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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/48

10:00 a.m., March 18, 1983

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

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
J. Anson	C. Taylor
	H. G. Schneider
	A. Le Lorier
	M. Teijeiro
R. D. Erb	
	T. Alhaimus
	Jaafar A.
T. Hirao	T. Yamashita
	G. W. K. Pickering, Temporary
A. Kafka	C. Robalino
G. Laske	
	C. P. Caranicas
R. N. Malhotra	A. S. Jayawardena
	J. E. Suraisry
J. J. Polak	T. de Vries
	M. J. Kooymans, Temporary
G. Salehkhou	O. Kabbaj
	E. I. M. Mtei
	J. L. Feito
J. Tvedt	A. Lindø
Zhang Z.	Wang E.

J. W. Lang, Jr., Acting Secretary
J. A. Kay, Assistant

Also Present
Asian Department: P. R. Narvekar, Deputy Director; K. A. Al-Eyd, J. T. Boorman, R. J. Hides, S. Kashiwagi, K. M. Meesook, I. Otani, S. M. Schadler. European Department: B. Christensen. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; D. K. Palmer, Deputy Director; S. Eken, M. Guitian, G. G. Johnson, P. J. Quirk. Fiscal Affairs Department: V. Tanzi, Director; W. P. Mahler, Jr., T. Yaganita. IMF Institute: S. Hatsukaiwa, Participant. Legal Department: A. O. Liuksila. Research Department: W. C. Hood, Economic Counsellor and Director; C. F. Schwartz, Associate Director and Director of Adjustment Studies; A. D. Crockett, Deputy Director. Western Hemisphere Department: M. Caiola, J. Ferrán, H. Hernandez-Cata. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: S. R. Abiad, A. A. Agah, J. R. N. Almeida, S. El-Khouri, I. R. Panday, P. D. Péroz. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. Bulloch, M. Camara, L. E. J. Coene, T. A. Connors, R. J. J. Costa, M. K. Diallo, G. Ercel, G. Gomel, P. Leeahtam, W. Moerke, V. K. S. Nair, Y. Okubo, J. G. Pedersen, E. Portas, J. Reddy, C. A. Salinas, J. Schuijer, D. I. S. Shaw, H. Suzuki, P. Verly, A. Yasseri, Zhang X.

1. JAPAN - 1982 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1982 Article IV consultation with Japan (SM/83/36, 2/18/83). They also had before them a report on recent economic developments in Japan (SM/83/17, 1/26/83).

The staff representative from the Asian Department made the following statement:

> Preliminary estimates of the national accounts for the last quarter of 1982 and revised figures for the third quarter have just been presented by the authorities. The third quarter data indicate that as a result of somewhat stronger than forecast growth of consumption and plant and equipment investment, GNP expanded during the quarter by 0.9 per cent, compared with the preliminary estimate of 0.6 per cent. Preliminary estimates for the fourth quarter show a substantially stronger than expected rebound of consumer and residential investment spending, but weaker equipment investment and a sharp decline in government spending. GNP is estimated to have increased by 0.4 per cent. On the basis of these estimates, growth during 1982 totaled 3 per cent, compared to the staff projection of 2.7 per cent, with the margin accounted for primarily by somewhat stronger than forecast consumer spending. The staff has not yet fully digested the implications of these data but they appear to call for little adjustment to the projections in the staff report. The somewhat better performance of consumer spending provides greater optimism that a sustained recovery is in the works, but the continued weakness of investment and the further downward revisions to investment plans indicated by recent surveys give the staff pause in revising its outlook for 1983.

Mr. Hirao made the following statement:

> In my statement, I propose to touch on three topics: developments during the current fiscal year, the outlook for the coming year, and some further observations on policy aspects.

Developments during FY 1982/83

> Economic growth in FY 1982/83 has been almost entirely the result of an increase in domestic demand, with virtually no contribution from external sources. Against the background of continued price stability, private consumption is now expected to grow at an annual rate of about 4.3 per cent--higher than the original estimate of 3.9 per cent--compared with 1.1 per cent in the previous fiscal year. Plant and equipment investment by large firms has been increasing at a moderate rate. With investment by small and medium-sized firms remaining stagnant, private

capital formation, as a whole, has been increasing at an annual rate of about 2 per cent. Private residential investment is expected to grow by some 0.5 per cent over the previous year.

Real economic growth for FY 1982/83 is estimated to be about 3.1 per cent, with increases in wholesale and consumer prices being about 1.6 per cent and 2.7 per cent, respectively. On the external front, both exports and imports have decreased from the previous year's level. In particular, exports have been much weaker than originally estimated, declining from the previous year's level at a faster pace than world trade. Consequently, the current account surplus is expected to be about $7 billion, which is below the original estimate of $12 billion.

In support of domestic demand recovery, the authorities last April decided to front-load public works expenditures, and in October adopted comprehensive economic measures, which included an additional ¥ 2 trillion public works program, further promotion of housing construction, and measures to strengthen small and medium-sized firms. Fiscal revenues turned out to be about ¥ 6 trillion less than originally projected; the revenue shortfall was financed by additional bond issues and other measures. The flexibility of fiscal policy demonstrated during the course of FY 1982/83 has been instrumental in helping the economy recover. During the period of continued weakness of the yen through October, and in the ensuing months when the authorities were still not assured of the strengthening trend of the yen, monetary policy was geared, with great caution, more to exchange rate considerations than to stimulating the domestic economy.

