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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/33

3:00 p.m., February 29, 1984

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

Executive Directors	Alternate Executive Directors
	L. K. Doe, Temporary
J. de Groote	
	X. Blandin
	J. Delgadillo, Temporary
R. D. Erb	J. C. Williams, Temporary
	T. Alhaimus
T. Hirao	T. Yamashita
J. E. Ismael	Jaafar A.
R. K. Joyce	
	J. R. N. Almeida, Temporary
G. Laske	
	C. P. Caranicas
	A. S. Jayawardena
	S. El-Khouri, Temporary
	T. de Vries
	K. G. Morrell
G. Salehkhou	
F. Sangare	E. I. M. Mtei
M. Senior	
J. Tvedt	
	J. Bulloch, Temporary
Zhang Z.	Wang E.

L. Van Houtven, Secretary
K. S. Friedman, Assistant

Also Present

African Department: O. B. Makalou, Deputy Director; S. E. Cronquist, G. Devaux, C. N. Egwim, J. M. Jimenez, S. M. Nsouli, B. A. Sarr, D. E. Syvrud, A. C. Woodward. Asian Department: 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: S. M. Thakur. Exchange and Trade Relations Department: C. D. Finch, Director; W. A. Beveridge, Deputy Director; G. Begashaw, S. Eken, T. Hatayama. Fiscal Affairs Department: R. A. Feldman. IMF Institute: H. Ujikane, Participant. Legal Department: A. O. Liuksila, Ph. Lachman. Research Department: W. C. Hood, Economic Counsellor and Director. Bureau of Statistics: J. A. J. Bove. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: S. R. Abiad, A. A. Agah, E. A. Ajayi, C. J. Batliwalla, A. K. Hansen, W. Moerke, J.-C. Obame, Y. Okubo, I. R. Panday, D. I. S. Shaw, D. C. Templeman. Assistants to Executive Directors: E. M. Ainley, I. Angeloni, R. Bernardo, M. Camara, M. B. Chatah, G. Ercel, C. Flamant, V. Govindarajan, H. Kobayashi, A. Kone, J. Reddy, D. Robinson, A. A. Scholten, Shao Z.

1. JAPAN - 1983 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/84/32, 2/29/84) their consideration of 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).

Mr. Ismael noted that there were some differences in the projections by the staff and the authorities for fiscal years 1984 and 1985. While both sets of projections suggested that a moderate recovery would occur, they differed in their emphasis on the sources of the recovery, the authorities being more optimistic than the staff abcut the strength of the domestic sector compared with that of the external sector.

Commenting on domestic demand, Mr. Ismael said that he was inclined to agree with the staff that there were increasing signs of recovery, particularly in private investment, where a strong pickup in industrial activity and profitability was evident. Moreover, he agreed with Mr. Hirao that the recent cut in income taxes should further strengthen private consumption. The staff and the authorities apparently held opposite views on the trend in residential investment, and further information was required to enable Executive Directors to form their own opinion. The staff had noted the underlying structural weaknesses of the housing sector, but the authorities apparently had good reason to believe that the demand for housing would recover, and that housing investment would grow by about 5.2 percent in the coming fiscal year, rather than the 0.5 percent forecast by the staff. A further comment on the differences would be helpful.

As for the external sector, Mr. Ismael remarked, he tended to agree with the staff that the projected 25 percent contribution to GNP in the coming fiscal year was moderate, particularly compared with the estimated 50-60 percent contribution in 1983/84. The recovery in the European and Southeast Asian markets, on top of the continued strength of the dollar, should help to moderate the contribution in the coming years; indeed, the moderating trend would probably strengthen if further progress were made in reducing the protection in Japan's major trading partners.

Economic growth in excess of the official forecast of 4.1 percent for 1984/85 was within reach, Mr. Ismael considered, and would make a positive contribution to sustaining the global recovery. In the light of the need to control protectionist tendencies abroad, he hoped that the recovery in Japan would not emanate strongly from the external side. It was not unreasonable, for instance, to expect a larger current account surplus, say, of the order of $30 billion, if the yen weakened and the dollar continued to strengthen.

The authorities had made substantial progress in removing import tariffs and nontariff barriers, Mr. Ismael remarked. They were to be commended and encouraged to continue working toward achieving a freer trade system. He agreed with the staff that the voluntary import restrictions were inconsistent with the promotion of both restructuring and technological innovation in Japan's trading partners. Experience showed that, once such restraint was introduced, it tended to be kept a long time; the voluntary import restrictions should be eliminated.

Substantial progress had also been made in liberalizing the financial system, Mr. Ismael noted. Indeed, the thrust toward liberalization had been evident for some time, and the main issue in that area was the pace at which it should occur. The kinds of fundamental changes discussed in the staff papers would have to be made carefully to avoid disruptions; calls for further substantial progress in liberalizing the financial system should be approached cautiously. Caution was also required in responding to recommendations for appreciating the yen. The authorities were to be commended for having eliminated the formal restrictions on Japan's money and capital markets, despite the recent substantial outflow of capital.

The reason for the weakness of the yen was something other than the capital outflows, Mr. Ismael went on. It was not possible to maintain an artificial pegging of the yen to the dollar through controls on capital flows, as the recent liberalization of the capital markets had made it difficult to stem flows over an extended period. The main factor in the weakness of the yen was probably the sharp differential between U.S. and Japanese interest rates, the higher rates in the United States reflecting the large budget deficit there, and the lower rates in Japan reflecting the need for flexibility. Interest rates in Japan would probably rise gradually with the increasing degree of integration of the Japanese financial system with the rest of the world. Meanwhile, the authorities should be urged to ease the controls over domestic interest rates.

The structural problems in public finances were well known, Mr. Ismael remarked, including the growth of the absolute size of the national budget and the rapid rise in government debt because of revenue shortfalls. While the level of the fiscal deficits had been falling moderately to more acceptable levels as a result of the authorities' recent efforts to cut expenditures, it was still sizable by international standards--4.8 percent in 1983/84 and 4.3 percent in 1984/85. Those levels might not be manageable. The deficits were certainly financeable, as domestic savings were the equivalent of some 19-20 percent of GNP, but the savings trend had been declining and would probably fall even more quickly as a result of the liberalization of the capital market. Moreover, the domestic recovery had begun to gather momentum with the improvement in profitability and the increase in capacity utilization, which had encouraged an increase in investment in plant and equipment. If the deficit persisted, there was a real danger that crowding out might make the domestic recovery unsustainable. There was a kind of built-in policy inertia due to the availability of bond financing, and it would be difficult to reverse, as the debt servicing and amortization were likely to keep rising and had already become a source of structural rigidity. Bond financing had reached almost 18 percent of public expenditure in 1984/85, and it could be expected to rise in coming years.

Efforts had been made to restructure the public finances, Mr. Ismael noted, but fundamental progress was still needed. Unless dramatic changes in public spending and taxation were made, no significant progress could be expected in minimizing the use of bond financing. As for public spending, the recent cut in public works expenditure was welcome, but the authorities might have to make cuts in other areas as well. The aging population would require welfare spending to be at least maintained, and political considerations might make cuts in subsidies to agriculture, railways, education, and research very difficult.

A realistic option for improving public finances was tax reform, Mr. Ismael remarked. There would be scope for increasing income taxes as the economy expanded. Although the income tax in Japan was highly progressive, its incidence was particularly large for high-income earners. Lower-income earners were not as heavily burdened by taxes as their counterparts in the United States, the United Kingdom, and Germany. The ratio of taxes to GNP also appeared to be relatively small, implying that there was room for introducing measures to increase revenues. A reform of indirect taxes would also add to the potential for total revenue collection. Corporate tax contributions were much larger in Japan than in other countries, probably because of the absence of a value-added tax in Japan. A comment on the absence of such a tax in Japan, despite its obvious advantage in terms of administrative efficiency, would be helpful.

The general thrust of austerity under the 1984/85 budget was welcome, Mr. Ismael said, but the substantial increase in transfers to the local governments was a cause for concern. Those transfers had been rising rapidly during the previous several years, and stricter control over local government spending was called for. Finally, the authorities were to be commended for their commitment to economic cooperation despite the obvious need to control expenditures in Japan.

Mr. Alhaimus remarked that the performance of the economy since the previous consultation with Japan had certainly been satisfactory and continued to reflect the high quality of the authorities' economic and financial management. The staff reports clearly showed that the combination of rising output, low unemployment, price stability, and a strong external position had been achieved through a delicate balance of difficult policy choices.

During the previous discussion on Japan, Mr. Alhaimus recalled, speakers had stressed the extent to which the domestic component of demand could be stimulated. At present, the focus seemed to be on the important question of the mix of policies that was most suitable for the attainment of a durable recovery of domestic demand. There were of course no easy answers to that question, particularly in view of the internal and external constraints under which the economy had been operating in recent years.

