. While the macroeconomic performance of the economy had been quite good, that observation did not mean that there were no current problems. However, his authorities were in basic agreement with the way in which the Japanese authorities had been managing their fiscal and monetary policy. Mr. Hirao's medium-term analysis of the fiscal situation had been persuasive. The Japanese authorities did not have much room for relaxing their efforts to control the fiscal deficit. The Japanese economy represented a relatively mature economy at the leading edge of some important changes affecting many industrial countries. It might be possible to identify some areas in which structural reforms might be needed while learning from the Japanese experience in others. It would be important to take into account the particular political and socioeconomic factors unique to Japan.

Two particularly interesting characteristics of the Japanese economy were: first, the weakness in recent years of private consumption and of residential housing demand, and, second, the shift in the economy toward high-technology industry and toward the services sector, which was raising new challenges for Japanese economic policy similar to those arising elsewhere in the industrial world, Mr. Erb continued. With regard to the first issue, it was possible that the strong dependence on export-led growth and the recent weakness of domestic demand would change over the medium term, taking into account demographic changes and shifts in taste. He invited the staff to comment on the matter and on the consequences for world economic adjustment. Similarly, the shift toward high technology and toward the services sector raised a number of interesting questions. For example, what had been the effect on productivity and on inflationary performance of the growth in the largely nontradable services sector? What had been the effect on the labor market of the increase in automation? Rapid changes in those areas highlighted the need to eliminate or to avoid imposing regulatory and market rigidities that discouraged technical innovation and the rapid mobility of labor and capital.

Concerning developments in the Japanese labor market, Mr. Erb remarked, foreign observers continued to be impressed with Japan's ability to maintain employment levels even in the face of two oil shocks and a world recession. Nevertheless, there appeared to be fundamental changes occurring in the labor market. For example, the staff mentioned that there might be an increasing amount of hidden unemployment and that the advanced state of automation in Japan compared to that of other industrial countries raised questions about whether employment levels would continue to be unaffected by such an important change. Similarly, the female participation rate had been growing in recent years, and a general aging of the population was under way. What could the staff or Mr. Hirao say about the effects of those developments on employment growth and stability in Japan? Those changes were also affecting the Government's fiscal policy, since population aging was cited as one of the chief motivations behind the authorities' determination to reduce the present size of the budget deficit in order to cope with expected rigidities in future expenditures for social welfare purposes. As Mr. Wicks had suggested during the Article IV consultation with the United Kingdom (EBM/84/30 and EBM/84/31, 2/27/84), further study by the Fund of the growth of transfer payments in industrial countries was merited.

Although Japan's economy had made great progress at home and abroad in producing and selling goods, Mr. Erb went on, liberalization and innovation in its financial markets had not kept pace. The international role of the yen had also been restrained within rather narrow limits, a situation incongruous with Japan's role in the world economy and its desire to assume a greater role in international institutions. There were numerous areas where a broadening of the market was needed to improve the efficiency and stability of exchange rates. For example, an expansion of the variety of savings instruments available in Japan should facilitate the rechanneling of financial capital to the new areas of the economy from declining sectors. At the same time, modernization of the domestic financial market and freedom of international capital movements would contribute to greater international efficiency of capital by allowing foreign lenders and investors to participate more fully in Japan's dynamic economy, while permitting an outflow to other industrial and developing countries. Financial market reform should also increase the authorities' flexibility in financing future budget deficits and managing the stock of public debt, for example, by the issue of and trading in short-term government securities and market instruments by both banks and nonbanks.

The development of the financial market and of the international role of the yen could be brought about mainly by eliminating existing barriers, Mr. Erb suggested, such as those that segregated different parts of the market or that prevented interest rates from being market determined. A number of changes had already been made in that direction, notably the relaxation of exchange controls on capital flows; a strong market response was already evident. As the staff had pointed out, liberalization in one area of the market created pressure for liberalization in others. Experience in the United States in breaking down barriers among different segments of the market and in freeing interest rates on deposits was a case in point. He strongly encouraged the Japanese authorities to act promptly to internationalize the yen and to liberalize their capital markets. He welcomed the interesting supplement to SM/84/41 analyzing Japanese experience in the integration of domestic and international financial markets.

The Executive Board had increasingly asked the staff to cover such areas as medium-term balance of payments prospects and the status of a country's trade and protective systems, Mr. Erb recalled. As one of the largest participants in world trade and financial markets, Japan had an important international responsibility in contributing to financial stability and world trade growth. The reduction in the general level of import tariffs in recent years had made an important contribution to open trading relationships. The record was less good with regard to nontariff barriers and agricultural trade. Because of the great success of Japanese exports and their continued importance to the economy, Japan should play a leading role in combating the spread of protectionism by its own good example. At the same time, countries that had erected barriers to Japanese exports had a responsibility to make the necessary internal adjustments to permit removal of protectionist measures so as to allow both consumers and producers to benefit from increased productive efficiency. Finally, the brevity and focus of his comments were not intended to suggest that he did not attach importance to the Japanese economy; on the contrary, the brevity of his comments reflected his admiration for Japan's economic performance.

Mr. Robalino remarked that he agreed with most of the staff's analysis. He welcomed the Japanese authorities' intention to continue to front-load the public works program and their adoption since October 1983 of some tax reductions and of specific measures to support small and medium-sized businesses. The action was significant, with those fiscal measures estimated to increase the FY 1983/84 central government budget deficit by 0.03 percent of GNP. Flexibility in fiscal policy was particularly important for the acceleration of economic growth because monetary policy would have to remain somewhat restricted in order to encourage the desired appreciation of the yen, a development that was clearly appropriate in the medium term.

Despite the recent appreciation of the yen against European currencies, Mr. Robalino continued, its overall appreciation in 1983 had been marginal, a situation about which no one was particularly happy. Due attention should be paid to the conclusions of Mr. Robert Solomon in his International Economic Letter of February 15, 1984, when he had noted that in both the United States and Japan cyclical factors had been less important than movements in real exchange rates in bringing about the present current account position. Mr. Solomon's policy conclusions, based on a study by the staff of the Federal Reserve Board, were that substantial changes in exchange rates were necessary to improve the current accounts of both the United States and Japan. Similarly, the staff had clearly concluded both in a recent Departmental Memorandum (DM/84/6, 1/31/84), and tentatively in Supplement 1 to SM/84/32, that the present weak cyclical position of the Japanese economy indicated that short-run gains in output and employment could be attained through expansionary demand management. The Japanese economy might be better off with a more expansionary demand policy than that planned at present. As things stood, the current account surplus in 1984/85 would not change from its present level of 2.1 percent of GNP, and total imports would remain below the 1980 level despite the significant reduction in trade barriers in 1983. The overall outlook for the next two years would be better if the voluntary export restraint measures were not in effect, because in those circumstances the yen would probably be somewhat stronger and Japan's trading partners would not have been able to justify their own restrictions against Japanese imports.

It was disappointing that the authorities' intention to double the dollar value of their official development assistance in the period 1981-85 relative to the previous five-year period was not being realized, Mr. Robalino commented. In both 1981 and 1982, ODA had declined. However, it was encouraging that the authorities remained committed to their announced targets. Finally, Supplement 1 to SM/84/41, dealing with the integration of domestic and international financial markets, had been particularly useful. Serious consideration should be given to having it published.

Mr. Caranicas observed that the Japanese authorities had been confronted with difficult policy dilemmas in 1983, but they had made the correct choices, for which they should be commended. Their policy decisions had helped to improve the Japanese economy while contributing to a better performance of the world economy. He particularly supported the authorities' continuing efforts to attain two of their main goals: the enhancement of domestic demand and the further opening of Japan's trade and financial markets to the rest of the world. Mr. Hirao had provided the details of his authorities' actions to enhance domestic demand, and he had outlined the basic policy stance of Japan, including the various options open to his authorities at the present juncture.

Monetary policies could, in principle, be instrumental in expanding domestic demand, Mr. Caranicas continued, but in Japan action in that area was constrained by concerns about possible adverse effects on the yen.

Similarly, fiscal policies could be geared to providing some impetus to the current slack domestic activity and could more briskly encourage the upswing in the economy. However, there were lingering doubts regarding the short-run effectiveness of fiscal policy, given the alleged decline in the fiscal multiplier, and regarding the most appropriate medium-term course of action. Such considerations had to be seen in light of the prevailing perception of what should be the appropriate size and growth rate of the public sector relative to the private sector.

Monetary policy had performed well and was likely to continue to do so, Mr. Caranicas considered. New, more diversified monetary instruments had emerged, while domestic financial markets had been gradually deregulated. Monetary management had shifted significantly from credit controls toward greater reliance on open market operations. Those monetary policy developments had been strongly influenced by the exchange rate target in 1983. Perhaps there was now room to ease the monetary stance because actual and expected inflation was low and real interest rates remained high. Such an easing could take place provided that the adverse impact of the persistent nominal and real interest rate differentials between the United States and Japan were outweighed by the fundamentals, i.e., by the balance of payments position and competitiveness. As the staff suggested in its appraisal, those tendencies in the direction of appreciation should lessen the external constraints on monetary policy. However, the long-standing issue as to whether Japan's favorable fundamentals could have a decisive effect on the exchange rate as long as interest rates in the United States remained high justified the note of caution struck by the authorities in that regard.