The outlook for FY 1983/84

The policy objective for FY 1983/84 remains that of achieving steady growth in domestic private demand, as well as maintaining price stability. It is important to further improve an environment conducive to regaining the vigor of the private sector and thus to lay the ground for sustainable growth in the medium term. Measures will be taken to boost private investment, in order to enhance productivity. Monetary policy will be conducted flexibly, while paying due regard to both domestic and external developments. Underlying this policy stance is the fundamental recognition that maintenance of price stability is the basis for the health and stability of the economy. Accordingly, monetary aggregates will be monitored closely. Against a backdrop of continued price stability, private consumption is expected to recover further. The authorities also intend to encourage the expansion of residential construction through such measures as stabilizing land costs.

Since the early 1970s, adjustment has taken place in response to significant changes both inside and outside the economy. Some of these changes resulted from the maturing of the economy. The oil price increases have also caused significant changes, such as shifts in the capital formation pattern in which more resources have shifted to replacement, rationalization, and energy-saving investment rather than to capacity-expanding investment. Thus, growth in the 1970s decreased to less than half that recorded in the previous decade.

For the FY 1983/84 outlook, there are several favorable factors in sight, including completion of inventory adjustment, continued stable prices, a gradual decline in interest rates, appreciation of the yen, and a decline in oil prices. With the prospect of these favorable developments, real economic growth is estimated at about 3.4 per cent. This can be viewed from the experience of the past several years as a near-optimal rate in terms of balanced growth in the respective aspects of the economy. Private consumption is projected to increase by about 3.9 per cent and private fixed investment by about 2.9 per cent, in real terms. Under the current volatile conditions, it is difficult to make any reasonably firm estimate of the balance of payments, but, on the basis of recent trends in both exports and imports, my authorities project that the next fiscal year's current account surplus will be about $9 billion.

Some further observations on policy aspects

In FY 1982/83, the revenue shortfall and supplementary public works outlays required the Government to issue ¥ 3.9 trillion worth of additional national bonds, raising the total amount of bonds issued in FY 1982/83 to ¥ 14.3 trillion. The FY 1983/84 budget envisages no growth in general expenditures (excluding debt service payments and transfers to local governments), reflecting the Government's strenuous efforts to curtail government expenditures. Along with the struggle to contain total expenditures, efforts have also been made to review expenditure items to ensure more efficient allocation of public resources. Less efficient expenditures have been replaced by important policy items, more responsive to changing needs. Public works spending has been selected with a view to its contribution to growth; a proposal for accelerated depreciation for small and medium-sized enterprises and tax incentives for housing investment have also been included in the draft bill. Within the framework of no growth in total general expenditures, expenditures for energy-related programs and official development assistance, among others, are expected to increase. As a result of these efforts, the Central Government's borrowing requirement is projected to be ¥ 13.3 trillion, ¥ 1 trillion less than in the revised budget, but much more than was envisaged in the original budget of the previous fiscal year (¥ 10.4 trillion).

With the changes that took place in the socioeconomic structure and the slowdown in the growth rate in the 1970s, the fiscal situation in Japan deteriorated sharply, reflecting ever-growing budget expenditures as well as a greater than expected deceleration in the growth of tax revenues. Large deficits have continued without interruption since FY 1975/76, perhaps indicating that a substantial part of them is of a structural nature. In the past seven fiscal years, tax revenues, on average, have covered less than 70 per cent of total expenditures. The ratio of fiscal deficits to GNP amounts to about 5 per cent. The outstanding national bonds will amount to about ¥ 110 trillion (about 39 per cent of GNP) by the end of FY 1983/84. Outstanding amount, among the highest in major industrial countries, has risen with great rapidity from only 9.9 per cent of GNP in the short period of eight years. Without any effective countermeasures, this ratio could continue to increase in coming years.

In order to cope with these persistent deficits, both a long-range perspective and a medium-term policy orientation are essential. Deliberations on administrative reform have been in progress. Reforming the administrative structure in response to the changing needs of the times is viewed as a national objective in order to establish the foundation for future prospects. More specifically, this would mean, on the expenditure side, that an intensive and fresh review is required to ascertain whether or not the Government should continue to be involved in certain specified areas, even though, within those areas, the involvement has traditionally been considered indispensable. Social welfare programs will have to be looked at in terms of both their costs and benefits. On the revenue side, tax structures will need to be examined on the basic understanding that current public services can be maintained only if the whole burden is shared equitably by all present members of society.

Unlike construction bonds, deficit financing bonds are issued to finance deficits in current expenditures. It would not be appropriate to depend on the issuance of deficit financing bonds over a prolonged period. Although the medium-term objective of eliminating such deficit financing by FY 1984/85 is unattainable, the elimination of deficit financing at the earliest feasible date through administrative reform is desirable; therefore, medium-term reviews, which take into account a number of fluidities and uncertainties, will be continued.