On the fiscal side, Mr. Alhaimus went on, the authorities understandably attached particular importance to restoring a sound position over time. The illustrative simulation mentioned by Mr. Hirao in his opening statement clearly underscored the need to correct the structural component of the fiscal deficit, and the staff apparently broadly agreed with the authorities' analysis. Moreover, the staff's arguments in favor of continued flexibility in the conduct of fiscal policy, particularly with respect to the timing and direction of government expenditure, seemed to be reasonably convincing. In that connection, the scope for synchronizing the withdrawal of fiscal stimulus with the strengthening of domestic demand recovery was especially noteworthy.

Apparently the authorities and the staff placed somewhat different emphasis on the role that monetary policy could play in the present domestic and international economic environment, Mr. Alhaimus remarked. In the authorities' view, there was room for an active monetary policy, especially as inflationary expectations had been brought firmly under control. Such a policy might stimulate both private investment and consumption while contributing to the fiscal adjustment effort. The staff had noted the possible implications of such a course of action for the exchange rate, but its concern seemed to be mitigated by certain empirical findings regarding exchange rate developments. For instance, in SM/84/41 the staff had indicated that "in general, the links between movements in the value of the yen against European currencies and developments in interest differentials between Japan and European countries have been very weak during the last several years." The staff had also concluded that "while interest rate movements appeared to have a key role in exchange rate developments between the yen and the dollar since November 1982, there were periods when the relationship was perverse." It was in the light of such observations that one could appreciate the difficulty of the authorities' position and their flexible attitude; they were willing to introduce corrective measures needed to prevent an undue weakening of the yen.

In commenting on commercial policy, Mr. Alhaimus noted, the staff had mentioned that "Japan has met international criticism of the growing exports by acceding to an increasing number of requests for voluntary export restraint." Although Japan had obviously shown its concern for the position of its major trading partners, the possible implications of its particular policy response--voluntary restraint--for all the countries concerned should be kept in mind. There were no guarantees that the gestures made by Japan would be temporary or serve to accelerate structural adjustments in the importing countries pressing for the restrictions. Moreover, as the staff had noted, Japan's voluntary export restraints might discourage private domestic investment in Japan, which would be inconsistent with the calls by certain countries for Japan to stimulate domestic demand.

Moreover, Mr. Alhaimus went on, voluntary export restraints, which were designed mainly to accommodate a certain category of Japan's trading partners, could have potentially distorting effects on the efficiency of domestic and global resource allocation and the world trading system. Instead of resorting to voluntary export restraints, it would be more constructive for the Japanese authorities to continue their efforts to liberalize the access of imports to Japan's domestic market. That approach would also encourage other industrial countries to reduce their protection.

The staff had explained, Mr. Alhaimus commented, that the authorities remained committed to their announced target of doubling the dollar value of official development assistance in 1981-85 over the value recorded in the preceding five-year period. Japan's performance in official development assistance was not greatly different from that of other major industrial countries; as previous speakers had noted, there was ample room for improvement.

Labor market conditions in Japan had continued to be stable at low rates of unemployment, Mr. Alhaimus observed. The staff attributed that phenomenon to the tendency of Japan's firms to retain workers despite fluctuations in output. That tendency seemed to be based on elaborate institutional mechanisms and arrangements designed to enable the labor market to respond flexibly to changing production conditions. Future staff reports on Japan could usefully elaborate on those mechanisms and arrangements.

Mr. Jayawardena said that Japan's successful and remarkably rapid adaptation to the two oil crises and the world economic recession constituted a major success story. The important structural changes that had been made were a reflection of the considerable dynamism and resilience of the Japanese economy. The management of the economy had been pragmatic and skillful, and the problems mentioned by previous speakers had arisen from successes, rather than failures. The Japanese economy had emerged from the deep international recession with the lowest inflation and unemployment rates among industrial countries, a fairly buoyant overall economy, and an export sector that had remained resilient and dynamic despite substantial trade barriers abroad.

The authorities had faced difficult policy dilemmas in the recent past, Mr. Jayawardena noted, and some of them had persisted to the present. High real interest rates had combined with the weakness of the yen to create a conflict between domestic and external monetary policy objectives. Similarly, in the fiscal area, the authorities' room for maneuver had been limited by the large structural budget deficit. As Mr. Hirao had shown in his opening statement, the fiscal deficit had remained stubbornly large and a serious constraint on the adoption of stimulatory fiscal policies. Mr. Hirao had indicated the narrowness of the margin available for meeting even the most legitimate demands, such as social security payments, improvements in the social infrastructure, and increases in official development assistance.

In the circumstances, Mr. Jayawardena went on, the authorities' unwavering commitment to the medium-term objective of reducing the resort to deficit financing was understandable. Since the policy options on the monetary front were particularly limited in the short run, the authorities had decided to front-load public works expenditures in an effort to stimulate domestic economic activity. In fact, however, the shifting of expenditure had had only a limited effect; during the previous two years, it had stimulated the economy a few months earlier in the fiscal year than would have been the case otherwise, and the stimulatory effect had been moderated in the final months of the year. A better approach would perhaps have been to undertake an in-depth examination of the structural nature of the fiscal deficit and to introduce measures with a lasting impact. On an earlier occasion, Mr. Wicks had made a useful proposal for having the Fund undertake a comparative study of structural rigidities in mature economies, so that the Fund could have a better understanding of the nature of the rigidities. He would endorse the proposal.

The authorities had refrained from adjusting the discount rate because they feared that it might further weaken the yen, Mr. Jayawardena commented, but the overall availability of credit appeared to be fairly liberal. The interest rate differential with the United States had narrowed as a result of the reduction in interest rates in the United States. Because of the low rate of inflation in Japan, the Japanese authorities faced the problem of historically high real interest rates. Gross capital investment had been adversely affected by the high rates, the running down of inventories, and the decline in corporate profits.

The macroeconomic policies that the authorities had maintained in 1982 had been painful and had involved certain costs, Mr. Jayawardena remarked. The growth of the economy in 1982 had been slow by historical standards and considerably below expectations. The continuing large budget deficit had caused an escalation of debt service charges. The fiscal constraint had weakened the role of the budget as a mechanism for countering the business cycle, and the authorities' firm resolve to restore fiscal soundness by reducing inefficient expenditures was welcome. A re-examination of the structural rigidities in the budget might help the authorities to restore the much-needed flexibility in macroeconomic policy management.

In 1983, Mr. Jayawardena continued, the authorities had had reasonable success in trying gradually to improve the economic situation. The staff had concluded that the recovery had begun, but it had noted that there had actually been mixed signals, and it remained cautiously optimistic about the strength of domestic demand in Japan. A recovery based on domestic demand seemed like a tender plant that needed to be nourished, but Mr. Hirao had painted a fairly convincing picture of the recovery of domestic demand. The recent pickup in investment was encouraging, and he was pleased that growth in the second half of 1983 had been the result largely of an increase in domestic demand.

In 1984/85, Mr. Jayawardena went on, the authorities expected a growth rate of 4 percent, due mainly to an expansion of domestic demand. The staff, however, felt that the main thrust would come from exports. Private equipment investment had begun to show signs of a strong recovery, but more vigorous growth in investment in the services sector was needed. Investment in the private sector would have looked less buoyant if a generation of service industries with promising prospects had not emerged. In fact, services had become Japan's main source of new economic activity and growth.

The improvement in the trade position in 1983, Mr. Jayawardena remarked, had been due more to a sharp reduction in oil and non-oil imports than to a significant increase in exports. It was encouraging that Japan had recognized its international responsibility as a major industrial country by moderating its trade surplus and by maintaining a healthy environment for balanced world trade. The authorities had responded to Japan's growing payments surplus by introducing a package of measures designed to encourage imports and to stimulate domestic demand, a commendable response in the face of the tight fiscal restraints. The new measures should make a considerable contribution to sustaining the economic recovery.

He agreed with the staff and the authorities that an increase in the value of the yen that reflected its underlying strength would be a positive development, Mr. Jayawardena said. It should help to adjust trade flows and encourage domestic growth through an improvement in the terms of trade. The authorities' efforts to liberalize trade, despite the growing protection abroad, were welcome and should be strengthened over time. Their willingness to support the internationalization of the yen, further liberalize the money markets, increase official development assistance, and reduce protection through multilateral negotiations, was a reflection of Japan's willingness to accept change gradually from a position of strength. The authorities were to be commended for acting to bear the international responsibility that naturally fell to the country with the world's second largest market economy.

The performance of the Japanese economy in 1983, particularly in the context of the international adjustment process, had been commendable, Mr. Jayawardena concluded. Japan had stood at the forefront of the technological revolution that would change lifestyles in coming years. The present era was not one in which senescent economic activity should be protected at the cost of the development of new activity. Instead, countries should make realistic adaptations to change. In that connection, Japan had a heavy responsibility as an important engine of technological and economic growth, and the increasing integration of its economy with the rest of the world was welcome. The authorities should remain mindful of Japan's global responsibilities.