The staff had presented an interesting and thought-provoking discussion of the allegedly weak link between the yen/dollar rate and current account trends, Mr. Caranicas went on. Contrary to conventional wisdom, the persistent trend in the Japanese trade and current account positions had failed to influence in a decisive manner the behavior of the exchange rate. An increase in net long-term capital flows into Japan could help to reinforce the currency; in that regard, the recent data on the surplus in the basic balance of payments might provide promising clues to future developments. He invited the staff to comment further on the question.

The issue of the yen deserved treatment at length because at the time of the previous Article IV consultation with Japan (EBM/83/49 and EBM/83/50, 3/18/83) there had been general agreement on the desirability of a stronger yen, Mr. Caranicas suggested. Furthermore, the Fund had to be concerned primarily with the question of assessing whether each member's exchange rate policies were appropriate from an explicitly multilateral standpoint. In other words, the standard by which to judge members' exchange rates and the policies resulting in those rates was to be found in the configuration of world payments balances appropriate from the standpoint of the welfare of the world economy. That responsibility was the substance of the Fund's surveillance activity. It was all the more important, although more difficult, with regard to the exchange rates of the large countries, because of their international repercussions.

The second goal of the Japanese authorities at present was the opening of trade and financial markets, Mr. Caranicas noted. He welcomed the authorities' increasing concern about the external repercussions of Japan's growing trade imbalance with the rest of the world. The recently enacted import promoting measures deserved praise; he agreed with the staff that further progress in removing trade restrictions was required. With regard to capital markets, great importance should be attached to the current endeavors directed at promoting capital imports and the internationalization of the yen. Mr. Hirao's affirmation of Japan's commitment to "maintaining and furthering the free trade system" and to continuing efforts to open its markets further and to increase its imports were in line with Japan's steady endeavors to assist in the international adjustment process. The authorities' insistence on the need for gradualism in that area had to be taken into account, as well as their justified concern about the potential consequences of liberalized capital controls on exchange rate fluctuations. However, he agreed broadly with the staff's suggestion that the removal of controls on capital flows into and out of Japan, as well as the growing integration of its financial system with foreign capital markets, would likely lead to greater market efficiency and to confidence in the establishment of a closer link between the exchange rate and economic fundamentals in the long term.

Commenting on fiscal policy, Mr. Caranicas welcomed the flexible attitude shown by the authorities in balancing their medium-term goal of fiscal restraint with the short-term need to revive a weaker than expected domestic economy. However, it had to be acknowledged that the stance of fiscal policy had been distinctly contractionary since FY 1981/82. According to the information in Chart 24 of SM/84/41, a withdrawal of stimulus was expected in 1984; it would be the third consecutive year in which fiscal support to the economy had been withdrawn. Although fiscal consolidation in the medium term was desirable, it should be borne in mind that at present there existed several macroeconomic conditions--a high savings ratio, low inflation, a large and rising current account surplus--that allowed leeway for a more active use of fiscal policies. He agreed with the staff that, given the importance of Japan in the world economy, the risks of slowing the progress toward the medium-term fiscal objectives were fewer than those attached to a faltering of the recovery.

Mr. Joyce said that he was in broad agreement with the staff's analysis. Following a period of weakness, domestic demand in Japan appeared to be picking up, and it was expected to continue to increase in the short term. That prospect should maintain and, indeed, accelerate the recovery that had been supported in large part by the external sector in the first half of the fiscal year. Japan continued to follow a pragmatic approach to economic policies, and the main thrust of those policies remained appropriate. Nevertheless, policymakers in Tokyo remained concerned about the future; while they appeared to be sure of what the basic stance of policy ought to be, they saw little room for discretionary measures to improve performance.

The fundamental problem was the balance to be struck among the requirements for domestic growth in the short term, the need to contain and reduce the fiscal deficit in the medium term, and exchange rate considerations that, at least in the short term, limited the room for maneuver by the monetary authorities, Mr. Joyce continued. The authorities envisaged a growth rate of slightly over 4 percent in 1984/85, compared with slightly under 3.5 percent now expected for the current fiscal year. While the current, more optimistic forecast of economic growth in 1984/85 was welcome, he was not certain that the Japanese economy would perform that well. Growth in the third quarter of 1983 had been 6.5 percent in real terms, largely because of a sharp rebound in domestic demand. However, he shared the staff's concerns that, although the rebound had been broadly based, there remained considerable uncertainties about disposable income growth, the savings ratio, and structural aspects of the housing market. In the staff's view, the recovery might be slower in gaining momentum than some forecasts suggested. There might be a temporary surge in growth, possibly fed by inventory expansion, but the growth could taper off unless the housing market turned around and there occurred the strong recovery in investment expected by Mr. Hirao. Mr. Hirao also looked for continued growth in personal consumption fueled by recent increases in personal income and tax cuts. His own view was not as firm as that of the staff; Mr. Hirao might well be right.

Nevertheless, there were areas of concern, Mr. Joyce stated. There was a marked difference between the authorities and the staff on the relative contribution to the recovery of foreign, as opposed to domestic, demand. For 1984/85, the Japanese authorities forecast a foreign sector contribution to growth considerably lower than that envisaged by the staff, who still expected about one fourth of GNP growth to be generated externally. In addition, the fiscal package of October 1983 was less stimulatory than appeared on the surface. For example, the reduction in local and income taxes, to be implemented over two years, would be offset by increases in indirect taxes proposed in the 1984/85 budget. Moreover, one third of the increase in public spending was designated for disaster relief and recovery operations, while another fourth was set aside for new expenditure measures by local governments; it remained to be seen whether those funds would be taken up or not. The staff's calculations confirmed that the fiscal measures of October, while helpful, would not alter the basic restrictive stance of fiscal policies. On a cyclically adjusted basis, there would still be a withdrawal of fiscal stimulus amounting to about 0.05 percent of GNP by the Central Government in the current fiscal year.

Commenting on what had been referred to as the "policy dilemma," Mr. Joyce remarked that Mr. Hirao was saying that the authorities continued to face persistent fiscal deficits and that there was, therefore, little or no room for discretionary fiscal measures. Indeed, he went further, arguing that only part of the fiscal deficit could be attributed to cyclical causes, that the underlying structural deficit was large, and that it had to be addressed. A stimulative fiscal policy, according to Mr. Hirao, would increase the deficit rather than decrease it. On the monetary side, there continued to be the problem of the weakness of the yen and the further weakening that might accompany any easing of interest rates in Japan. The staff correctly suggested that the risks attached to a possible faltering of the recovery of the Japanese economy, especially in view of its importance to the world economy, were greater than those associated with slowing somewhat the progress toward meeting the authorities' medium-term fiscal objectives. Mr. Hirao was right in pointing out that it was essential to restore fiscal soundness if Japan were to attain--"maintain" might be more appropriate--sustained economic growth over the medium term.

However, estimating the size of the structural component in budget deficits was more an art than a science, Mr. Joyce commented. OECD economists believed that there had been a significant discretionary shift toward fiscal restraint in Japan and that, compared with the period 1975-79, the cyclically adjusted deficit in 1983 appeared to have been reduced. As Mr. Hirao said, the constraints on fiscal policy might have increased because of the cumulative effects of past fiscal actions on interest rates, debt service, and, through a possible impact on expectations, on private sector confidence. Furthermore, the fact that the central government deficit was substantially larger than the general government deficit could be a source of concern in terms of the overall conduct of macroeconomic policy and the setting of monetary policy in particular. Notwithstanding those considerations, he encouraged the Japanese authorities to be flexible in the pursuit of their medium-term fiscal objectives, especially in view of the uncertainties regarding the development of output and domestic demand, and in view of his expectation that, given the high propensity to save, domestic demand could be substantially lower than predicted by the authorities.

With regard to monetary policy, Mr. Joyce went on, he agreed with the staff that, while domestic considerations alone would warrant an easing of monetary conditions, the authorities should continue to use monetary policy to support domestic activity only to the extent that an undue weakening of the yen could be avoided. The authorities were more pessimistic about the prospects for a significant strengthening of the yen; they believed that the problem was more the strong dollar than the weak yen. Nonetheless, the absence of the development of weakness in the yen following the discount rate reduction of 0.5 percent in October might be evidence of the strengthening of fundamental conditions and, in particular, of recent current account developments. The capital account had undoubtedly been subjected to portfolio shifts associated with the removal of Japanese restrictions on international capital flows and earlier measures by the U.S. authorities to improve the climate for private investment in the United States. The likelihood that a high proportion of those portfolio adjustments had been completed might also be a factor that could henceforth support the yen. Thus, despite the uncertainties involved in assessing the yen's prospects, there might well be a progressive lessening of external constraints on monetary policy, which should help the authorities considerably. With regard to financial market policies, there had been recent progress by the authorities in liberalizing their financial system, including deregulation of capital flows into and out of Japan. However, there remained a long way to go before the system could be said to be fully liberalized.