On the presumption that revenues will continue to fall short of expenditures, strenuous efforts to contain expenditures will clearly have to be continued. In addition, an overall review on the revenue side will be necessary. In the tax structure, the ratio of revenues derived from direct taxes to those derived from indirect taxes has recently been about 7:3, whereas 25 years ago the ratio was about 5:5. The structure of indirect taxes--

mainly a liquor tax, a commodity tax, and other excise taxes--has remained unchanged over the decades. Personal income tax has not been reformed in the past five years, and one may question tax brackets that have remained unchanged over the years. A fundamental re-examination of the tax structure, with a view to attaining an appropriate equity and to promoting elasticity in the tax system, seems to be advisable.

With regard to balance of payments developments, the volume of exports since April 1982 has been lower than the volume in the respective month of the previous year. The total value of exports in 1982 declined by $11.9 billion, and the total value of imports was lower than that of 1981 by $10.1 billion, or about 8 per cent. Among commodities, crude oil import values decreased by about 13 per cent, reflecting further progress in energy conservation and a decline in prices.

Trade liberalization is most important for improving efficiency and assisting the international adjustment process. While my authorities believe that Japan's markets for manufactured goods are as open as those in other industrial countries, they continued their efforts during 1982 to substantially reduce or eliminate import tariffs and to further simplify import procedures and modify the testing standards. These measures leave Japan with the lowest tariffs on imports of industrial products among major industrial countries.

The effects of exchange rates on an economy vary, depending on its particular circumstances. It is widely recognized that throughout 1981 and 1982, the authorities as well as the business community hoped for and expected a stronger yen. Under present circumstances, the appreciation of the yen would not only contribute to stabilizing prices and strengthening consumption, but would also benefit corporate profits as a whole. It would, moreover, help to stimulate growth by improving Japan's terms of trade.

Despite this widespread expectation, the yen rate vis-à-vis the U.S. dollar in 1982 was on a steadily declining trend until early November. Various factors were cited as affecting the rate at different phases; for example, fears that the debt problems might overwhelm the international financial system surfaced in the summer to sustain the value of the dollar. However, in the main, it was a reflection of the strengthening of the dollar against other major currencies, supported by the large interest rate differential.

In early November 1982, the yen started to appreciate, mainly due to the reduction in interest rate differentials and, more directly, to the turnaround in long-term capital flows.

The market began to turn its attention more toward fundamentals. The easing of strains in the international financial system also helped strengthen the value of the yen.

Throughout 1982, the authorities intervened heavily in the exchange markets to support the excessively weak yen. Under the floating exchange rate system, the exchange rate is to be determined primarily by supply and demand in the market. However, timely and appropriate intervention is undertaken to counter erratic movements; and it is considered desirable to intervene in the market under disorderly conditions--when necessary at times of excessive movements, and in cooperation with the authorities of other major currency countries.

On official development assistance, the Government intends to continue increased assistance. In the FY 1983/84 budget, my authorities have decided to raise ODA budget expenditures by 8.9 per cent, against a background of severe budgetary restraint, i.e., no growth in general expenditures.

The Tokyo capital market continues to assume an increasingly important role in meeting the financial needs of member countries. In 1982, flotation of yen-denominated bonds registered an all-time high, exceeding the level of the previous year by about $1 billion. Yen-denominated syndicated loans approximately doubled in 1982.

Mr. Erb stated that he was in general agreement with the staff analysis. The points that he wished to make were essentially ones of emphasis. He agreed strongly with the statements made in the staff report on trade policy. His own authorities welcomed the market-opening measures that the Japanese Government had announced during the past year, including its commitment to revise the standards and certification system, which hampered the easy entry of imports into Japan. His authorities did however urge the Japanese Government to continue taking initiatives and assuming greater responsibility for the openness of the world trading system, from which Japan had greatly benefited. Although Japan's overall economic investment policies had enabled the country to adjust successfully to sharp increases in energy prices and changes in comparative advantage among countries, certain measures such as the Structurally Depressed Industries Law raised questions about whether they might not act as obstacles to complete adjustment.

Commenting on fiscal policy, Mr. Erb stated that he supported the staff conclusion, though perhaps with a somewhat different emphasis. The authorities ought to continue trying to reduce the fiscal deficit over time. Nevertheless, he could support the staff call for continued flexibility in the conduct of fiscal policy, interpreting flexibility to refer in particular to the timing of government expenditures within the course of the year, and to the direction of government expenditures. He noted that Prime Minister Nakasone was said recently to have proposed the preparation of an economic stimulus package. The elements of the package that had been publicly reported included an acceleration of public works contracting in the first half of the fiscal year, something that the staff had also recommended. However, Mr. Nakasone was also said to have proposed a cut in the official discount rate together with measures to encourage private plant and equipment investment. He would be interested to have confirmation of the content of the stimulus package from Mr. Hirao or the staff.