Mr. Salehkhou remarked that 1983 had been a good year for the Japanese economy. Stimulated by the substantial current account surplus, the growth rate of GNP had risen from 3 percent in 1982 to 3.8 percent for the first nine months of 1983. Moreover, inflation had been kept under control, labor market conditions had shown signs of further improvement toward the end of 1983, the rate of unemployment remained low in comparison with that of other industrial countries, and industrial production had increased with the resurgence in exports. The root causes of the exemplary performance of the Japanese economy were the remarkable resiliency, flexibility, and structure of the society, which had enabled the authorities to deal effectively with the emerging external pressures and to adapt the economy rapidly to them.

The present strength of the economy, Mr. Salehkhou commented, was traceable to the development effort, which had been based on the identification of available and potential domestic resources and on hard work, discipline, and perseverance in the full utilization of the resources. Self-reliance had been the main vehicle for industrialization and growth in Japan, and, in that sense, the Japanese development strategy was a model for developing countries.

As the pace of development had increased, Mr. Salehkhou went on, Japan had been able slowly but gradually to open its domestic markets to foreign competition and to integrate its capital and financial markets with foreign markets. That effort had been facilitated by the removal of some of the barriers to international capital movements and had resulted in the growth of capital inflows and outflows. The gradual reduction of regulations had enabled commercial bank operations to be internationalized. As a result, the financial system had become increasingly diversified and had significantly accommodated private initiative and enterprises.

As to the exchange and trade system, Mr. Salehkhou remarked, the continuous favorable export performance and the huge current account surplus had created growing pressures by foreign competitors for greater access to the Japanese market. The authorities had reluctantly taken steps aimed at voluntary export restraint and at increasing the accessibility of foreign manufacturers to Japan's domestic market. As protectionist pressures abroad had intensified, the measures increasing exporters' access to Japan's markets had ranged from the easing or removal of some tariff barriers to the simplification of import testing procedures. Despite those measures, trade frictions with other industrial countries had continued, mainly because of the continued existence of certain tariff and nontariff barriers.

The Central Government's general account budget had remained in deficit, Mr. Salehkhou noted, and the revised projections for the present fiscal year and the estimates for the coming year underscored the persistence of the relatively large deficit financing. The authorities were concerned about the large size of the deficit, but, given the pressures in other policy areas, they understandably had relatively little room for fiscal policy maneuver. They had given priority in a medium-term framework to eliminating the budget deficit gradually. Accordingly, the main objectives of the 1983/84 budget were to restrain expenditure and increase revenues, mainly through a flexible tax system, and to reduce reliance on deficit financing.

In fact, however, Mr. Salehkhou went on, a supplementary budget had been approved in January 1984. It incorporated earlier fiscal measures needed to provide a further boost to domestic demand. Because of the stimulus package, including increased expenditures, and reduced personal income taxes, the revised projected budget deficit was larger than the original projection. However, the increase was not large--from 4.5 percent of GDP to 4.8 percent--and should not significantly affect the major favorable trends in the economy. The inherent flexibility of fiscal operations, despite the limitations imposed by the continued budget deficits, would compensate for any adverse side effects of the supplementary budget.

The 1984/85 budget reflected the Government's continued efforts to reduce the budget deficit, which was projected to decline further to 4.3 percent of GNP, Mr. Salehkhou remarked. Under the new budget, expenditure was expected to grow in comparison with 1983/84, owing mainly to increases in interest payments and transfers to local governments; other categories of expenditure were to be restrained. On the revenue side, changes in the tax system were expected to shift the composition of tax revenues without noticeable net change in total revenues. Individual income taxes were to be reduced in response to what Mr. Hirao had referred to as the need to alleviate the burden on wage earners resulting from the increased fiscal draft in recent years. Local taxes were to be cut, while corporate income and other tax categories were to be increased. Mr. Hirao had referred to the structural component of the budget deficit, and had mentioned that some public expenditure increases had apparently been institutionalized. The staff had noted that there were no official estimates of the size of the structural element of the budget deficit. Any further comment on the recent budgetary measures and their effects on reducing the structural burden of the budget deficit would be helpful.

In Japan, Mr. Salehkhou observed, monetary policy was apparently the preferred mechanism for stimulating domestic private demand. However, in 1983 monetary policy had been influenced by exchange rate considerations. There appeared to be a conflict between the need for strong domestic demand, which in turn required a relatively lax monetary policy, and the need to maintain or even strengthen the value of the yen to reduce the trade imbalance between Japan and its trading partners. Further elaboration on the precise importance of interest rates, the balance of trade surplus, and other factors, in influencing the dollar-yen relationship would be helpful. The staff papers suggested that the current account balance played a more important role in Japan than in the United States in determining the movement of the exchange rate. Indeed, the decision of the Japanese authorities in October 1983 to cut the discount rate had apparently been based on the conclusion that the strong foreign balance would continue to affect favorably the exchange rate for the yen. Since then, the dollar-yen rate seemed to have stabilized, thereby underscoring the importance of the timing of the monetary measures.

The recovery of exports and the decline in petroleum prices, Mr. Salehkhou said, had sharply increased Japan's current account surplus, partly at the expense of oil producers, from $7 billion in 1982 to $21 billion in 1983, despite the extension and broadening of Japan's voluntary restraints on its exports. The rapid and sizable increase in Japan's exports was attributable to the recovery in North America, Southeast Asia, and the Middle East, considerable excess capacity in industry because of weak domestic demand, aggressive and well-prepared marketing strategies, and the lagged effects of the depreciation of the yen up to late 1982. The staff analysis suggested that the volume of Japan's exports was particularly susceptible to movements of the exchange rate, and that export growth in the coming financial year would continue, but at a reduced rate. Given the lagged effects of the appreciation and the later stabilization of the yen in 1983 on export volumes, any sizable reduction in the current account surplus would probably have to come from an increase in imports; manufactured imports were expected to rise in response to the projected continued recovery in domestic demand.

Manufactured imports usually accounted for a quarter of the value of imports, Mr. Salehkhou remarked, and they had risen in 1983, after a large decline in 1982. Some two thirds of manufactured imports consisted of capital equipment, imported mainly from other industrial countries. Under the category of fuel imports, petroleum products, which presumably consisted of refined or processed fuel, accounted for some 10 percent of Japan's imports. Hence, it appeared that Japan's imports from developing countries consisted mainly of raw materials and fuels and therefore had a minimal impact on those countries' economic development. An increase in imports by Japan of manufactures from the developing countries would obviously be a desirable and effective way of enhancing Japan's contribution to the economic development of developing countries.

The authorities' intention of extending in 1981-85 more than twice the amount of official development assistance in dollar terms that had been disbursed during the previous five-year period was welcome, Mr. Salehkhou said. As a percentage of GNP, official development assistance by Japan had fallen from 0.32 percent in 1980 to 0.29 percent in 1982. He hoped that the figure for 1983 would be larger and that steps could be taken to increase the share of grants in Japan's total bilateral official lending. There was ample room for diversifying the distribution of Japan's regional bilateral aid, particularly in the direction of poorer African and Asian countries that had been hit hard by adverse external developments. At the same time, a greater share of Japan's aid should be directed toward developing other countries' agricultural sectors and meeting their food requirements; such an effort would go a long way toward alleviating some of the immediate problems facing those countries.

The cost-saving procedures that had reduced the size, and increased the efficient operation, of the public sector were welcome, Mr. Salehkhou said. Given the coordination between Japan's private and public sectors, the administrative reforms were particularly significant, and a further comment on them would be helpful.

Mr. Delgadillo considered that the Japanese economy had adjusted remarkably well to the disruptions in the world economy in the late 1970s. Indeed, Japan's performance with respect to output and inflation had exceeded that of other industrial economies.

The prudent demand management policies that the Japanese authorities had maintained in recent years, Mr. Delgadillo went on, and the increased competitiveness of Japanese industry had resulted in a significant strengthening of the external current account, which could be seen to some extent as a source of financial resources for other countries. However, given the importance of Japan in the world economy, it would be more helpful at the present stage for Japan to increase its demand for foreign products. That step would have a more favorable effect on output and employment in Japan's trading partners than the mere availability of Japanese savings. Having successfully stabilized its economy, the Japanese Government could make an important contribution to world trade and employment by further opening its domestic markets to external competition.

The Government's present stance of monetary and fiscal policies should be maintained with a view to consolidating the noninflationary recovery of economic activity, Mr. Delgadillo said. A relaxation of monetary policy to foster domestic demand was not called for.

For the short run, Mr. Delgadillo continued, a case could be made for an active fiscal policy to support domestic demand, but in the longer run the recovery in economic activity should be the consequence of increased international trade rather than of large fiscal deficits. To that end, the increase in protection among major industrial countries in recent years should be reversed. The growing role that Japan was playing in the GATT and other forums was welcome, and he hoped that the authorities would persist in their efforts to dismantle domestic and foreign barriers to trade.

As one of the main beneficiaries of a free trade system, Mr. Delgadillo remarked, Japan should play a leading role in reversing protectionist practices. However, action in that field must not be limited to areas where pressure from abroad was strong, such as restrictions on manufactured goods from other industrial countries. It should also apply to areas, such as agriculture, where the pressure was relatively weak. The agricultural sector was still heavily protected by import quotas and tariffs that caused significant price differentials for several products. Japan's food distribution system could be seen as constituting another informal trade barrier.