The steps taken over the past few years by the authorities to open their markets were welcome, Mr. Joyce stated, particularly their commitment to revising the standards and certification system. Such nontariff barriers, rather than tariff levels, had hampered the easy entry of imports into Japan. He urged the authorities to continue with those initiatives. It was time for Japan to assume greater responsibility for the openness of the world trading system, from which Japan, like the United Kingdom and Canada, had benefited so greatly. Japan's role was especially important at the present juncture, when protectionist pressures were rife in so many industrial countries. In that connection, he welcomed the recent support by the Japanese Government for a new round of multilateral trade negotiations.

Mr. Wicks commented that in recent years the Japanese economy had demonstrated two characteristics distinguishing it from other major economies: first, the very high level of private savings; second, and related, a persistent tendency toward large current account surpluses. The present configuration of macroeconomic policy in Japan, operating in the context of Japan's distinctive economic structure, had led to substantial imbalances in the economy, manifested particularly in the overseas trade sector. Unusually, those imbalances resulted from the strength of economic performance, not, as so often occurred, including in the United Kingdom during some periods of its history, from deficiencies in economic performance. The fact that the present imbalances had, in a sense, arisen from the underlying strength of the Japanese economy did not eliminate the need for policy action. Japan had the world's second-largest market economy; with that economic importance went an international obligation to pursue policies that were not only responsible in domestic terms but also outward looking. Current account surpluses of the size forecast were not compatible with world economic convergence in the medium term. Action needed to be taken in both domestic and external policy to bring the Japanese economy into better balance.

In the domestic area, the thrust of policy should be to increase the capacity of the Japanese economy to absorb domestic savings, even, perhaps, to reduce them, Mr. Wicks continued. He invited Mr. Hirao to comment on whether there was a highly developed consumer credit and house mortgage sector in Japan as in many other industrial countries. More important, domestic demand should be revived. Such a revival should permit the economy to continue to expand without excessive dependence upon the external sector. In that regard, judgment would have to be reserved on present policies. Although domestic activity had picked up toward the end of 1983, the prospects remained uncertain. At the same time, strong export growth was expected to continue. The staff correctly questioned whether the growth in domestic demand in the second half of the current financial year might not be somewhat lower than the authorities had forecast. If domestic activity failed to respond as the authorities expected during the remainder of the current financial year, he hoped that they could modify their planned withdrawal of fiscal support. He agreed with the staff that "the risks of slowing somewhat the progress toward meeting the authorities' medium-term fiscal objectives are considerably less than those attached to a possible faltering of the recovery."

Although such continued flexibility on fiscal policy was warranted, Mr. Wicks considered, he did not disagree with the authorities' commitment to eliminating the current budget deficit over the medium term. However, perhaps the authorities were too cautious with regard to the size of the budget deficit and the pace of its elimination. Japan's comparatively high savings ratio was a factor to be taken into consideration. That high ratio should allow budget deficits to be financed without undue pressure on credit markets. Moreover, the general government budget deficit was lower than the deficit for the Central Government. It was true that the ratio of public sector debt to GDP had been increasing rapidly and that, consequently, the authorities were properly cautious about further borrowing. In short, the authorities faced a dilemma, but the staff had not provided firm guidance on how it believed policies should be adapted to meet that dilemma. He invited the staff to comment further on the question. He agreed with the staff that there could be a role for tax policy in reducing the deficit, as well as for expenditure restraint, particularly because the tax burden in Japan, especially the burden of indirect taxes, was below the average for OECD countries.

On monetary policy, Mr. Wicks remarked that the authorities should continue to use it to support domestic activity only to the extent that such action could be taken without unduly weakening the yen. The authorities had been right to resist pressure for a cut in the discount rate until the threat of a weaker yen had receded.

A substantial strengthening of the yen, especially against the U.S. dollar, would be welcome, Mr. Wicks suggested. The effective rate for the yen had depreciated broadly in line with that of the dollar since early in 1984. If the dollar were to decline further, it would be important for the Japanese authorities not to resist any consequential appreciation of the yen. More fundamentally, the yen exchange rate reflected a wide variety of factors, including not only developments in the current account, but also the effect of substantial gross capital inflows and outflows. On the outflow side, he welcomed the relaxation of exchange controls so as to allow the channeling of Japanese savings toward other countries. However, on the inward side, there was scope for further measures to encourage investment in Japanese markets.

The Japanese economy had particular responsibilities because of its size and strength, Mr. Wicks stressed. Indeed, the yen needed to take on a full role in the world economy. He encouraged the authorities to continue their efforts to promote the internationalization of the yen and to promote further liberalization of the domestic capital markets. In the longer term, that kind of policy should allow the currency to reflect more closely the underlying strength of the Japanese economy. He welcomed the announcement in October 1983 that the authorities would review the "real demand principle" in forward exchange transactions and would consider the establishment of a yen-denominated bankers' acceptance market. In the medium to long term, such measures should increase the attractiveness of the yen as a trading currency. In that connection, progress on the liberalization of capital markets had been slow, although the authorities had been taking small steps in the right direction. The unique structure of financial markets in Japan was not a convincing reason in itself for that slow progress. He hoped that the authorities would feel able to increase the range of instruments available to overseas investors in Tokyo.

There were two areas of external policy to which the staff could have devoted more consideration in its report, Mr. Wicks considered. The first was long-term capital flows, such as bonds and direct investment. In the course of Article IV consultations with developing countries, the Executive Board had argued strongly for an examination of the scope for nondebt-creating capital flows to counteract the recent overreliance on short-term commercial bank loans. The corollary of that policy should be a distinct treatment in Article IV consultation reports on industrial countries of the openness of their capital markets. There was some information in SM/84/41 on that question; for example, the data in Table 28 indicated that the share of developing countries in yen-denominated foreign bonds issued in Japan had declined in recent years. The subject deserved fuller treatment as part of the Fund's surveillance process. Similarly, there should have been more explicit treatment of nontariff barriers in the staff report. The Fund should examine such restrictions as fully as the more conventional tariff and quota restrictions as part of its trade surveillance function. Nevertheless, his authorities welcomed the market-opening measures that the Japanese authorities had adopted during the last few years, and they also welcomed Japan's latest initiative aimed at achieving a multilateral rollback of protectionist tendencies.

In sum, despite its great strength, the Japanese economy was in substantial imbalance, Mr. Wicks observed. Both domestic and external policy action would be required to bring it into better balance if it were to achieve medium-term convergence with its major trading partners.

Mr. Laske commented that the Executive Board's Article IV consultations with Japan could almost invariably begin with the judgment that "the Japanese authorities had again been able to manage their country's economy more successfully than the authorities of other industrial countries." He agreed broadly with the staff's analysis of Japan's favorable economic performance and the reasons behind it. Developments in the past year had once again demonstrated that the Japanese authorities were capable of dealing effectively with emerging economic imbalances, although those imbalances had not yet been fully removed, as Directors had noted.

It was generally agreed that an excessively rising current account surplus in Japan could have detrimental implications, at least to a certain degree, for the rest of the world, Mr. Laske continued. The proposition held true both for a rapid increase in exports and for a slow increase in non-oil imports. The Japanese authorities had reacted in various significant ways to international complaints about developments in both respects. They had flexibly adjusted fiscal policy to a weaker than expected domestic demand, they had used the room that had become available to reduce domestic interest rates, they had removed a number of restrictive regulations affecting the money and capital markets, and they had continued gradually to liberalize the trade system. All those steps were welcome, and the authorities should be commended for taking them. However, both internal and external liberalization could be carried further, benefiting the domestic Japanese economy as well as its trading partners. At the present juncture of the world economy, and in view of Japan's large current account surplus, the country should be expected to play a leading role in promoting free trade and in forestalling protectionist tendencies. Additional measures to liberalize imports, to rationalize cumbersome customs procedures, and to reduce the admittedly not excessively high tariffs, would be desirable and appropriate. He welcomed the authorities' intention to implement ahead of schedule the tax reductions agreed upon in the Tokyo Round of the multilateral trade negotiations, as well as their intention to enter into a new round of such negotiations.

An important aspect of balance of payments developments was the exchange rate of the yen, Mr. Laske remarked. The prospects of a further strengthening of the current account surplus and the generally favorable fundamentals underlying the overall performance of the Japanese economy did not appear to be fully reflected by the present valuation of the yen in the exchange markets. For an extended period, the yen had been relatively weak vis-à-vis the dollar, weaker than might be expected in view of the strong trade performance, the low rate of inflation, and the virtual absence of inflationary expectations. He fully shared the authorities' and the staff's view that an effective appreciation of the yen, particularly against the dollar, would be desirable.