There was one aspect of the staff comments with which he was not certain that he could agree, Mr. Erb went on. On page 53 of SM/83/17 the staff seemed to lend tacit support to those who argued that Japan could afford to expand its budget deficit as a percentage of GNP because of the country's high savings rate. In the papers prepared for the discussion of the World Economic Outlook by Executive Directors in 1982, it could be seen that the Japanese authorities' borrowing requirement, at 29 per cent of net private savings in 1981, was not far from the average of 37 per cent among industrial countries. At that time, the equivalent figure for the United States was 37 per cent, for the Federal Republic of Germany, 23 per cent, for France, 30 per cent, and for the United Kingdom, 57 per cent.

In trying to determine whether the Government's borrowing requirements were in effect crowding-out private investment, Mr. Erb said, Directors should look not only at the net and gross savings rates, but also at the capital/output ratio, or the marginal capital/output ratio. If Japan had a relatively higher marginal capital/output ratio than other countries, it would have to achieve a much higher savings rate in order to bring about the same increase in output potential.

There were also other ways of looking at crowding-out, Mr. Erb considered. As he had suggested, for instance, during the recent discussion for the Article IV consultation with the United Kingdom, the concept of crowding-out could be related to the size of a country's government, the rate of increase in the size of government, the composition of government expenditures, and the proportion of government expenditure allocated to investment rather than to consumption. In analyzing the possibility of crowding-out in individual countries, the Fund staff should try to reach a conclusion by assessing the full impact of the government's fiscal actions, including whether it financed expenditures through taxation or borrowing in the markets. If the Fund were to develop a more complete framework of analysis of members' fiscal expenditures, it would be easier to make cross-country comparisons of the appropriateness or inappropriateness of fiscal policies.

Taking up monetary policy in Japan, Mr. Erb noted that the depreciation of the yen had been a significant consideration in formulating monetary policy both in 1982 and in 1983; the downward trend in the growth of monetary aggregates seemed to be appropriate. Moreover, the difficult decision to maintain interest rates at a higher level than might be desired for domestic considerations had been the correct one. As to the proposal to cut the discount rate, it might be wise to consider the impact of so doing on the yen/U.S. dollar exchange rate. The staff had placed a great deal of emphasis on the yen/dollar rate, and he asked the staff or Mr. Hirao to state how the authorities viewed the rate for the yen vis-à-vis the European currencies and some other currencies in the region where Japan had major trading relationships.

In the past few years, the Japanese authorities had made significant progress in removing restrictions on capital flows, and in opening their financial markets to increased foreign participation, Mr. Erb noted. Liberalization had been a welcome development, and he hoped that it would continue. There had also been a movement toward a more market-oriented interest rate structure. The same policy should apply to government debt, even if there might be negative implications for the cost of servicing it. The present method of financing the government debt simply hid the real economic costs. While they might not be large at present, they could pose a problem in the future if government debt were to rise and general market interest rates with it. In any event, it was likely to cause tensions within the financial structure of the economy, if the Government continued to try to finance the government debt at lower than market rates.

More generally, Mr. Erb considered, financing the Japanese Government debt through open-market issues would deepen and broaden the financial markets in Japan, actions which, taken together with the relaxation of capital controls, would attract more foreign investment into the country. Foreign investors would wish to see both how broad and how liquid the market actually was.

In the circumstances, Mr. Erb wondered whether the Japanese authorities planned additional direct offers of government debt to the nonbank public, as they had done earlier in 1982. He understood that consideration was being given to issuing 15-year government bonds; when would a final decision be taken? Were the Japanese authorities considering the possibility of issuing yen-denominated bonds abroad? Such an issue would increase the potential demand for yen securities in other financial centers, which might not have immediate access to them on the Japanese domestic market itself.

Mr. Schneider commented that he was rather hesitant to offer observations on the economy of Japan, since the staff had shown how well the authorities had managed. The growth of the Japanese economy in 1982, and its projected growth in 1983, were moderate by historical standards, and he wondered whether the country's comfortable external position would not permit a higher level of domestic demand, thus benefiting the world at large.

The fundamental question seemed to be how such a higher level of domestic demand could be achieved without recourse to fiscal policy, Mr. Schneider considered. He could certainly agree that the authorities had cause for concern over the size of the fiscal deficit, and that there was little room for fiscal stimulus. The authorities were to be commended for their restraint in not intensifying their efforts to improve the fiscal situation in view of the revenue shortfall from which they were suffering. The public works program adopted in October 1982 and the redirection of expenditures into more efficient uses were particularly welcome. He himself was not particularly concerned about the lack of success in reducing the fiscal deficit, since it was not particularly large compared with private savings. In that connection, he drew different conclusions from Table 23 on page 53 of SM/83/7 from those reached by Mr. Erb. Subtracting the fiscal deficit on general government account from gross private savings for 1980 left a remainder that was still in the neighborhood of 25 per cent of gross national product. There was therefore little room to fear that the private sector might be crowded out of the capital market. The level of savings was still the most dominant aspect of economic development in Japan. It would therefore have been helpful if the staff had commented more extensively on the place of savings in the Japanese economy and their effect on the external balance.