The authorities were to be commended for their commitment to providing financial assistance to developing countries, Mr. Delgadillo considered. The commitment could be enhanced by a further opening of Japanese markets to items in which many developing countries enjoyed a comparative advantage, such as agricultural products and semimanufactured goods. He hoped that Japan would continue to play an active role in the promotion of multilateral trade.

The Deputy Director of the Asian Department remarked that differences in statistical methodologies explained only a small part of the difference between the rate of unemployment in Japan and the rates in other countries. An important factor was the willingness of Japanese labor unions to accept flexible wage arrangements and to share the burden of the effects of external developments on the Japanese economy, thereby maintaining profit shares and keeping the long-run demand for labor high. The practice of keeping labor during cyclical downturns was another important feature of the Japanese labor market. It was of course difficult to quantify the extent of that practice, but rough calculations by the staff suggested that, if industries removed excess labor from their payrolls, the rate of unemployment would be in the range of 4.5-5 percent, instead of the reported 2.5 percent or so.

Apparently there was less concern in Japan than in other countries about the effect of automation on employment, the Deputy Director said. On the other hand, it was true that the unemployment rate in Japan had shown a rising trend over the past several years. The trend was due in part to cyclical factors, and in part to structural ones, of which increasing automation could be one. The relatively greater sense of responsibility assumed by Japanese employers toward their employees, as reflected in the practice of lifetime employment in a single establishment, naturally led employers to retrain workers with obsolete skills and to shift them from one aspect of work in a firm to another aspect in the same firm.

Over the years, the Deputy Director continued, the staff had gained a better understanding of the authorities' view on the budget deficit and the reasons why they felt that there was a compelling need to reduce the deficit rapidly. The reasons had been listed by the staff in its reports. One of them, the inflexibility of fiscal policy, had been mentioned by Mr. Morrell, and there was a great deal of merit in that argument. The share of interest payments in total government expenditure had been growing, and in coming years social security payments would rise even more sharply than they had in recent years, as the Japanese population became more aged and the social security system, which was relatively new, matured.

However, the Deputy Director said, one could legitimately ask whether it was wise to give up flexibility completely now--by abjuring its use for cyclical purposes--in order to achieve flexibility at some future time; there was an important trade-off. Overall, the staff felt that progress must be made in the medium term in reducing the fiscal deficit, and that it should be accomplished in a flexible manner; the fiscal stimulus to the economy should not be reduced too sharply when private domestic demand was weak. In that connection, the difference between the staff and the authorities was probably not as great as it might appear at first sight. In his opening statement, Mr. Hirao had said that the deficit should be reduced in a flexible manner, and the actual performance of the authorities showed that they were fully conscious of that need. During the past several years, when the rate of economic growth and revenues had fallen below the estimates in the budget, expenditures had not been reduced accordingly, and larger deficits than initially planned had been accepted. Moreover, public works expenditure had been front-loaded, whenever there had been doubt whether domestic demand was sufficiently strong.

The staff had noted in its supplementary paper, the Deputy Director went on, that its working assumptions with regard to the outlook for 1984/85 had been more or less borne out in the new budget. The staff continued to feel that, although domestic demand had picked up somewhat, there was some uncertainty about its continued strength, and that fiscal policy should remain flexible to ensure that demand would not falter. In its report, the staff had concluded that it might be best to postpone the imposition of indirect taxes to offset the income tax reduction introduced by the authorities, but the authorities had in fact increased other taxes. The staff had also suggested front-loading public works expenditures in 1984/85; no decision on that issue had yet been taken.

The authorities believed that the proper response to the budget deficit was a reduction in expenditures rather than an increase in taxes, the Deputy Director explained, mainly because of their concern about the size of the Government. Another reason was that the authorities felt that expenditures could be reduced most effectively at a time when taxes were not being increased. In any event, there was strong political pressure against tax increases. The staff felt that, in the medium term, it would be difficult for the authorities to meet their fiscal objectives without an increase in taxes. The authorities' own projections showed that, in the absence of a tax increase, expenditures would have to be kept constant in nominal terms for the next seven years.

The share of developing country bond issues in total issues in Japan had fallen from 30 percent in 1982 to 15 percent in 1983, the Deputy Director noted, but the volume of loans and trade credits to developing countries had been growing. As a result, the developing countries' share of the total net outflow of capital had risen from 26 percent in 1981 to 39 percent in 1982.

As Mr. Zhang had suggested, the Deputy Director remarked, the relative income elasticities of Japanese imports and imports of Japanese goods abroad were probably reflected in Japan's current account surplus. As for the rate of savings, the staff had discussed it to some extent with the authorities, noting the clear-cut implications of the high savings rate in Japan for the country's current account position. In a world that was short of savings, the staff hestitated to recommend to a major country that the savings rate should be reduced. However, it seemed appropriate to question whether tax policy should provide special incentives to savings. Such incentives were far greater in Japan than in any other industrial country. The authorities recognized that the present system of tax incentives for savings was outmoded, and they were considering various options for adapting it to current requirements.

The savings rate in Japan was in any event likely to decline in coming years, the Deputy Director went on. The rate had risen sharply, to some 23 percent, in 1976 and then had fallen more or less continuously until 1983, when it had stabilized. The authorities apparently felt that, because of the uncertainties in the labor market in that year, consumption had declined, thereby stabilizing the savings rate. Over the coming years, the rate was expected to return to about the level of 1965 as a result of additional tax payments' being deferred, the social security payments for the aging population, the strong likelihood of continued noninflationary growth and a rise in disposable income, and the possible development of consumer credit facilities, which had been inadequate in the past, thereby helping to keep the savings rate high.

The difference between the estimates of the staff and the authorities on housing investment had been noted by one speaker, the Deputy Director remarked. The structural weakness in the housing market was the excess of housing units on the market, and the high cost of land and structures relative to disposable income. The slow growth of family formation was another important factor. On the other hand, incomes had been gradually rising; moreover, there was a need to replace old housing units. On balance, the staff had a somewhat less optimistic view than the authorities about the immediate prospects for housing investment.

Japan had not introduced a general consumption tax in the whole postwar period, the Deputy Director noted. Several years ago, the then Prime Minister had strongly supported the introduction of such a tax, but he had found it politically impossible to implement it. The existing consumption taxes were primarily on liquor, tobacco, and petroleum products.

Several measures in the new budget would tend to reduce the structural deficit, although the staff was not certain by precisely what amount, the Deputy Director said. As for the progress that had been made in administrative reform, it was described in the staff report on recent economic developments. Recommendations had been made by the Administrative Reform Commission, and the authorities believed that the recommendations had helped them to establish priorities for expenditure programs and for implementing structural changes. During the past two years, steps had been taken to reduce subsidies and raise user charges, and progress had been made in deregulation. The decision to transform the national railway into a private enterprise would have important implications in coming years.

Mr. Hirao remarked that there was apparently some feeling among Executive Directors that, given the high savings ratio, the lack of an immediate threat of inflation, and the growing external surplus, a more flexible fiscal policy stance than that envisaged in the budget for 1984/85 should be taken. Restoring fiscal soundness was of central importance to achieving sustained growth over the medium term. The medium-term guidelines called for an elimination of deficit-financing bond issues by 1990/91. Consistency in taking various policy actions under the guidelines was the key to restoring a sound fiscal position. The flexible implementation of fiscal policy was of equal importance for ensuring a proper response to the phases of the business cycle. A strong upward trend in the business cycle was expected in 1984/85, and it was for that reason that his authorities believed that the draft budget presented to the Diet was the most suitable one.

There was a public consensus that a sound fiscal position should be restored over the medium term, Mr. Hirao noted. That objective could conceivably be achieved through continued restraint on, or cuts in, expenditures, or a tax increase and new taxes, or a combination of those.

Long-term public expenditure and taxation prospects were of course far-reaching issues that certainly deserved extensive public debate. It had already become clear, after two years of discussions within the Ad Hoc Committee for Administrative Reforms, that first priority should be given to expenditure cuts. There had been growing doubt whether expenditure cuts alone would go very far toward restoring fiscal soundness while providing needed public services. One possible option was to introduce a new, broad-based tax, perhaps in the form of a general excise tax. The selection of an option was to be based on public consensus.

A number of Executive Directors seemed to believe that the option of again front-loading public works expenditure should be kept open, Mr. Hirao continued. Domestic private demand was expected to recover strongly in 1984/85, and his authorities felt that there would be virtually no need for discretionary stimulative measures. They would be monitoring closely developments in the domestic economy through the latter part of March 1984, when they would decide on a detailed schedule for implementing the program for the new fiscal year.