While it was relatively easy to agree that the exchange rate of a currency, such as the yen, was undervalued, Mr. Laske suggested, it was more difficult to show by what measures the desired appreciation of the currency could be brought about. That observation had been valid in the recent past and was likely to be so during the foreseeable future because high foreign interest rates, especially in the United States, might overshadow the influence of the relatively favorable fundamentals of the Japanese economy. Because of the exchange rate-imposed constraint, monetary policy in Japan faced a dilemma, known also to other countries, that real domestic interest rates had to be kept at a higher level than would be desirable in view of the apparent slack in domestic economic activity. That policy dilemma substantially limited the contribution that the Bank of Japan could make at present to strengthening the yen. Another experience that the monetary authorities at the Bank of Japan shared with those at the German Bundesbank was that intervention in the exchange market, even on a relatively large scale, was unlikely to achieve a sustainable turnaround in exchange rate movements.

There might be scope to support the yen rate in other, indirect ways, Mr. Laske considered. One possibility already mentioned by other speakers was the authorities' policies with respect to the financial markets. There could be no doubt that substantial progress had been achieved in liberalizing the Japanese financial system, and, considering the important role of the yen as a kind of reserve currency, such progress was welcome. Nevertheless, in a number of important ways, further liberalization could be helpful in creating foreign demand for yen-denominated assets. The staff had cited a long list of examples, of which the most significant were: reducing control over administrative bank deposit rates, relaxing restrictions on the range and characteristics of money market assets, and reforming the functional separation of financial institutions. As Mr. Hirao had pointed out, changing long-standing practices too rapidly could cause serious frictions, but cautious liberalization in the areas that he had mentioned could serve to promote demand for yen assets and to encourage more international participation in the Japanese economy and in Japan's financial markets; it would also allow greater use of the yen in international transactions. Mr. Hirao's assurances that his authorities planned to go ahead in that direction were encouraging.

Commenting on fiscal policies, Mr. Laske noted that for a number of years the Japanese authorities had held the view that the public sector finances were in disequilibrium and in need of correction over the medium term, a view that found universal public support in the country. The desirability of reducing the structural part of the fiscal deficit had also been recognized by the Executive Board in previous Article IV consultations. However, there might be less agreement on how rapidly those deficits should be adjusted. Mr. Hirao had provided additional arguments in support of his authorities' policies; he had demonstrated convincingly that fiscal policy was of dubious effectiveness as a mechanism for supporting domestic demand in Japan under the present circumstances. The authorities' medium-term guidelines seemed appropriate, therefore, in calling for elimination of the issuance of government bonds for the financing of current expenditure by 1990/91. In the context of that new time frame, those guidelines were less ambitious than they had been under the original medium-term plan. The adjustment in fiscal planning demonstrated the authorities' flexibility when deviations from projected developments provided grounds for modifying their policy stance. The implementation of the adjusted guidelines would result in a smoother adjustment path both for the Japanese economy and for the rest of the world. While adherence to the medium-term objective was important, maintaining an adequate degree of flexibility in implementing policy from year to year was obviously desirable, particularly if domestic demand turned out to be weaker than currently expected.

The staff continued to endorse reduction of the fiscal deficit over the medium term, Mr. Laske observed, while legitimately raising the question whether the envisaged fiscal adjustment might be too fast in view of the perceived moderate strength of the recovery in the domestic economy. The staff's assessment appeared to be based on a more sanguine view than that held by the authorities about the effectiveness of the automatic stabilizers and the probable effects of fiscal stimulus. The issue was largely a matter of judgment, not of precise calculation; he invited the staff to elaborate further on that vital aspect of Japan's situation.

The Japanese authorities' attachment to trade liberalization as a means of assisting the international adjustment process was appreciated, Mr. Laske stressed. Through additional actions in that area, Japan could make an important contribution to reversing protectionist tendencies; he encouraged the authorities to take further steps along the lines that he had suggested earlier. One particular aspect of Japan's trade policy was causing considerable worry for his authorities. In bending to foreign pressures, the Japanese authorities had agreed to the implementation of "voluntary export restraint measures" for a number of sensitive manufactured products, such as automobiles and certain kinds of electronic equipment, in which Japan appeared to have gained an edge over its competitors. He agreed fully with the staff's observation that such measures could only be defended as temporary bandaids intended to allow the protected industries time to adjust to a changed competitive climate. They could not be a long-lasting panacea; his authorities expected that the importing countries concerned would resist asking for their extension or renewal. He strongly hoped that additional trade liberalization measures on the part of the Japanese authorities would forestall further protectionist pressures from abroad and would lead to a process of dismantling existing protectionist practices.

Mr. Nimatallah said that he was in broad agreement with the staff's conclusions about the Japanese economy. Its recent performance was fully in line with its remarkable track record. Japan had adjusted smoothly and had emerged from recession in a stronger position than other industrial countries. Real growth was relatively high; unemployment and inflation remained low. Exports were expanding rapidly, and investment was also picking up. Although there were uncertainties, particularly with respect to private domestic demand, the outlook for 1984 and 1985 was generally favorable. However, as Mr. Hirao had pointed out, the authorities faced a number of difficult policy choices. The choices that they made would be crucial, not only for domestic recovery, but also for attaining exchange market stability and for reversing the trend to protectionism.

The first choice was on the fiscal side, Mr. Nimatallah continued. The authorities had to reconcile their medium-term objectives of phasing out deficit financing with the more immediate aim of sustaining domestic demand. In general, Mr. Hirao was correct in stating that "no economy can achieve sustained growth over a number of years with an unsound fiscal position." There was no doubt that the large central government deficit was a major constraint on the effectiveness of fiscal policy. Therefore, he supported the continuing efforts in the new budget to curb public expenditure, to improve the tax structure, and to make the public sector more efficient. Those moves provided an appropriate longer-term framework for shifting resources to the private sector and encouraging private investment. At the same time, the flexibility that the authorities had shown in the recent past was both understandable and commendable. The October 1983 package of public works spending and tax cuts had helped to strengthen domestic demand for both consumption and investment. If that package proved insufficient, it might be helpful, as the staff suggested, to front-load budgetary expenditures in 1984. Such action could give the authorities useful room to maneuver, particularly as inflation was likely to remain low.

Commenting on monetary policy, Mr. Nimatallah observed that domestic and external considerations pointed in different directions. On the one hand, high real interest rates might discourage private investment; on the other, any significant relaxation in monetary policy could lead to an unnecessary depreciation of the yen. The present fairly cautious stance was, therefore, understandable. He appreciated Japan's dilemma and hoped that international interest rates would decline further in real terms. In the meantime, he encouraged the authorities to take advantage of any such decline, as they had done in October 1983, to assist the domestic economy.

With regard to the exchange rate, Mr. Nimatallah noted that the yen had appreciated significantly against the major European currencies in 1983 but had remained stable against the dollar. He agreed with the staff's view that the situation was as much a dollar problem as a yen problem. Given the underlying strength of the Japanese economy, there could be important domestic benefits if the yen strengthened further. As Mr. Hirao had remarked, such a development could enhance price stability, improve corporate profits, and perhaps assist structural shifts toward new industries. It could also help to ease trade frictions among the major industrial countries. In that regard, Japan had a critical role to play in preserving the free trade system. He commended the authorities for the measures that they had taken to reduce tariffs, to simplify import procedures, and to open up Japanese markets to foreign competition. He also welcomed Japan's recent call for a new round of multilateral trade negotiations. He hoped that those efforts would lead to reciprocal action by Japan's trading partners. More generally, he encouraged all the major countries to liberalize imports and to return to free trade.

The steps to open up domestic capital markets to overseas participants and the moves to encourage private foreign investment in Japan were also welcome, Mr. Nimatallah added. As the staff pointed out, the integration of Japanese and international markets had contributed greatly to the overall efficiency of the domestic financial system. He hoped that that process would continue. The Japanese authorities should be congratulated for having managed their economy well; they should also be commended for the increase in ODA in the recent budget and for adhering to their objective of doubling aid flows in the period 1981-85 despite the budgetary constraints.

Mr. Zhang noted that economic performance of Japan in recent years had been better than that of other industrial countries. The rate of increase in GDP had continued to be high and steady, and the pattern of growth had been characterized by strong domestic demand, which had generally accounted for the larger part of the increase in output. The fight against inflation had been successful, with a continuous deceleration of increases in all price indices. Hourly compensation had shown only a moderate change, and the unemployment rate had been the lowest among the industrial countries. There had also been a rapid structural adjustment in industry. The external position had remained strong. In those circumstances, he agreed fully with the staff assessment that such a remarkable performance reflected not only the flexibility and effectiveness of government policy, but, even more important, the ability of the society to effect an acceptable apportionment of adverse external impacts among its various economic and social groups.