In any event, Mr. Schneider went on, domestic savings were certainly larger than investment. Consequently, lowering the exceptionally high savings rate would boost domestic demand and provide a larger stimulus to growth. Experience had shown that lowering the inflation rate had not by itself reduced the savings rate, as the authorities had expected. There had been some improvement in 1982, but efforts along those lines should continue. Other measures should also be devised for making savings somewhat less attractive than at present. He would appreciate it if the staff would comment on the effects of the legislative measures mentioned in the report for the 1981 Article IV consultation with Japan. If domestic private demand became more buoyant, it might also become easier to reduce the fiscal deficit by increasing revenues, perhaps by raising the share of indirect taxation, which seemed quite low compared to that of direct taxation.

Domestic demand might also be stimulated by a somewhat different approach toward the exchange rate, Mr. Schneider remarked. He agreed with the authorities' policy of letting the yen appreciate in effective terms during recent months. However, since the yen seemed to have appreciated to more normal levels of competitiveness, he wondered whether the time might not have come to let the upward pressure on the yen be reflected in the lowering of interest rates. So doing would provide more room for increased investment consumption, and would be especially stimulating for investment by small and medium-scale enterprises. The spillover effect of the expansion in domestic demand to imports resulting from such an approach would probably be larger than could be expected from a mere further appreciation of the yen. Such a policy approach would also help to avoid a new and excessive upswing of the yen, to be followed by the inevitable downturn. He would welcome comments on his proposal.

The import liberalization policy recently followed by the authorities was fully in line with the sort of approach he had proposed, Mr. Schneider considered. The authorities would moreover thereby provide a strong argument against protectionist tendencies in other countries vis-à-vis Japanese exports. Although import penetration had increased, there did still seem to be room for further improvement, particularly with respect to the removal of nontariff barriers to trade. There was little danger that the expansion of domestic demand would spill over into excessive imports.

He agreed with the staff's assessment of monetary policy, Mr. Schneider stated. The Bank of Japan had succeeded very effectively in sterilizing the effects of its interventions in the exchange market in support of the yen. He agreed with the Japanese authorities that such interventions could not be effective unless they were supported by monetary authorities in other countries, and that greater cooperation should be sought in that field. In any event, the Japanese authorities had demonstrated that the effects of their interventions on the money stock could easily be absorbed. He would therefore be inclined to argue for a policy mix that would allow domestic demand to take a more expansionary stance than had been achieved so far. Nevertheless, he wondered how much room existed for additional expansion in view of the authorities' estimate that potential GNP growth was no more than 4 per cent or 5 per cent per year. Finally, it would be interesting to have some preliminary indications about the effects of the recent decline in oil prices on the prospects for the Japanese economy in 1983 and thereafter.

Mr. Caranicas commented that it was rare to find a staff appraisal offering so much praise for a country's authorities as had been contained in SM/83/36. He agreed with every word in the last paragraph of page 23 of that paper.

Commenting on the policy perspectives for 1983/84, Mr. Caranicas remarked that, by implementing their policies flexibly during 1982, the authorities had managed a remarkable economic performance despite a mild recession, growing unemployment, lower exports, and larger government deficits. In view of the weak state of domestic demand, the authorities had chosen to follow a less restrictive fiscal stance and a somewhat tighter monetary policy. In the course of the discussion for the 1981 Article IV consultation with Japan, his chair had put forward the view that the policy mix adopted by the authorities had not been appropriate for solving the two main problems facing the country: the weakness of the yen and the growing trade surplus, which threatened to cause disruptions in bilateral flows. By choosing to follow a less restrictive stance in the somewhat tighter monetary policy, the authorities had brought about a stronger yen, positive growth based to a smaller extent than previously on the contribution of the external sector, and a rather larger budget deficit than had originally been envisaged. The skill shown by the Japanese authorities in implementing their policy deserved admiration and praise.

Still further appreciation of the yen was warranted, Mr. Caranicas considered; great care would therefore be required in the conduct of monetary policy. He regarded the attention devoted by the Japanese authorities to interest rate differentials between Japan and the United States as particularly appropriate, and he was confident that they would not allow rates to rise to a level that was inconsistent with a strengthening of the yen.

So far as fiscal policy was concerned, Mr. Caranicas stated, he appreciated the Government's intention to eliminate the bond financing of current expenditures in the medium term. He also noted that no firm date had been set for the complete elimination of such financing. Like the staff, he was worried that a withdrawal of expansionary stimulus from the public sector might not be offset by an increase in demand from the private sector. The signs of weakness in domestic demand reported by the staff were indications that such a danger could not be excluded. He had however noted the front-loading of public expenditures during the first part of 1982/83, and suggested that the authorities should monitor private sector activity closely before reducing the fiscal stimulus.

Commenting on the authorities' trade policies, Mr. Caranicas observed that a stronger yen would certainly help to redress trade imbalances, which had led to the unfortunate emergence of agreements on voluntary restraint for particular products and particular countries. While he recognized that Japan's tariffs were among the lowest in industrial countries, the market-opening measures announced a year previously should be implemented. A wider opening of the agricultural markets to outside influences seemed desirable, since Japanese consumers ought to be able to benefit from freer trade, as did consumers in countries importing Japanese manufactured goods. He hoped that the efforts deployed by the authorities to reduce or eliminate import tariffs and to simplify import procedures and modify the testing standards would be continued during the current year.