Some Executive Directors had observed that, because of the large savings ratio, a reduction in the fiscal deficit would not necessarily be compatible with a decline in the current account surplus, Mr. Hirao remarked. They also felt that, because of the high savings ratio, the large government deficit was not a cause for as much concern as if would be otherwise. Executive Directors who held those views apparently believed that private savings were equal to the sum of private investment, the fiscal deficit, and the current account surplus. That equation held true, but only as ex post, not as an ex ante one. In fact, that causal relationship did not always hold true. It could not be assumed that the savings ratio would remain high if other variables changed; experience showed that the savings ratio tended to fluctuate from one year to another. In 1974/75, for instance, it had risen from 20.6 percent to 23.1 percent. Moreover, there was a tendency for the sum of voluntary and involuntary savings to stabilize at a certain level. Involuntary savings, including tax payments and social security contributions, had increased by 8.5 percentage points between 1975/76 and 1982/83. During the same period, the savings ratio had fallen by 4.9 percentage points. Hence, experience suggested that, if fiscal deficits were reduced through an increase in tax and other burdens, there would be a concurrent decline in savings. Smaller fiscal deficits probably would not necessarily lead to a larger current account surplus.

It had been suggested, Mr. Hirao noted, that the General Government should be taken into account when fiscal deficits were analyzed. The deficit of the General Government was smaller than that of the Central Government, although only because the General Government included the social security fund, which was in surplus, the number of people claiming benefits being much smaller than the number of persons making contributions. The social security system in Japan, unlike that of other industrial countries, was immature. Over time, the number of persons claiming benefits would grow rapidly, and the surplus would diminish; indeed, it was expected that the surplus might well disappear in about 10 or 20 years.

Hence, the present surplus represented only a temporary pool of resources that was to be paid out in coming years, and it seemed best not to include the social security fund in an assessment of the size of the structural fiscal deficit. Including the surplus would merely distort the overall picture of the structural deficit. When the social security fund was excluded, the deficit of the General Government was larger than that of the Central Government.

Some Executive Directors believed that the effect of an income tax cut might be offset by an increase in other taxes, Mr. Hirao remarked. His authorities had a somewhat different, and more optimistic, view. A preliminary estimate showed that real disposable income would increase by 0.5 percent as a result of the proposed income tax cut, while consumer prices would rise by about 0.2 percent as a result of an increase in liquor and commodity taxes, leaving a net increase in real individual income of roughly 0.2-0.3 percent. Accordingly, an increase of about 0.1 percent in GNP could be expected.

Good arguments could be made both for and against the present preferential tax measures for savings, Mr. Hirao commented. The Tax Commission was scheduled to review the matter with a view to reaching a conclusion around end-August 1984. According to one proposal mentioned in recent press reports, such preferential measures should be limited to individuals with annual incomes of less than a certain prescribed amount. The likely final outcome was not yet clear.

Commenting on the prospects for domestic demand in the coming fiscal year, Mr. Hirao said that there was no disagreement between the staff and the authorities about the general thrust of the forecast. However, the staff projection was at the lower end of a group of 20 major private forecasts, while the projection of the authorities was about in the middle. The staff's forecast might be excessively cautious. Private residential investment should grow steadily. It had been back on a normal path since October 1983, after the rapid increase in housing starts in the fall of 1982 and the temporary slowdown that had begun early in 1983. Residential investment in 1984 would be supported by the growth in real incomes, the stability in the cost of land and construction, and a decline in interest rates on housing loans.

There were no statistics measuring hidden unemployment in the form of excess labor maintained by enterprises, Mr. Hirao remarked, although the results of the short-term economic survey of all enterprises conducted by the Bank of Japan indicated that there had been a rather significant reduction in the number of manufacturing enterprises that felt that their work force was too large. There seemed to be little or no hoarding of excess labor by small and medium-sized enterprises. Moreover, there had been an increase in female participation in the work force since 1975, and particularly in 1983, when an increase of 1 percentage point had been recorded. There had also been a rising trend of participation in the labor force by women over 40 years of age. There was thought to be a structural element to the recent rise in unemployment, and it could have significant implications for employment in the future.

Consumer credit had historically been a relatively minor factor in consumer behavior in Japan, Mr. Hirao explained. That fact might be a reflection in part of the conservative attitude of Japanese consumers toward borrowing. According to the latest available data, consumer loans extended by banks amounted to less than ¥ 1 trillion, compared with total bank loans outstanding of ¥ 200 trillion. However, given the relatively rapid rate of increase in consumer loans, they might have a growing effect on consumer behavior in the future.

Commenting on the size of the current account surplus, Mr. Hirao said that about half of the swing in the current account from the previous year was a reflection of the decline in world oil prices and of Japan's conservation efforts. The authorities shared the concerns of observers outside Japan about the current account imbalance and the protectionist tendencies, and they had made strenuous efforts to advance further the liberalization of imports.

In monetary policy, Mr. Hirao remarked, more than enough stress had been placed on exchange rate considerations. Great care had been taken in setting monetary policy, and further unilateral actions would add little to the effort to reduce the external surplus. The experience of 1977-79--when large imbalances had emerged and then been effectively reversed--suggested that exchange rate changes should play a greater role than other policy adjustments in correcting the imbalances. The value of the yen had risen sharply against European currencies, and imports from Europe had increased. The yen had appreciated against the U.S. dollar, although less so than had generally been expected.

As a result of the exchange rate changes during 1983, Mr. Hirao went on, the exchange rate between the yen and European currencies seemed not to have been misaligned, while there had been misalignment between the dollar and the yen. A number of factors affected the market perceptions, including inflation rates, the strength of economies, external balances, expectations, and interest rate differentials. It was difficult to say which of those factors would dominate in 1984. The interest rate differentials had apparently been the dominant factor in the exchange market in 1983.

The medium-term plan formulated in 1981 to double Japan's official development assistance during the first half of the 1980s had helped to increase the assistance in recent years, Mr. Hirao remarked. Unfortunately, however, achieving the established aid guidelines had become increasingly difficult because of such factors as the appreciation of the U.S. dollar and the delay in capital subscriptions of international development finance institutions. However, it was fair to say that, because of the guidelines, an exceptionally high rate of growth of official development assistance could be achieved, despite the environment of severe expenditure restraint.

Commenting on the internationalization of the yen, Mr. Hirao said that capital flows involving yen-denominated assets had increased substantially since the removal of foreign exchange controls, although trade denominated in yen had not shown any remarkable progress, mainly because of the difficulties involved in changing long-standing business practices, particularly with respect to imports, most of which had traditionally been denominated in dollars. The authorities would like to see further internationalization of the yen following the continued liberalization of the capital and money markets. Steady development in that area would contribute to further improving the efficiency of the markets, and to increasing their size and depth; it should also promote exchange rate stability.

The Chairman made the following summing up:

Directors welcomed the recent signs of recovery in the Japanese economy and hoped that the conditions fostering the recovery would persist. The strong fundamental conditions in Japan--particularly the effective financial policies that had helped to achieve virtual price stability and dispel inflationary expectations, the responsiveness of wages to economic conditions, and the rapid adaptation of industry to structural changes--were felt to have been important factors behind the better than average performance of the Japanese economy in recent years; they had also reflected the authorities' successful management of the economy. The likely persistence of these conditions should contribute toward the strengthening of growth.

One aspect of Japan's performance had been the emergence of a large current account surplus. Most Directors expressed concern over this development and the associated large contribution of net external demand to economic growth in Japan during the past year. They hoped that the recent pickup of industrial output and profits in response to the resurgence of exports would quickly translate into more rapid growth of domestic demand. This in itself should contribute to lessening the current account surplus and attendant protectionist pressures in trading partner countries and also to enhancing Japan's contribution to the recovery of the world economy. It was noted, however, that the staff was more cautious than the Japanese authorities with regard to the speed of the recovery of the main components of domestic demand in 1984/85.

Many Directors shared the authorities' view on the need to reduce the fiscal deficit during the coming years. The fiscal burdens that are likely to accompany the projected aging of the population as well as the inflexibility introduced into fiscal policy by the growing share of interest payments in total expenditure heightened the need to reverse the budgetary trends established during the 1970s. Several Directors, noting the progress already made in controlling the growth of government expenditure, wondered whether a larger role for tax policy would not be appropriate and necessary to achieve the authorities' medium-term fiscal goals. The appropriateness of heavy tax incentives to savings was also questioned.

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In monetary policy, Mr. Hirao remarked, more than enough stress had been placed on exchange rate considerations. Great care had been taken in setting monetary policy, and further unilateral actions would add little to the effort to reduce the external surplus. The experience of 1977-79--when large imbalances had emerged and then been effectively reversed--suggested that exchange rate changes should play a greater role than other policy adjustments in correcting the imbalances. The value of the yen had risen sharply against European currencies, and imports from Europe had increased. The yen had appreciated against the U.S. dollar, although less so than had generally been expected.

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While understanding the authorities' medium-term deficit reduction goals, many Directors stressed the impact on domestic demand of the restrictive fiscal policy followed in the past three years, and they welcomed the moderation to the stance of fiscal policy implied in the October stimulus package. Although the recovery of domestic demand appeared to be gathering strength, most Directors shared the staff's view that the authorities should moderate the pace of withdrawal of fiscal support while the strength of the recovery remains uncertain. In this context, front-loading public works expenditure again in 1984/85 would be appropriate. Several Directors stressed their view that less risk was attached to a slower than projected fiscal adjustment than to a faltering of the revival of domestic demand.