During the first half of 1983, Mr. Zhang continued, the rate of growth in domestic demand had tended to flatten out as a result of weakened consumption demand arising from unfavorable special factors and sharp falls in residential construction and public investment. However, that development had been offset by the continued large improvement in net exports during the year; consequently, real GDP had increased in 1983 at about the same rate as in 1982, one of the few occasions in recent years when growth in Japan had been sustained by trade performance. In view of the hesitant recovery of domestic demand in the first part of the year, the authorities had decided to adopt expansionary fiscal measures in October 1983, including public works expenditures, housing finance, and increased investment by electric power companies, as well as proposals for cuts in income and local taxes. With the cut in the discount rate by 0.5 percent as part of that economic package, the stance of monetary policy had become relatively accommodating.

The prospects for 1984/85 were good, Mr. Zhang considered. Because of those stimuli, domestic output was expected to grow by more than 4 percent, a higher rate than in the previous two years. Among the various components of domestic demand, business fixed investment was forecast to show the largest rate of expansion, reflecting the strong recovery of exports and the improvement in corporate profitability, although high interest rates would remain a restraining factor, particularly for small enterprises. Net exports were expected to improve further as a result of the continuing recovery of world demand for Japanese exports.

In reviewing the impact of the policy stance on the course of economic development in recent years, Mr. Zhang remarked, it could easily be seen that the Japanese authorities continued to encounter conflicts between domestic and external objectives. Generally, in Japan, because of the absence of many of the structural rigidities that beset other industrial countries, macroeconomic policy had been more pragmatic and flexible than elsewhere. More recently, however, the somewhat sluggish trend in domestic demand, the weakness of the yen in relation to the "fundamentals," and the size of the public debt, had caused problems for both fiscal and monetary policies. Under such circumstances, the authorities had announced medium-term measures aimed at more balanced growth with a stronger yen and a more restrained increase in the current external surplus.

Commenting on fiscal policy, Mr. Zhang suggested that price stability, the large external surplus, the low ratio of the budget deficit to GDP, and the high level of private savings that had prevailed in the Japanese economy in recent years should have led to a more expansionary policy stance than the authorities had actually pursued. Although the economic package adopted in October 1983 would provide stimuli to domestic demand in 1984, the possibility of a more expansionary fiscal policy that could support domestic demand on a medium-term basis would be constrained by the authorities' strategy of deficit reduction included in the medium-term guidelines for growth through 1990/91, adopted in August 1983. That strategy was partly based upon the belief that economic activities could be better carried out by the private sector, and that, therefore, a reduction in the budget deficit would lead to a better allocation of resources. According to the program in the guidelines, the reduction in the budget deficit was to be achieved mainly by cutting current expenditures without large increases in taxes.

However, given the actual economic and social situation, was it realistic to expect that expenditures could be substantially reduced over the medium term? Mr. Zhang inquired. Fiscal policy would probably retain its role as a countercyclical instrument, as in the October 1983 economic package. Some public investment in social infrastructure might not be cut. Social transfers were certain to rise considerably because of projected demographic shifts. As clearly shown by Mr. Hirao, interest payments would also be rising. In that connection, it would be interesting to know why the Japanese authorities had not attempted to increase taxes, particularly as the overall tax burden in relation to GDP was among the lowest in the industrial countries.

Monetary policy had become relatively accommodating only recently, Mr. Zhang went on. The basic dilemma remained the conflict between domestic and external policy objectives. From a purely domestic need, a substantial reduction of real interest rates to stimulate domestic investment was clearly desirable at present, but the authorities had been reluctant to resort to such steps, fearing that they would trigger another round of renewed yen depreciation that could result in further intensification of the frictions in trade relations between Japan and the other industrial countries. That basic dilemma had prevented monetary policy from giving full support to fiscal policy at present.

Japan was also facing a rather difficult situation in trade policy, Mr. Zhang commented. Under an open multilateral trading system, a country such as Japan, which exported manufactures to industrial countries but depended heavily on imported raw materials from other sources, had unavoidably experienced bilateral trade imbalances in varying degrees with individual countries. To a considerable extent, such imbalances reflected the overall trend of the structural changes in the world economy that would have to be dealt with by appropriate structural adjustment policies rather than primarily by exchange and trade measures. In line with its market-opening policy, Japan had already taken various import liberalization measures and had also accepted "voluntary export restraint" measures.

In general, however, the necessary structural adjustment needed by the importing countries to lessen the tendency toward protectionism remained slow. Could the staff say whether the higher income elasticity of world demand for Japanese exports than of Japanese demand for world exports had been more important than the exchange rate and price factors in the persistent and growing trade account surplus in recent years? Had the kind of goods that only Japan could export not also played a relatively important role? Finally, the Japanese authorities should be commended for their continued and rising commitment of financial assistance to developing countries.

Mr. de Groote said that he generally agreed with the analysis and conclusions in the staff appraisal. The higher growth rate, lower unemployment, and better price performance of Japan in comparison with other industrial countries in recent years were mainly the result of efficient and timely economic policies in response to the changing circumstances of the world economy, reinforced by the fundamental strength of Japanese society, particularly a strong social consensus that permitted the sharing of the burden of adjustment by both capital and labor. From an internal perspective, the policies followed by the Japanese authorities appeared appropriate; they aimed in the right direction by linking monetary policy to the exchange rate and by resolving to reduce the budget deficit over the medium term, to increase profits and productivity, to strengthen the yen, and to liberalize the trade and capital accounts. However, the combination of a relatively high savings ratio, a huge current account surplus, relatively weak domestic demand, and the weakness of the yen made it difficult to formulate coherent policy recommendations from the viewpoint of international adjustment.

A point raised in Executive Board discussions in the previous three years had been the weakness of domestic demand in Japan, Mr. de Groote continued. As the staff had indicated, domestic demand had remained weak in 1983, and growth performance had been mainly attributable to exports. Domestic demand was expected to increase only gradually in the coming year, despite a number of positive signs. It was worth asking how higher domestic demand could be achieved. The staff had discussed the reasons for its depressed level, and it was particularly correct in stating that "the risks of slowing somewhat the progress toward meeting the authorities' medium-term objectives are considerably less than those attached to a possible faltering of recovery of the Japanese economy." However, the authorities' hesitation to make active use of monetary and fiscal policies to stimulate domestic demand was understandable in view of their determination to reduce the fiscal deficit over the medium term. Indeed, the size of the deficit left little room for fiscal stimulation, particularly since interest payments now represented about 18 percent of expenditures. Nevertheless, it was questionable whether the authorities should go so far as to withdraw an amount of fiscal stimulus equivalent to about 0.5 percent of GNP, which they intended to do in the 1984 budget, and which they had done in the past two years.

Because monetary policy was linked to the exchange rate, thereby excluding a more active use of that policy instrument, other ways of increasing domestic demand had to be found, Mr. de Groote suggested. During the previous two Article IV consultations with Japan (EBM/82/17 and EBM/82/18, 2/17/82; and EBM/83/48 and EBM/83/49, 3/18/83), he had suggested a possible approach to increasing domestic demand, namely, to bring down the high savings rate, thereby providing substantial domestic stimulus to growth. Because interest rate policy was not usable for the moment, a change in the fiscal treatment of interest income might be an effective alternative means of lowering the savings rate; it might obtain results equivalent to a reduction in interest rates. Reduced savings would, in turn, provide more room for increased consumption and investment. If domestic private demand became more buoyant, the fiscal deficit would also benefit through increased revenues. In that regard, the staff's comment that the high current account surplus was "a ready source of savings for other countries" was particularly interesting. Nevertheless, savings in Japan were excessive because the balance on current account was in itself perceived as a major problem in the international adjustment process, giving rise to protectionist tendencies elsewhere. Therefore, the Japanese authorities should take action to reduce the gap between savings and investment. If they did not, a continuation of the present current account surplus would have to be accepted.

In contrast to that view, there had been recent proposals that Japan should play a more active role in international adjustment through an appreciation of the yen initiated by raising the domestic interest rate, even at some cost to economic recovery, in order to avoid a later, uncontrollable escalation of the value of the yen, Mr. de Groote added. Such a policy could affect savings, discourage consumption, investment, and capital outflows, and intensify the present position of insufficient domestic demand and excessive surpluses. He invited the staff or Mr. Hirao to comment on those two contrasting approaches to the role of interest rates in the management of economic activity and on the possible effect that measures affecting interest income might have on the excessive rate of savings.

Turning to financial market policies, Mr. de Groote considered that the experience of the previous decade in Japan held several lessons, not only for the developing countries, but also for most industrial countries. Extensive reforms had transformed a highly regulated financial system into a system governed by both foreign and domestic market forces. However, implementation of measures toward further liberalizing the financial markets, such as the loosening of controls over administered bank deposits and regulations compartmentalizing the operations of financial institutions, would help a great deal to increase the efficiency of the financial markets and hasten the internationalization of the yen. It was difficult to accept that the second-largest market economy continued to live with a financial system that maintained a high degree of "currency protectionism." Internal measures limiting the use of the currency of a major industrial country and hindering the creation and exchange of financial assets expressed in that currency and the establishment of appropriate markets for those assets could be as detrimental as any outright form of trade protectionism. Mr. Hirao's plea regarding the need to progress slowly in that area was not convincing, as Japan had succeeded in adapting itself more rapidly than any other country to innovation and changed circumstances.