Mr. Kafka stated that he agreed with the analysis contained in the consultation report; he would therefore limit himself to points of emphasis. It was understandable that the Japanese authorities were paying particular attention to fiscal policy. It was also satisfactory that they should be directing their expenditure policy to stimulate of private investment demand, as well as to bringing about an increase in growth. It was particularly encouraging that the authorities proposed to increase official development assistance even though the budget envisaged no growth in general expenditures. Nevertheless, he missed any assurance, either by the staff or by Mr. Hirao, that, in the event of a shortfall in private demand, the Japanese authorities were prepared to show the same admirable flexibility that they had exhibited in 1982/83 in supplementing the budget and in front-loading expenditures. Flexibility in fiscal policies was particularly important, since monetary policies should remain somewhat restrictive in order to encourage the further appreciation of the yen, something clearly appropriate from the medium-term standpoint, considering the admirable performance of prices in Japan. The Japanese authorities had certainly made efforts to reduce barriers to trade, and it seemed likely that many of the reasons for the failure of Japanese imports to increase were related to the lagging efforts of traders in other countries. The further phasing out of Japanese nontariff barriers to imports could still take considerable time, although as soon as the yen had appreciated further, Japan's trading partners would lose any justification for their own restrictions against Japanese imports.

He had been attracted by Mr. Erb's suggestion that a country with a relatively high marginal capital/output ratio needed a higher savings ratio than other countries, Mr. Kafka stated. While Mr. Erb's statement was clearly appropriate from the short-term standpoint, in the long run a country with a relatively high marginal capital/output ratio might be advised to change its output mix and possibly, by implication, to become a larger exporter of capital.

Mr. Zhang remarked that the Japanese authorities had responded to an increasingly difficult situation at the end of 1981 by steering a careful course between the requirements of domestic economic growth and exchange rate considerations. The performance of the Japanese economy had been remarkable in many areas. Continued flexibility in the implementation of fiscal policy and the careful weighing of exchange rate considerations in deciding the policy mix would be no less essential in 1983.

He welcomed the staff report as an example of the effective use of procedures for Article IV consultations with a member country for several reasons, Mr. Zhang stated. It showed that Japan's policies in 1982 had broadly reflected the recommendations of the Fund mission of 1981. Second, the report provided a clear account of Japan's current economic prospects and of the authorities' present policy dilemmas in the international setting. Third, in contrast to several recent consultation reports on industrial countries, the staff's recommendations for the coming year showed a new appreciation of the need to take into account the general situation prevailing in the industrial world when making policy recommendations for major countries like Japan. For instance, SM/83/36 was one of the few consultation reports that had not recommended a further intensification of strict demand restraint, in a world situation reminiscent of the Great Depression of the 1930s.

The most troubling development in Japan during 1982 had been the almost continuous weakening of the yen until November of that year, Mr. Zhang considered. The staff had raised the question whether the authorities' policies had taken sufficient account of the pressures created by the steep rise in the interest rates in the United States and other financial centers, and whether the authorities were correct in their opinion in early 1982 that, "it was appropriate to use an easier monetary policy for the purpose of stimulating domestic demand." Nevertheless, it would be wrong to lose sight of the fact that the mix of budgetary and monetary policies applied in the United States had been a major factor in the weakening of the yen during 1982. Furthermore, recourse to such a combination of policies by the industrial countries, resulting in a rise in the real exchange rate of the U.S. dollar and other major currencies, had been an important element in establishing rising protectionist pressures because it had created increasing difficulties for the traded goods sectors of the countries concerned.

The authors of the report raised the question whether aggregate output could increase by 3.4 per cent in Japan in 1983 if the Government withdrew the fiscal stimulus as currently planned, Mr. Zhang remarked.

In fact, government spending had recently been an important element of strength in the domestic economy, enabling 3 per cent growth to be achieved in 1982, despite the decline in exports. The staff had observed that the austerity in planned expenditures for 1983 was "very striking."

The staff had commended the adoption of the market-opening measures announced in the past 12 months, Mr. Zhang noted. It had also welcomed Japan's persevering commitment to help the low-income countries of the world and the continuation of the liberalization of money and capital markets. He supported such changes.

In conclusion, Mr. Zhang raised a more general question concerning the Fund's surveillance in the present difficult period. The Fund had in recent months discussed the difficulties that had arisen in several industrial countries. However, in discussing those closely linked economies, he did not believe that the Board had really assessed the policies of each country in the light of those being implemented or planned elsewhere. The Board had tended to subscribe to the assumption that the best outcome for all countries would be assured if only each country implemented correct policies for its own case judged in isolation, without an adequate review of how it would be affecting the constellation of policies and developments in closely linked economies. In the present case, he doubted whether the Board could effectively assess and recommend policies to the Japanese authorities without considering policies in force in the United States and other industrial countries.

A simultaneous review of major countries' policies would help to ensure consistency and compatibility in the policies of eonomically closely linked individual countries, Mr. Zhang considered. He wondered whether the Fund was not in danger of recommending similar policies of continuing restraint to one country after another, without considering the combined effect of the policies in depressing the level of real world demand, output, and income, in limiting world trade, in intensifying the balance of payments and debt repayment problems of member countries, and in strengthening the unwelcome pressures for protectionism.