Directors generally commended the authorities' conduct of monetary policy during 1983. The high level of real interest rates in Japan and the sustained low rate of inflation suggest that some easing of monetary policy would have been appropriate for purely domestic considerations. However, concern that such an easing could have produced a weaker yen was considered to have outweighed the likely positive effects on the domestic economy. Directors were pleased to note that the reduction in the official discount rate had not led to any weakening of the yen, and they appreciated the authorities' commitment to taking action, including on interest rates, should the yen show signs of weakening in the future.

Directors noted the appreciation of the yen's effective value during 1983 but stressed that further strengthening would be desirable. It was observed that the appreciation of the effective value of the yen had resulted from a strengthening of the yen vis-à-vis European currencies while the yen had remained stable vis-à-vis the dollar over the past 12 months. Nevertheless, the strength of Japan's current account as well as of its actual and prospective price and cost developments was not felt to be fully reflected in the current value of the yen.

Directors welcomed the authorities' continuing efforts to improve the efficiency of Japan's financial markets through liberalization measures. However, they urged the authorities to accelerate this process, particularly in increasing and diversifying yen investment instruments available to foreign investors. Directors also commended the authorities' commitment to undertaking further steps to promote the internationalization of the yen. The effects of these changes on the value of the yen in the short term could not, of course, be predicted with certainty, but in the medium term such changes would provide greater assurance that the value of the yen reflected relative economic fundamentals.

Directors noted the growth of the current account surplus during 1983/84 and the staff's projection for a further increase during 1984/85. Although about half of the increase in the surplus during 1983/84 had been the result of lower oil prices, the very rapid growth of exports and the sluggishness of imports during the early part of the year had played a substantial role. It was hoped that the strengthening of domestic demand would help reverse these developments. The important role that could be played by a further appreciation of the yen was also emphasized.

Directors commended the authorities for measures, both announced and implemented during the past year, to further open Japan's market to foreign producers. Japan was urged to further dismantle its tariff and, especially, nontariff barriers and to take an active leadership role in rolling back protectionist measures. Such steps would not only help increase Japan's imports but would also tend to forestall protectionist tendencies abroad. The authorities' recent initiative in proposing multilateral discussions on these issues was warmly welcomed. The staff's concern about the increasing pressure from trading partners for voluntary restrictions on Japan's exports was shared, and it was stressed that such practices should only be a temporary device to promote structural adjustment in importing countries.

Directors noted the continued growth of foreign lending by Japanese banks during 1983. They also noted Japan's high level of foreign direct investment, which contributed toward reducing protectionist pressures abroad and spreading the technological advances underpinning Japan's relatively good economic performance. While regretting the decline in official development assistance in dollar terms in 1981 and 1982, a number of Directors urged the authorities to fulfill their commitment to increasing such assistance substantially in the coming years.

It is expected that the next Article IV consultation with Japan will be held on the standard 12-month cycle.

2. BURUNDI - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Burundi (SM/84/12, 1/10/84; Cor. 1, 2/22/84; Sup. 1, 2/23/84; and Sup. 1, Cor. 1, 2/24/84). They also had before them a report on recent economic developments in Burundi (SM/84/33, 2/2/84; and Cor. 1, 2/22/84).

Mr. Sangare made the following statement:

Burundi is a small landlocked country whose economic activity is largely dependent on a single export crop, coffee, which accounts for about 90 percent of total export earnings. Hence, the falling demand in the international coffee market in 1982 and 1983, against the background of a small industrial sector, limited arable land, and technical and financial constraints, which seriously hampered output in the private sector, resulted in a relatively weak performance in economic activity, evidenced by a 6 percent decline in real GDP in 1982 and minimal growth of 1.7 percent in 1983. However, an average growth rate of 2.6 percent over the past four years compares favorably with other developing countries with similar characteristics.

Adverse developments in the international commodity markets have also affected the Government's financial position. The contribution of the coffee industry to government revenue fell from 17.2 percent in 1979-80 to only 3.1 percent in 1983. Overall budgetary deficit thus widened from the equivalent of 2.4 percent of GDP in 1980 to 4.9 percent in 1983, and a sizable accumulation of domestic payments arrears emerged. Despite the attendant deficit financing through the domestic banking system, inflationary pressures were contained, mainly through increased food production and a restrained wage policy. Consequently, the inflation rate measured by the consumer price index, fell from about 10 percent in 1982 to 8 percent in 1983.

The balance of payments position also continued to be weak, although the deficit on the current account narrowed from SDR 83.2 million in 1982 to an estimated SDR 53.7 million in 1983. Gross official reserves declined from SDR 82.1 million in 1980--the equivalent of 33 weeks' import cover--to SDR 32.6 million in 1983, barely enough to cover imports for 12 weeks. As with GDP and government finances, falling coffee export receipts were mainly responsible. The impact of a cumulative 44 percent deterioration in the terms of trade between 1978 and 1983 on the balance of payments was compounded by factors beyond the control of the authorities, including bad weather and disruptions to the country's outlets to the sea.

The authorities are aware of the difficult economic situation and are taking actions aimed at correcting the domestic and external imbalances and putting the economy back on an even keel within the framework of the country's Fourth Development Plan (1983-87). They have given priority to improvements in the regional transportation network with neighboring states--Tanzania, Rwanda, Kenya, and Uganda--through which Burundi has access to the sea. A unified transit document concerning road tolls, vehicle weights, and other road regulations aimed at facilitating cargo movements has been agreed. Traffic movement through Tanzania has also been improving with the introduction of unit trains. Particular attention is being given to payment of remunerative prices to farmers despite falling world market prices, the opening up of new farming areas, the expansion of extension services, and, the introduction of integrated rural development schemes. These have so far resulted in increases in domestic food production and the quantity and quality of coffee output.

The authorities are also developing local energy sources, including hydroelectric, solar, and bio-gas as well as import-substitution industries, with a view to saving scarce foreign exchange. They hope that foreign financing will be made available for these projects as a result of the Donors' Conference held early this month.

On the budgetary front, the authorities continue to be concerned about the limitations imposed on possible revenue-raising measures by the weakness of the economy, particularly as the increase in the beer tax adopted in 1982 has resulted in a fall in both consumption and revenue, and the foreign exchange constraint has led to a reduction in imports, thereby limiting the scope of import duties to boost government revenue. In the circumstances, the authorities are looking forward to the technical assistance mission from the Fund's Fiscal Affairs Department for specific recommendations to enhance tax revenue. Meanwhile, they are taking measures on the expenditure side, including a reduction in capital outlays, a curb on personnel recruitment in the public service, laying off of daily contract workers, economies in the purchases of goods and services, and reductions in budgetary transfers to the public enterprises. It is worth noting that many of the recommendations of an IDA-financed study on the parastatals have already been implemented. In this connection, a General Commissariat for public enterprises has been established to devise a broad strategy for the parastatals, promote the development of management skills, and elaborate an information system to monitor their performance. The staff agrees that the framework of the Commissariat and its guidelines are appropriate and adequate. Furthermore, the authorities have indicated that some of the enterprises that are not financially viable will be closed down. As a result, the 1984 budget, apart from making provision for repayment of arrears, envisaged a reduction in the overall budget deficit to about 3.7 percent of GDP in 1984.

Monetary and credit policies have reflected the growth in the public sector deficits and the swings in coffee financing despite increasing efforts being made to limit the Government's access to bank credit. Outstanding ordinary advances to the Government by the banking system, which the Treasury was unable to liquidate, have been converted to medium-term loans under an agreement between the Treasury and the Central Bank. The maturity of special advances was also reduced from 50 years to 15 years, with 5 percent interest on the outstanding amount. In addition, the Central Bank has been empowered to monitor the implementation of all projects financed with special advances. Interest rates have remained on the high side, with the lending rates varying between 10 percent and 15 percent.

On the external front, the authorities are aware of the possible adverse impact of an appreciating exchange rate on the balance of payments. They have therefore devalued the Burundi franc by 30 percent, with effect from November 22, 1983; the staff agrees that the current rate is broadly appropriate. The restrictions on external transactions imposed in 1983 were aimed largely at protecting the rapidly deteriorating balance of payments position. The authorities have stressed that the restrictions are temporary and will be in place until appropriate policies are formulated and adopted. They are concerned about the projected increase in the debt service ratio from 11.5 percent in 1983 to 18.2 percent in 1987. However, they are watching developments in this area very closely and have stressed the need for a cautious external borrowing policy. The authorities have prepared an inventory of projects designed to attract external loans on concessional terms, bearing in mind that projects which do not attract foreign financing on very concessional terms will not be started.

Mr. Blandin remarked that the main feature of Burundi's economy was its vulnerability to external shocks, which had been the main causes of the difficulties facing the economy during the previous year. The external vulnerability was reflected in Burundi's exports. The country relied heavily on coffee, whose price, fixed in the world market, had fallen sharply in recent years; moreover, the quantity of coffee exports was limited by the quota under the International Coffee Organization. As a result, Burundi was unable to take full advantage of an increase in the output of coffee and an improvement in the product's quality. At the same time, transportation constituted what seemed to be a permanent bottleneck.