With regard to commercial policies, Mr. de Groote went on, the steps taken to open Japan's markets to foreign producers in the past two years were welcome, despite the small potential effect on total imports. He hoped that further efforts to reduce trade barriers would be made. He shared the concern of the Japanese authorities about increasing protectionist tendencies in other countries with regard to Japanese exports. World economic recovery, together with growth in the volume of trade, should lead to a lessening of protectionist pressures in general and should increase the benefits of free trade, not only for Japan, but also for other countries that had faced protectionism. Finally, the Japanese authorities should be commended for their continued commitment to meeting their medium-term goals with respect to financial assistance to developing countries. Although Japan's official development assistance, as a percentage of GNP, was below that of most major industrial countries, he hoped that the authorities would succeed in their efforts to achieve a doubling of official development assistance by 1985.

Mr. de Maulde said that he fully agreed with the staff's well-balanced appraisal. With regard to internal problems, the Japanese authorities deserved both admiration and sympathy. They should be admired for the way in which Japan had succeeded in overcoming the second oil shock and the ensuing worldwide depression. At present, the domestic position was fully restored, the apparent rate of unemployment was extremely low, the growth of GNP was sizable by other countries' standards, if not by historic Japanese standards, and there was practically no inflation. The forecast for the coming 12 months, upon which the staff and the Japanese authorities generally agreed, was for continued improvement with further growth and even lower inflation.

However, the authorities deserved sympathy for the serious problems that they faced in the management of their fiscal and monetary policies, Mr. de Maulde continued. The staff pointed convincingly to a major inherent contradiction. If the authorities lowered interest rates, in order to boost domestic demand further, there would be a perverse effect on the exchange rate, making the yen even more competitive relative to the dollar. On the other hand, the size of the budget deficit and of the public debt generated by past deficits made it increasingly difficult to boost the share of public spending within overall domestic demand, as Mr. Hirao had pointed out. Although he did not entirely share Mr. Hirao's view of the balance between risks and benefits in those two policy areas, he fully appreciated the problems.

With regard to the external position, Mr. de Maulde remarked, Japan's continued and growing surpluses were creating an increasingly unacceptable situation for the rest of the world. Those surpluses had amounted to about $72 billion since 1980, necessarily matched by deficits in other countries. There was no doubt that Japan's external surpluses were structural. Their causes were well known. The staff correctly referred to a savings rate much higher than in other industrial countries, resulting in lower domestic consumption, lower imports, and higher exports for any given level of domestic production. Other factors were the remarkable organization of the productive sector that led to high productivity and the national characteristic that resulted in Japanese consumers' preferring, in almost all cases, domestic goods over imported goods. In addition, there had been a broad array of administrative nontariff barriers, effectively isolating large segments of the Japanese market from the rest of the world, although the authorities had recently taken measures to eliminate those barriers. Although more remained to be done in that regard, the authorities had acted in good faith, and such barriers played only a minor role in Japan's surpluses at present, the fundamental causes lying in the very fabric of Japanese social behavior.

The particular characteristics of the Japanese economy were not to be deplored, in theory, Mr. de Maulde suggested. The Fund would be pleased if other industrial countries succeeded in increasing their savings rates and improving both the overall productivity of their manufacturing sectors and the profits and investments of their firms. The problem was that at present Japan stood alone in its economic success. From a theoretical point of view, the best solution would be for other countries to learn how to perform as well as Japan. In that regard, Japanese investment abroad could play an important role in diffusing technological and organizational innovation. However, even if such a process were to occur smoothly, it would take a long time, and, meanwhile, there would be a tendency to react against the successful country. While he shared the staff's concerns about "voluntary export restraint measures," they had been an unavoidable reaction and might have prevented the emergence of even worse measures in the international trade system.

The question was what could Japan do to alleviate other countries' problems and to avoid the strengthening of barriers against its exports, Mr. de Maulde considered. The usual suggestion was that the growth of GDP should be increased through measures directed at boosting domestic demand. He agreed with that view, in principle, because Japan was able to achieve sustainable growth at a higher rate than its competitors. The forecast 4.1 percent rate of growth of GDP for 1984 was well below the sustainable level. The authorities should aim at previous levels of growth, more than 6 percent, which would go a long way to reducing, perhaps eliminating, the structural trade surplus. In order to achieve that aim, risks would have to be taken on the fiscal side. He agreed with the staff that such risks were worth taking, particularly in view of the alternatives. However, it was obvious that, given the budgetary dilemma, the limits of fiscal action would be reached before the desired target had been achieved.

There were two other ways in which Japan could move forward, Mr. de Maulde suggested, namely, through incomes policy and industrial policy. It appeared that wage agreements in the past year had been too restrictive and that, more generally, the current rigid link between wages and the profitability of firms contributed unduly to the insufficient level of domestic consumption. If the Japanese authorities wished to achieve a better balance between consumption and savings without indulging in "fiscal foolishness," they would be well advised to study the possibility of encouraging firms to conduct their wage policies--including nonwage benefits--in line with the overall economic policy of the country.

With regard to industrial policy, Mr. de Maulde went on, Japan did not play its full role in the international division of labor. Its industries remained strong in all sectors, not only in the so-called high-technolgy sector. The Fund generally advised industrial countries to rid themselves of certain activities in order to open their markets to manufacturers in other countries, particularly developing countries. Even if the extent of subsidies in Japan was relatively narrow, the composition of the country's imports demonstrated that much remained to be done in the field of specialization. What was needed was a strong and voluntary policy through which Japan would open itself to certain types of foreign manufacturers in exchange for access of Japanese manufacturers to foreign markets.

Although the two types of measures that he had suggested involved a large element of state intervention, Mr. de Maulde observed, it was worth bearing in mind that the normal tools of budgetary and monetary policy had clearly shown that they could not cope with the present situation in Japan, and that past practice could give Directors every confidence in the effectiveness of state intervention and administrative action in Japan. Finally, the Japanese authorities' decisions in official development assistance should be noted. Those decisions were all the more welcome given that the level of assistance, 0.29 percent of GDP in 1982, remained below that of other major industrial countries. It was encouraging that Japan was taking a position in that area commensurate with the responsibilities that went with its economic stature. He looked forward with confidence to parallel actions in other fields.

Mr. Senior noted that the staff had focused its analysis on the main elements of the Japanese economy that had a strong bearing on developments in the international economy, a particularly important approach in light of the Fund's surveillance function. The most salient features of the recent performance of the Japanese economy were the moderate recovery of domestic demand and the relatively bright picture for the coming year. However, while recent indicators suggested that the recovery in domestic demand was encouraging, there continued to be uncertainty about its strength. Private consumption had increased in the third quarter of the previous fiscal year, investment by small and medium-sized corporations had begun to pick up, and demand for plant and equipment investment had also started to recover. Housing construction, however, had not recovered to the level of a year earlier, although it had begun to move upward. On the external front, the current account surplus and the evolution of the factors on which it was based suggested that there was ample room for expansion of domestic demand. Overall, a gradual recovery in domestic demand could be expected in the coming fiscal year.

In that context, Mr. Senior continued, the flexible stance of the macroeconomic policies that the authorities intended to follow in the immediate future in order to achieve the desired increase in domestic demand was appropriate. With regard to fiscal policy, he agreed with the staff that, given the uncertainties surrounding the recovery of domestic demand, several policy options used in the past to support economic activity would have to continue to be available in the coming year. In recent years, the authorities' growth expectations had not materialized, making it necessary to provide fiscal stimulus to help to sustain economic activity. Such evidence indicated that a flexible approach would continue to be needed.

Although the fiscal imbalance as a proportion of GDP was lower than in other industrial countries, Mr. Senior remarked, he agreed with the staff and the authorities that there was a need to avoid a further deterioration of the fiscal position. Therefore, the authorities' decision to restore fiscal soundness in the medium term was welcome. Nevertheless, their goal should be approached gradually, taking account of the most recent trends in economic recovery, the rigidities built into the budget, and the importance of Japan in the present circumstances of the world economy. With regard to the budget rigidities, the scope for reducing the fiscal imbalance was limited by certain structural elements of the deficit. As Mr. Hirao had pointed out, the constraints included the heavy burden of government debt and the increasing interest payments associated with it, as well as certain institutional and legal limitations. However, it was also important from an international point of view, as well as from the point of view of progress toward reducing the fiscal imbalance in the medium term, that economic recovery in Japan did not falter.