At the moment, Mr. Zhang considered, there were encouraging signs of recovery in the United States, which should significantly ease the Japanese authorities' task in achieving their economic objectives in 1983/84. He wondered whether the present was not the time to undertake a careful review of the combination of policies being pursued by or recommended for major industrial countries with a view to assessing the possibilities for widening recovery and countering the unfavorable tendencies that he had mentioned.

Mr. Salehkhou stated that he endorsed the main elements of the staff analyses and conclusions. He hoped that the staff would be able to give a quantitative assessment of the effects of the recently announced drop in oil prices on the gross national product of Japan and on its import prospects. Because of the country's heavy dependence on imported oil, any significant fall in oil prices of the size recently announced was bound greatly to improve some key economic variables.

In the real sector, Mr. Salehkhou went on, the economy had adjusted well to the changed environment. Despite the adverse external conditions, cost-price distortions had been kept to a minimum, and significant positive structural changes had been undertaken, thus maintaining the economy on a healthy and progressive course. In both 1981 and 1982, substantial growth rates had been recorded, and inflation had been fully contained. However, while the external sector, and exports in particular, had assumed much of the burden in the drive for higher growth, private domestic activity had slipped, and in 1982 in particular the response of domestic demand to the measures adopted by the authorities had proven to be sluggish, with the result that unemployment--although minimal by the standards for other industrial countries--had become historically high in Japan, and therefore cause for concern to the authorities.

In the fiscal field, the Government's intention gradually to aim for a reduction in the issuance of deficit financing bonds had been hampered by the need for further invigoration of the domestic economy, Mr. Salehkhou noted. In 1982/83, the revised budget deficit would amount to 5.5 per cent of gross national product, a figure above the planned level. The main cause of the increase had been a revenue shortfall, brought on partly by a reduction in the revenue base, and partly by lower tax performance and a decline in corporate profits. Notwithstanding the continued sizable budget deficits, the authorities would have resorted to higher domestic public works expenditures, had it not been for the need to maintain flexibility of fiscal policy, and to keep the size of the deficit within manageable bounds.

For 1983/84, Mr. Salehkhou observed, revenue was expected to increase, and the deficit on the General Account was expected to decline to some 4.6 per cent of gross national product. There would be a fall in real expenditure, and the budget contained wide-ranging austerity measures that would hardly prove growth oriented. Despite the favorable growth prospects resulting from a fall in the price of oil, more expenditure, particularly on housing and public works, would prove helpful.

In 1982, Mr. Salehkhou remarked, monetary policy had diverged from its longstanding objective of helping to expand private domestic activity and to contain inflation. Instead, it had been--and still was--geared to exchange rate considerations. In response to a fall in the value of the yen early in 1982, brought about by a rise in interest rates overseas, and hence an outflow of Japanese capital, monetary policy had been tightened early in the year, and long-term interest rates had risen. The yen had however continued to depreciate, and a further tightening of monetary measures was therefore contemplated. Finally, however, other criteria, mainly those related to domestic growth, had prevented any such tightening. Toward the end of 1982, the yen had strengthened considerably, and the authorities hoped to raise the rate still further. Both the control of monetary aggregates and interest rates would be used toward that end in 1983, although they would also have to accommodate the predicted growth of the economy.

The staff seemed to be leaning toward continued caution in the stance of monetary policy, Mr. Salehkhou noted, lest the positive upward effects of easier policy on the exchange rate of the yen be thwarted. However, with the sharply higher surplus in the current account as a result of the expected reduction in the import bill, there would be more leeway for the authorities to ease the stance of monetary policy with a view to further invigorating the economy.

In the external sector, Mr. Salehkhou went on, exports had declined in the face of recession abroad, an accumulation of stocks, relative loss of competitiveness, and voluntary export restraint schemes. However, in 1982 imports had also been lower, reflecting sluggish domestic demand and further energy conservation measures. As a result, during the year the current account surplus had increased by 44 per cent to nearly $7 billion. As the staff had mentioned on page 13 of the report, in 1983 another sharp increase in the current account surplus was projected.

He welcomed the authorities' decision to seek further measures to open up domestic markets for imports, Mr. Salehkhou said. He urged the authorities substantially to ease the import testing and approval procedures. There was a need to remove what were commonly known as nontariff barriers and to take further measures to encourage the import of finished and semifinished products from developing countries.

Commenting on assistance by Japan to Third World countries, Mr. Salehkhou noted that in 1981 official development assistance had been 4 per cent less than the previous year. Within that category, bilateral grants and bilateral development lending had increased, while the flow to multilateral agencies had declined. A large proportion of assistance from Japan went to Asian countries, no doubt for geographical, political, and economic reasons. As a result, the shares of Africa and the Middle East in aid from Japan had declined in 1981. While the increase in the share of Asian countries with bilateral trade tied to Japan was understandable, he urged the authorities to diversify the aid spectrum by placing more emphasis on the criterion of need and by raising their contribution to multilateral development institutions. As a percentage of gross national product, Japanese ODA had decreased in 1981, and Japan was now far behind the target of 0.7 per cent of GNP agreed in the United Nations, as indeed were the other industrial countries. Moreover, the proportion of grants in the total had steadily fallen, to the detriment of the neediest countries.