Table 3, Mr. Blandin continued, showed a striking parallelism in the evolution of the nominal effective and real effective exchange rates. The appreciation of the real effective exchange rate had resulted from the pegging of the Burundi franc to the U.S. dollar and had not been the result of internal inflation. The staff had fully described the adverse effects of the peg to the dollar. Revenues from the coffee sector had fallen, contributing to the increase in the budget deficit that had fueled inflationary pressures. The real producer prices for tea and cotton had become inadequate and were inconsistent with the objective of diversifying exports away from coffee. The Government was to be commended for its decision, effective November 23, 1983, to devalue the Burundi franc by 30 percent in local currency terms, thereby broadly offsetting the previous overvaluation. The decision to terminate the link to the dollar and to peg the Burundi franc to the SDR was fully appropriate, as it would avoid a recurrence of fluctuations in the value of the Burundi franc resulting from erratic fluctuations in the dollar.

The authorities' intention to prepare a program that could be supported by a stand-by arrangement was welcome, Mr. Blandin stated. The program would help them to take full advantage of the devaluation, which had cleared the way for a reduction in the budget deficit and an increase in producer prices. The Government had already taken some steps to make the needed reduction in the budget deficit, but they had consisted mainly of expenditure restraint. The improvement on the revenue side reflected essentially the impact of the devaluation. He wondered whether some additional measures could not have been implemented to reduce the internal payments arrears.

He agreed with the staff, Mr. Blandin said, that great caution was needed in implementing the investment program. It was unwise to implement all the projects in an investment plan for which financing could be secured. The least productive and least profitable projects should be eliminated. To that end, preliminary studies should be made to determine the order of priorities; in that connection, the cooperation of the World Bank would be helpful. A cautious approach to investment was needed, particularly because of the steady rise in the debt service ratio despite the concessional nature of most of the external debt. The debt service ratio was expected to continue rising in 1984.

The Government was to be commended for the steps already taken on the path toward adjustment, Mr. Blandin concluded. The remaining steps could be made easier with the support of the Fund.

Mr. de Groote remarked that imbalances in the economy had been accumulating for several years, mainly because of the deterioration in the terms of trade and the expansionary domestic policies. The effects of those developments had been exacerbated by the appreciation of the Burundi franc, which had created price distortions and a misallocation of resources away from exports and toward imports. The decision to peg the Burundi franc to the SDR and to devalue the currency had paved the way for a meaningful adjustment effort, and the authorities were to be commended for their bold actions. The exchange rate adjustment would have a significant positive effect on the budget position, economic activity, and the balance of payments, thereby permitting the resumption of rapid economic growth.

The staff had noted the improvement in the budgetary situation that had already taken place, Mr. de Groote went on. Budgetary revenues had already begun to strengthen. It was important to consolidate the gains in order to generate the public savings needed to support the public investment program. The improvement in relative prices would stimulate import-competing industries. The devaluation would encourage increases in producer prices for noncoffee exports such as cotton and tea, thereby reversing the declining trend of production of those crops and achieving the desired diversification of export earnings. Imports had already been administratively constrained, and little improvement was to be expected in the immediate future in the form of a reduction of imports. In the medium term, increasingly remunerative producer prices would stimulate production and export diversification.

The various favorable effects of the exchange rate adjustment would be maintained only if the exchange rate remained flexible over time, Mr. de Groote said. The exchange rate action would have to be complemented by a variety of measures, particularly by more appropriate prices and by more restrained public sector finances.

A development plan consistent with available resources could usefully be worked out, Mr. de Groote commented. As for monetary policy, it should stress the financing needs of the private sector. The Fund could play a useful role in the formulation of desirable policies if it could provide some support under a stand-by or extended arrangement. There seemed to be ample justification for such an arrangement, and also for collaboration between the Fund and the World Bank in assisting Burundi. The World Bank's evaluation of the development plan and its assistance in strengthening the administration of public enterprises would reinforce the Fund's help in the various macroeconomic policy areas.

Mr. Doe remarked that the latest data showed that the economic and financial problems facing Burundi had been somewhat less serious in 1983 than in 1982. Indeed, real GDP was estimated to have grown by nearly 2 percent in 1983, following the substantial fall in 1982. Moreover, the rate of inflation had moderated somewhat, the current account deficit had declined as the result of an increase in exports and a fall in imports, and the overall balance of payments position had improved significantly, swinging from a large deficit to a small surplus. On the other hand, credit expansion to both the Government and the private sector had grown more rapidly in 1983 than in 1982, and the external debt service ratio had increased.

The economic and financial improvements in Burundi in 1983 were marginal in comparison with the achievements in several other developing countries, Mr. Doe considered. However, Burundi was a small, landlocked country, with a limited endowment of natural resources, a large population, and an external environment characterized by a deterioration in the terms of trade and a small export quota.

Commenting on the real sector, Mr. Doe noted that the authorities had made an effort to encourage farmers to increase output and the marketing of crops. Farmers had been given supplies of fertilizers and high-yield seeds and assistance in constructing storage facilities. He hoped that the decontrol of food prices would also encourage domestic production. The Government's efforts to diversify the output of cash crops away from coffee in favor of cotton, tea, and sugarcane were welcome. The provision of adequate support services and the timely payment of remunerative prices could be powerful incentives for increased output and should be encouraged.

In the fiscal sector, Mr. Doe said, the accumulation of payments arrears of about FBu 1.5 billion in 1982 and the further increase estimated in 1983 were indicative of the serious nature of the financial imbalance of the government sector. The need for an effective policy to reduce the imbalance could not be overemphasized, especially in the light of the limited possibilities for revenue expansion outside the coffee sector. The Government's intention to reduce the payments arrears in 1984 and to tighten expenditure was welcome. The implementation of a restrained wage policy, the suspension of automatic hiring of school graduates, and the scaling down of transfers to public enterprises and of capital outlays should keep the growth in total spending at a sustainable rate in 1984 and beyond. The authorities had appropriately decided to implement an expenditure policy that was consistent with revenue performance; accordingly, spending authorizations would be suspended when revenue shortfalls emerged. The effective implementation of that decision would encourage budgetary discipline.

The inherently weak current account position, which reflected the expansionary fiscal and monetary policies, the unfavorable terms of trade, and the small quota for coffee exports, was a cause for concern, Mr. Doe considered. The authorities recognized the major maladjustment in the external sector, and their efforts to deal with it were welcome. The decision to depreciate the currency by 30 percent--a rate thought to be satisfactory by the staff--was courageous, and it would be unfortunate if its favorable effects on the external and internal imbalances were reduced because of a lack of supportive policies in other areas. He agreed with the staff that the exchange rate adjustment should be reinforced by a scaling down of investment expenditure to more realistic levels, a pruning of current outlays, a moderate bank credit policy, and incentive-oriented pricing and incomes policies. There were indications that some of the policies were already in place in varying forms and degrees, and the authorities should be encouraged to strengthen them.

The staff had noted that the small size of Burundi's export quota of coffee constituted a serious obstacle to the expansion of coffee output, Mr. Doe commented. Could Burundi export its excess coffee to nonquota countries? Did the authorities intend to approach the Fund for conditional financial assistance?

He was pleased that the authorities were aware of, and seriously concerned about, the depth of the imbalances in the economy, Mr. Doe concluded. They had shown their determination by taking unpopular actions such as the depreciation of the Burundi franc and the suspension of the automatic hiring policy. They should be encouraged to persevere in their efforts to solve the structural problems facing the economy. The proposed decision was acceptable.

Mr. Williams said that he broadly agreed with the staff appraisal. The proposed decision was acceptable. Burundi's economic performance had continued to be weak through 1983, although there had been some modest improvement. Unfortunately, the policy response of the authorities in the past had been slow and inadequate, and the prospects for 1984 and beyond were worrying.

The decision to depreciate the currency in November 1983 was welcome, Mr. Williams continued, but the authorities must maintain a flexible exchange rate policy. The exchange rate adjustment should be buttressed by appropriate decisions in other macroeconomic policy areas to ensure that the full potential benefit of the adjustment was gained.

He agreed with the staff, Mr. Williams went on, that additional policy decisions were needed to improve the structure of the budget, and the Fund's technical assistance mission should be helpful. When were the results of the mission to be made available to the authorities? Domestic payments arrears had increased substantially in 1983, and he hoped that the fiscal performance in 1983 would permit the authorities to reduce the arrears in 1984 and to adopt a feasible plan for their prompt elimination.

Commenting on monetary and credit policies, Mr. Williams said that the expected improvement in the financing of the budget deficit was welcome, and he hoped that the planned reorientation of domestic credit resources to the private sector could be acheived. Most real interest rates were negative and could become more so as the impact of the November 1983 devaluation worked its way through the economy. The authorities should adopt a more flexible interest rate policy; it would be a key element of any comprehensive adjustment program.