From an international perspective, the expected economic recovery would be most effective if it were accompanied by increasing imports, Mr. Senior commented. He agreed with the authorities and the staff that an increase in imports would be facilitated by a further strengthening of the yen against the dollar and by a further liberalization of trade. Significant progress has been made in the latter area. He joined the staff in commending the authorities for the substantial progress made in that regard, especially taking into account that trade liberalization in Japan had been implemented in the face of the intensification of protectionism in other major industrialized countries. The substantial current account surplus achieved in 1983, together with the most recent projections of the growth of GDP, clearly indicated that growth was below its potential rate and that there was room for a considerable increase in imports. However, he did not wish to imply any criticism of the substantial effort that had been made in energy conservation and in the adjustment of the economy's productive structure, factors partly responsible for the extraordinary external performance. Finally, he commended the authorities for their continued support for official development assistance and their commitment to doubling ODA flows in the next few years.

Mr. de Vries said that, as some other speakers had noted, the remarkable performance of the Japanese economy was due in large part to noneconomic factors. In the staff's words, it reflected "the ability of the society to effect an acceptable apportionment of the adverse impact of external shocks among its various groups." Because of such factors, the Japanese economy had been able to adapt more effectively than others to the changing world economy. Another factor was the degree of consensus that existed in the Japanese decision-making process, thereby avoiding conflicts in economic policy as well as in other areas.

There were a number of technical points in the staff papers that deserved consideration, Mr. de Vries continued. It had been difficult to find certain kinds of economic data, as Mr. Polak had pointed out in discussing the papers for the 1983 Article IV consultation with the United Kingdom (EBM/84/30 and EBM/84/31, 2/27/84). Had there been a decision to change the design of consultation papers? Although it was possible to find in the papers the various elements needed to construct the data, it was not easy to do so when the papers were long. In particular, as in the papers for the consultation with the United Kingdom, it was difficult to find the main components of GDP and the main components of demand expressed as percentages of total GDP or of total demand. It was also difficult to reconcile the available figures. For example, on page 23 of SM/84/32, the staff presented a breakdown of the main components of GDP, but only for 1981, although the changes in those components were given through 1983. On that page, total government demand in 1981 was shown as 19 percent of GDP, but in one chart in SM/84/41 government disbursements were shown to be increasing to almost 35 percent of GDP. However, the section of SM/84/41 dealing with financial markets had been most interesting. He agreed with Mr. de Groote that further innovation in financial arrangements in Japan would be useful.

As a number of Directors had commented, the Japanese economy was the second most important among the Fund's members, and it should, therefore, be discussed in an international context, Mr. de Vries observed. Japan's high propensity to save was behind the current account surplus, which, it could be argued, was relatively modest, both from the point of view of Japan and from the perspective of the world economy. If a society such as Japan wished to spend less than it produced, then, other things being equal, there would be a long-term trend to surplus on the current account. However, that surplus was neither excessive nor undesirable. First, it represented only about 2 percent of GDP at present, not a large amount when many developing countries were in need of import surpluses. Second, it should not be considered harmful simply on the grounds that it was structural, as had been suggested.

Looked at in the context of the position of other industrial countries, Mr. de Vries added, it could be concluded that Japan's surplus was creating few problems. A number of industrial countries were already experiencing current account deficits. The total surplus of industrial countries in 1983 had been estimated to be about only $3.5 billion, and it was forecast that they would incur a deficit of about $13 billion in 1984. As Mr. de Maulde had pointed out, the cumulative Japanese current account surplus since 1980 was about $72 billion. However, it appeared that the deficit of the United States alone in 1984 might well be in excess of that amount. On that basis, the Japanese surplus should not be considered a worrisome problem in the international context. He agreed with the staff that Japan's surplus was a ready source of savings for other countries. If a number of industrial countries wished to borrow to finance their current account deficits and if the developing countries were to receive the required capital imports, some countries would have to be in surplus.

The imbalances in the present situation could be said to be created, at least in part, by Japan's industrial trading partners, Mr. de Vries considered. Most countries had a tendency to permit large budget deficits that absorbed a large amount of savings, leading to deficits on the current account. Obviously, those current account deficits had to have a counterpart elsewhere in the system, and that counterpart would have to be found among industrial countries. However, a policy inconsistency arose when the countries experiencing budget deficits did not wish to accept the imports that were a corollary of the excess spending that they were engaging in. There also appeared to be inconsistency in the advice being offered to Japan by Executive Directors. The Fund generally advised countries to reduce their budget deficits because too much stimulation of domestic demand would be counterproductive and because the private sector should be encouraged. It appeared that, in dealing with Japan, Directors were suggesting that too much demand might be taken out of the economy as the result of efforts to reduce the budget deficit. There also appeared to be a tendency to favor extreme supply-side theories, such as the theory that a reduction in taxes would encourage the economy to expand to such an extent that the authorities would end up with larger receipts than they had begun with. The Fund did not usually apply that theory to other countries. It was, therefore, somewhat worrisome that, in a world where there was a general tendency toward overspending and too little saving, the one country that produced net savings by carrying out the policies usually recommended by the Fund to its members was being criticized for doing so.

Japan's initiative in the new round of tariff negotiations was welcome, Mr. de Vries stated. Insofar as there continued to be room to liberalize Japan's import policy, it would be desirable to open up the economy further. Perhaps measures in that area could be counterbalanced by less emphasis on voluntary export restraints. He agreed with Mr. Laske that the policy of voluntary restraint could not be continued for much longer; it was fundamentally an expression of protectionism by the importing countries, leading Japanese exporters to concentrate even more on high quality, and more advanced kinds of exports. The policy thereby accentuated the difficulties that it attempted to alleviate.

Commenting on budget policy, Mr. de Vries remarked that he supported the authorities' aim of carrying out their policy flexibly. They planned to shift some tasks from the government sector to the private sector, a policy that had two advantages: the activities in question would continue to be undertaken in the economy, but at the same time there would be a reduction in government expenditures and, thus, in the deficits. The high propensity to save in Japan might limit the extent to which the growth in government debt could be slowed or reversed. There appeared to be a high demand for government bonds as a savings medium. Government debt should not grow faster than GNP. If possible, it should be stabilized at the present level in relation to GNP, but there seemed to be little prospect for reducing its share in GNP and no prospect at all for reducing its absolute size. Finally, perhaps the Executive Board should consider at an appropriate time the relationship between Japan and the other major industrial countries to see how the various imbalances might be eliminated without friction. That Japan had a structural current account surplus did not in itself point to a particular appropriate policy action.

Mr. Tvedt remarked that the performance of the Japanese economy during the recent past had been extremely good by existing international standards. Since the second oil price shock, Japan had adjusted its economy in a way that deserved admiration, and inflation had been reduced to a low rate. Inflationary expectations appeared to have been broken, and in some months the price level had even declined. According to the projections made by both the authorities and the staff, domestic inflation was expected to remain at the present comparatively low level. Moreover, given that recent wage settlements had been the lowest for almost three decades, unit labor costs had fallen significantly, and, according to estimates by the OECD, the prospects pointed to a further decline.

Japan also had a large and growing current external surplus, Mr. Tvedt continued. The sharp rise in the trade surplus had, perhaps unavoidably, contributed to strengthening the already strong pressures for protectionist measures in the United States and Europe and for even tighter "voluntary export restraints" on the part of Japan. Such measures should be temporary. He hoped that the importing countries would make decisive efforts to improve their competitiveness and to speed up their structural adjustment.

Given the strong position of the Japanese economy, as well as present international conditions, Mr. Tvedt went on, it was surprising that a tightening of fiscal policy had been planned for 1984. The structural component of the fiscal deficit appeared to be high in comparison with that in other industrial countries, and strong upward pressures on the deficit could emerge in the late 1980s. A more expansionary fiscal stance involved risks from a medium-term perspective. Nevertheless, the actual Japanese budget deficit was not particularly large in relation to that of other major industrial countries. Moreover, the slack in the economy should not be underestimated despite the relatively high activity. For example, capacity utilization in manufacturing was for the most part at the same relatively low level as in the period 1976-78, when overall output had been growing substantially faster than at present. For several years, the growth potential in Japan had been greater than actual GNP growth, and the growth of GNP was unlikely to exceed the growth potential in 1984. The increase in domestic demand had been substantially smaller than the increase in overall output. Moreover, although the rate of inflation had been low for several years, there had been no clear sign that an upswing was being generated primarily by domestic impulses. However, the present signs of an upswing might have domestic origins.

Commenting on the slack in the labor market, Mr. Tvedt observed that the staff had pointed to the problem of labor hoarding. However, registered unemployment rates could underestimate the weakness of the labor market because of the existence of discouraged workers not included in measured unemployment. The decline in the cyclical sensitivity of the labor supply following greater and more persistent female participation might also have had an impact on labor market developments. The Japanese people should be commended for the flexible labor market in which there was a broad willingness to share the burden of adjustment among the various groups in the economy. There appeared to have been little incidence in recent years of cost-related declines in production and employment, implying that a shift in an expansionary direction should, at least in the short run, have a good chance of being reflected in increased production and employment and, to a smaller extent, in price and cost increases. In that context, there had been a recent interesting staff study on prices and wages in manufacturing in Japan and the United Kingdom (DM/84/6).

Given the present background, Mr. Tvedt said, there appeared to be scope for a cautious expansion of fiscal policy, rather than a tightening, for example, through a parallel increase in fiscal receipts and public expenditure that would provide some stimulus to the economy through the balanced budget multiplier. In any case, as there continued to be doubt about the strength of the upswing in domestic demand, partly because of high real interest rates, and as the past consequences of more expansionary policies had not been serious, he agreed with the staff that the risk of postponing a reduction in the budget deficit was substantially smaller than the risk of aborting the upswing. It should also be borne in mind that the private savings ratio in Japan was high, a factor partly related to the social security system. Therefore, although gross public savings were small, the total savings ratio remained high. Because investment had been comparatively low in 1982 and 1983 by Japanese standards and was expected to remain low in 1984, the overall result was a substantial surplus on the current external account. Against that background, the authorities were intending to reduce the surplus on the current external account and, simultaneously, the public budget deficit. Those targets appeared to be incompatible.

The authorities and the staff correctly pointed out that the high interest rates in other countries limited the possibilities for relaxing monetary policy in Japan as long as the yen remained clearly undervalued, Mr. Tvedt stated. An appreciation of the yen against other currencies would, therefore, be welcome. In that regard, he supported the occasional active intervention in the foreign exchange market by the Japanese authorities in order to counteract disorderly conditions and to signal the desired direction for the market. To further the effectiveness of the capital market and to bring about a strengthening of the yen, he hoped that the authorities would take steps toward a further liberalization of the capital market with a view to making it more attractive to nonresidents. It would also be important to remove factors that had a more direct limiting effect on the inflow of capital.

The measures taken by Japan to open the domestic market for foreign goods and services were steps in the right direction, Mr. Tvedt considered, and he hoped that further similar efforts would be made. He agreed with the staff that, because Japan was the second-largest economy among the members of the Fund and because it had a strong external position, it had an important responsibility in counteracting protectionism and in strengthening the open and multilateral trading system in support of the emerging international recovery. He was confident that Japan was fully aware of that responsibility. He welcomed the authorities' determination to step up their assistance to developing countries. In light of the strong external position, he hoped that they would make further efforts to that end.

Mr. Mtei remarked that Japan's remarkable record over the years stood out quite clearly. Indeed, rather than receive advice, it might be more useful if Japan could share the secrets of its success with other countries. Not many countries could boast of an inflation rate below 3 percent and an unemployment rate that came close to 2.6 percent. There were not many countries, including developed countries, that had been able to adjust their economies to changing conditions in the international economy as rapidly as Japan. The successful efforts of the Japanese to conserve energy had been an important part of that adjustment process; they had also played a part in maintaining the competitiveness of Japanese exports. All those achievements had been the result of sound economic policy, for which the authorities deserved high commendation.

However, Japan had not been insulated from developments in the rest of the world, Mr. Mtei continued, as was clear from the slowdown in the rate of economic growth in the period 1980-83, reflecting in part the decline in foreign demand as the result of the global recession and the high real interest rates, a factor related to the persistence of high interest rates overseas. In that regard, the Japanese authorities were concerned that the situation had limited their ability to use monetary policy to boost domestic activity for fear that an easing of monetary policy might lead to a further undue depreciation of the yen.

The Japanese experience in recent years drew attention to one of the classic problems of adjustment facing many nations, Mr. Mtei suggested, namely, how to reconcile the objective of reducing large fiscal deficits, which were potentially damaging to an economy in the longer run, with the more immediate need of keeping economic growth at reasonable levels, which could require expansionary fiscal measures or, at least, the maintenance of the level of government expenditure. Fortunately for Japan, however, that problem was not as vexing as it was for many other countries because the state of the economy permitted the authorities to take a medium-term approach to reducing the budget deficit. Even so, they were exercising caution, because the measures taken to stimulate domestic demand were expected to result in only a marginal increase in the budget deficit in relation to GNP. He was, therefore, not overly worried about the present policy stance, given the proven ability of the Japanese authorities to cope with adverse developments.

Commenting on the external sector, Mr. Mtei welcomed the steps that the authorities had taken to open up the domestic market to imports by easing nontariff barriers. By the same token, in the long term, efforts should be made to curb the proliferation of voluntary export restraints involving Japanese exports, another form of protectionism. Such arrangements were not in the interest of free trade, nor would they necessarily lead the countries that promoted them to undertake the required structural adjustments. He commended the Japanese authorities for their increased efforts to assist the development process in less developed countries. In particular, they intended to double their assistance in 1985/86. However, there appeared to be a need to work with recipient countries to identify problems that had limited rapid disbursement of Japanese financial assistance.

Mr. Morrell said that he broadly agreed with the staff's assessment of recent economic developments and policies in Japan. Japan had undoubtedly adapted to the disruptions of recent years more successfully than most industrial countries. The flexibility of the Japanese economy, in particular its capacity to absorb external price increases without distorting domestic price and wage structures, had played a central role in that adaptation. With sustained low inflation, continued wage moderation, and a rise in corporate profitability, Japan was at present well placed to take advantage of the recovery in international economic activity.

Although he agreed with the judgment that crowding out was not as immediate a concern for the Japanese economy as it was for a number of other countries, Mr. Morrell continued, it was difficult to accept the staff's relatively relaxed attitude toward Japanese fiscal policy. On the contrary, he shared the view of the authorities that the argument for immediate progress in reducing the deficit was compelling. The present deficit was large, and budget projections indicated that a deficit financing problem would persist until at least the beginning of the next decade. A lesser effort to reduce the deficit at present could only magnify future difficulties. Of particular concern was the prospect that growing interest payments would limit future flexibility at a time when demographic factors were also likely to militate against reductions in the deficit. Moreover, the staff overstated the risk to the recovery of further reductions in the deficit, particularly given the recovery in domestic demand in the second half of 1983. The draft budget for 1984/85, which had been released after the preparation of the staff report, maintained a restrictive fiscal stance, providing for a real decline in government expenditure. It would be interesting to know the staff's response to some of the points raised by Mr. Hirao concerning fiscal policy, in particular, the forecast growth rate of 4.1 percent in private consumption expected by the authorities. In view of that forecast, could the staff justify further discretionary fiscal stimulation, and did it accept the arguments made by Mr. Hirao concerning the limited flexibility available to the Japanese authorities in future?

Given higher domestic interest rates, the relatively low value of the yen against the dollar, and protectionist sentiments abroad, which had been exacerbated by the rapid increase in the current account surplus, there remained problem areas for the Japanese economy, Mr. Morrell remarked. The issues were interrelated and, to a considerable extent, could be legitimately traced to external factors, the most significant of which was the U.S. budget deficit. He agreed with the staff that the strengthening of the yen would do much to ameliorate those difficulties. Recent moves to liberalize the Japanese financial markets might ultimately assist in that respect, although it was not likely that those moves would have an immediate significant impact on the value of the yen, which would, therefore, continue to constrain the conduct of monetary policy. He joined other Directors in urging the authorities to liberalize some of the controls on the domestic banking system and capital markets.

The perceived need to protect the postal savings system, an important source of finance for the Government, was a factor slowing the pace of liberalization of deposit rate controls, Mr. Morrell noted. A similar situation had existed in New Zealand a few years previously, when the Post Office Savings Bank had been a major source of finance for the Government and its uncompetitiveness had served as a restraint on all other savings institutions. The New Zealand authorities had decided to allow the institution to lend to the private sector so that it no longer became entirely a source of funds for the Government. The measure had provided a considerable boost to the institution and its staff, and it had given it a much more competitive position in relation to the other savings institutions, as well as removing one of the major arguments against competitiveness in the interest rate field.

Although the Japanese authorities had made some efforts to reduce protectionist barriers, Mr. Morrell went on, he agreed wholeheartedly with the staff's observation that there was a compelling case for further progress in agricultural trade. Some commentators had noted that agricultural protection had been a major inefficiency in the economy, distorting the price of land, leading to inadequate housing and congestion and to prohibitive construction costs, thereby preventing the establishment of adequate infrastructure. He also supported the staff's recommendation that Japan, as a major trading nation, should adopt an active leadership role in defending an open, multilateral trading system. The multilateral aspect was particularly important; proliferation of voluntary export restraints, orderly market arrangements, and the like threatened the multilateral system that had well served the world economy and its participants, not least Japan, for more than 30 years. He welcomed the authorities' intention to meet announced medium-term targets for official development assistance, although their aim required an increase in disbursements of about 28 percent between 1983 and 1985.

The Executive Directors agreed to resume their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/31 (2/27/84) and EBM/84/32 (2/29/84).

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 83/123 and 83/124 are approved. (EBD/84/56, 2/22/84)

Adopted February 28, 1984

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/39 (2/24/84) and by an Advisor to an Executive Director as set forth in EBAP/84/39 (2/24/84) is approved.

APPROVED: August 13, 1984

LEO VAN HOUTVEN
Secretary