As for supply policies, Mr. Williams remarked, the recent decline in cotton and tea production was particularly worrying, as it did not bode well for achieving the objective of diversifying export production away from the considerable reliance on coffee. There was a clear need for adjustments of producer prices for the 1984/85 crop season. A further comment on the criteria that would be used to set producer prices in the future to provide adequate incentives for production would be helpful.

The authorities should be encouraged to implement the recommendation in a recent World Bank/UNDP study on the petroleum sector, Mr. Williams considered. He agreed with the staff that the present development plan was overambitious and should be trimmed. He hoped that, as a result of the recent Donors' Roundtable, the authorities would be encouraged to adopt a more feasible plan that would be consistent with resource availability and absorptive capacity. The present one-year planning horizon was inappropriate.

He hoped that progress could continue toward the early implementation of a comprehensive adjustment program that would warrant the Fund's financial support, Mr. Williams concluded. A more detailed analysis of Burundi's medium-term prospects would have been welcome, as it would have helped Executive Directors to evaluate the appropriate magnitude and duration of financial involvement by the Fund in Burundi. A further comment on the amount of time that would probably be needed for Burundi to attain a sustainable balance of payments position would be useful.

Mr. de Groote remarked that, during a recent discussion on Rwanda, Mr. Polak had suggested that the Fund's recommendations to the authorities should exclude the word "devaluation" because the authorities were being asked merely to reverse the revaluation that had taken place. Similarly, in the present case it seemed appropriate to refer to the "adjustment" of the exchange rate, rather than the "devaluation," since, after all, the authorities had merely acted to reverse the effects of the large appreciation of the exchange rate when it had been linked to the dollar. The point was more than merely presentational; a reference to a devaluation could be seen by observers as a reflection of inappropriate policies of the past, while mention of an exchange rate adjustment might well be seen as the reversal of an appreciation that had in effect occurred accidentally.

The staff representative from the African Department remarked that the delay in adopting additional revenue measures at the time of the announcement of the budget was explained by the authorities' wish to wait for the results of the Fund's fiscal mission, which would probably be able to make its recommendations to the authorities by about mid-1984. It was important to note that the tax base in Burundi was limited, and that the authorities had hesitated to introduce new revenue-raising measures following the unfavorable experience with the beer tax in 1982.

On several occasions in the past, the staff representative explained, the authorities had explored the possibility of selling some of its coffee in the nonquota export market, but they had discovered that the discounts in that market would not make sales worthwhile. At present, the discount of up to 60 percent in the nonquota market meant that the prices that Burundi would receive would be insufficient even to cover production costs. While it was true that Burundi's small export quota caused some problems for the authorities, Burundi also enjoyed the benefit of being able to export its total quota whenever it had the market availability to do so; most participants in the coffee agreement had to export a portion of their coffee exports on a quarterly basis. Burundi was therefore given greater latitude than others in dealing with its coffee inventories, which accumulated because its coffee year straddled the export quota year; inventories that accumulated in Burundi from one season could quickly be sold as a part of the quota for the following year.

The staff expected to receive a request from Burundi for Fund assistance in the near future, the staff representative explained.

In assessing interest rate policy in Burundi, the staff representative commented, Executive Directors should note that the cost of living index was highly suspect, as its coverage was quite limited. As a result, it might not be the best reflection of the general trend in prices. The GDP deflator suggested that present interest rates were not necessarily negative in real terms. It was also important to note that interest rates were fixed by the Government and were floor rates. The most important interest rate--the savings rate--was set at a minimum of 6 percent. The authorities felt that there was competition in the markets, and that the spread between the lending and the various deposit rates was sizable. It was difficult for the staff to know precisely how interest rates were actually moving in Burundi, but there were indications that actual interest rates on larger deposits were considerably higher the minimum rates set by the authorities.

The authorities were concerned about producer prices, the staff representative explained, and increases in those prices would probably be announced when producer prices for the next period were set, beginning in April 1984. In setting producer prices, the authorities wished to avoid overstimulating coffee production. On the other hand, they realized that substantial incentives were needed for cotton and tea production. In setting prices, the authorities compared the implicit profitability of the various domestic food products with the export products. They also looked at prices in neighboring countries, where many of the same products were produced.

In the absence of an economic and financial program for Burundi, the staff representative from the African Department commented, it had been difficult for the staff to give a more detailed analysis of the medium-term sustainability of the balance of payments. Aware that a program was likely to be negotiated, the staff had thought that it would be best to wait until the program had been finalized before making a more detailed analysis of the medium-term outlook for the balance of payments.

Mr. Williams remarked that he had meant to say that, as the effects of the devaluation worked their way through the economy, the consumer price index and other price indices might well increase. He appreciated the point that the staff representative had made about the applicability of the GDP deflator. As for the medium-term prospects for the balance of payments, the staff could have usefully included various scenarios on the attainability of a sustainable position in Burundi in comparison with some other countries. He suspected that the prospects for Burundi were somewhat more favorable than those for other countries.

The Deputy Director of the Exchange and Trade Relations Department remarked that, in principle, the kind of comparative analysis that Mr. Williams had requested would certainly be useful. In fact, the staff was constrained in a number of ways--by its own limited resources, for example--in making such an effort. The staff was paying considerable attention to the medium term in the large number of cases in which a Fund-supported program was in place. The staff had not had an opportunity to make such an analysis of Burundi.

Mr. Sangare stated that the authorities were well aware of the domestic and external problems facing Burundi because of the country's heavy dependence on coffee exports, its geographic position, and the declining demand for coffee in the international market in 1982 and 1983. In the circumstances, there was an urgent need for the authorities to restructure the economy by diversifying the production base in accordance with the Fourth Development Plan. The recent donors' conference had concluded that the Fourth Development Plan was perhaps somewhat ambitious, but the conference had been successful; many of the participants had expressed their support for the authorities' various efforts. International cooperation, including assistance from the Fund and the World Bank, in the effort to diversify the economy would certainly be most appropriate and welcome. As Mr. de Groote had remarked, a stand-by arrangement, or even an extended arrangement, would be suitable.

The Burundi authorities, Mr. Sangare went on, had long considered that Fund assistance would be useful, and they had examined the possibility of requesting an extended arrangement because they strongly believed that the problems facing the economy were structural and could only be solved in a longer-run framework. However, they felt that a stand-by arrangement would be appropriate, and they were clearly interested in requesting one. They believed that their adjustment objectives could be achieved only with the support of an arrangement with the Fund.

The authorities had reiterated their commitment to maintaining a flexible exchange rate policy and to continuing to strengthen fiscal policy, Mr. Sangare stated. In comparison with other countries with very limited natural resources and an unfavorable geographic location, the authorities' economic policy management had been impressive and successful.

The Chairman made the following summing up:

> Directors commended the authorities on the exchange rate action undertaken in November 1983, which had reversed the previous appreciation of the currency, brought the rate back to a broadly appropriate level, and adjusted the peg to the SDR. This measure was viewed as an important initial step in the drawing up of a comprehensive adjustment program, but Directors cautioned that there was a need for continued flexibility of the exchange rate. They encouraged the authorities to move quickly in putting the necessary supporting measures into place in the form of a comprehensive program; otherwise, there was a real risk that the benefits of the exchange rate action would be dissipated. Directors stressed the need to adopt appropriate producer prices and incentives to increase output and exports of agricultural crops.
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> Directors noted the large budgetary imbalances that had persisted in recent years, and expressed satisfaction that the 1984 budget aimed for an important reduction in the overall deficit and in bank financing. However, they pointed out that the improvement in the fiscal area will be sustainable only if strengthened promptly by additional measures to restrain outlays and to increase tax revenue. Directors stressed the need for the early formulation of monetary and interest rate policies consistent with the Government's adjustment objectives and with the financing need of the private sector.
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> Directors encouraged the authorities to move quickly in improving the financial situation of the public enterprises. They felt that the current Five-Year Development Plan was over-ambitious and required pruning to a more realistic level, more closely linked to the country's absorptive capacity, as well as its debt-carrying capacity. The latter also highlighted the need to limit loans on commercial terms.

Several Directors expressed the view that the Fund could assist Burundi, if a comprehensive adjustment program were to be put in place, and added that World Bank collaboration in such circumstances would prove most appropriate.

It was recommended that the next Article IV consultation should be held on the standard 12-month cycle.

The Executive Board then took the following decision:

Decision Concluding 1983 Article XIV Consultation

1. The Fund takes this decision relating to Burundi's exchange measures subject to Article VIII, Section 2, and in concluding the 1983 Article XIV consultation with Burundi, in the light of the 1983 Article IV consultation with Burundi conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Burundi continues to maintain restrictions on payments and transfers for certain current international invisible transactions. The Fund encourages the authorities to pursue policies that will enable them to remove the remaining restrictions described in SM/84/33 as soon as possible.

Decision No. 7637-(84/33), adopted
February 29, 1984

APPROVED: August 15, 1984

LEO VAN HOUTVEN
Secretary