A great part of Japan's economic achievement was linked to its easy access to abundant resources, as well as to the untapped markets of the less developed countries, Mr. Salehkhou stated. Notwithstanding the financial assets and other resources placed with the less developed countries, the strength of the Japanese economy should make the country a prime candidate for taking the lead in substantially raising the volume of concessional aid and in increasing the real transfer of technology to the developing countries. With the fall in oil prices and the subsequent significant improvement expected in the Japanese economy, it was only fair that Japan, and other countries in a similar position, should pass on some of the accrued benefits to poor countries that were struggling to make ends meet in the face of heavy odds. Indeed, knowing that the present worldwide financial difficulties could also be partly due to unjustifiable programs carried out by certain institutions in industrial countries, those countries should be prepared to take over the work that might have to be greatly reduced or even terminated by some oil producing countries in the face of changed fortunes. In other words, while the Japanese authorities had significant achievements to their credit, in their own best interests there was much more that they could do, and would be expected to do, to help others. In that connection, he would appreciate it if the staff could give some indication of the volume of aid provided by Japan in 1982.

Having had the benefit of observing the remarkable achievement of the Japanese authorities at close range, Mr. Salehkhou observed, he particularly praised the discipline and resilience present in almost all sectors of Japanese society. In that spirit, he would offer some more general comments.

Japan was in a unique position, Mr. Salehkhou considered; having overcome the devastation of war and battled against great odds, the authorities should be cognizant of the experience of underdevelopment and hence should be better able to appreciate the problems of poverty. In those circumstances, Japan, morally, if not materially, should be more sensitive to the plight of the South rather than to the prosperity of the North. The country was more of an example for the developing nations than the other industrial countries. The developing countries thus expected from Japan more understanding, more cooperation, and greater efforts than from other countries. The traditional image of Japan in the Third World as being a partner in progress was based on cooperation between the developing countries and Japan, one contributing the raw materials and natural resources, the other processing the resources and offering final products; or again, one providing the energy, the other supplying the technology, so the expectations of the developing countries were not confined to aid and grants. It was the real transfer of technology, and not its commercialization, in combination with financial transfers that would go a long way toward alleviating the present problems of underdevelopment. Japan should take the lead; bilateral or multilateral industrial products could be a helpful avenue for enabling the developing countries to achieve their goal. He therefore hoped that Japan would undertake to initiate more joint venture projects, and to complete existing ones. He also hoped that, as a matter of urgency, the country would greatly ease or completely remove its tariff and nontariff barriers to the trade of developing countries. It was to be understood that, unlike industrial countries, the developing countries had not found themselves in a position to reciprocate by engaging in protectionist policies aimed at a single country or group of countries, preferring instead to voice their legitimate calls for preferential treatment through international institutions.

Mr. Tvedt remarked that Japan had undergone a fundamental adjustment process in a difficult international economic environment in recent years. As a result of the structural changes, Japan appeared to be one of the best examples of an economy where a cautious shift toward a more expansionary stance of policy was particularly called for.

Inflation had been brought under control in a climate of realistic inflationary expectations, Mr. Tvedt considered. The rate of price increase as measured by the consumer price index was only about half that of the average increase recorded during the 1960s. For the past seven years, with the exception of 1979 and 1980, the current account of the balance of payments had been in surplus. The recent marked decrease in the oil prices was expected further to strengthen the balance of payments, at least in the short run. A current account surplus for 1982/83 approaching $20 billion did not seem unlikely. Taking account of the idle capacity in the Japanese economy, there was at least some room for a further increase in the potential growth rate of the economy foreseen by the Economic Planning Agency.

In January 1983, Mr. Tvedt had noted, unemployment had risen to a 30-year high of 2.72 per cent of the work force. Furthermore, according to a recent review of the demand for labor in industry, about one third of the larger companies were reducing overtime and recruiting due to weak domestic demand. The austerity of central government expenditure for the coming fiscal year was striking and, combined with price policies in the proposed budget, indicated a restrictive stance for fiscal policy.

As his authorities had said during the Interim Committee meeting of February 1983, Mr. Tvedt went on, countries like Japan should at least in the short run be prepared to tolerate fiscal deficits of a cyclical nature. His authorities also considered that fiscal deficits should be judged in connection with the savings behavior of other sectors of the economy, a technique that would be particularly valid in Japan, which had the smallest ratio of budget deficit to private savings among all the large industrial countries. Furthermore, the staff considered that the high savings ratio in Japan was an important factor helping to prevent crowding-out, because extensive savings had been available to finance the fiscal deficit. Table 23 of SM/83/17 also showed clearly that the amount of savings left to the private sector was considerably higher in Japan than in the United States or Germany, and probably than in all other industrial countries as well. Against that background, his authorities had been rather surprised to find that the staff had not advocated a gradual shift in economic policy in Japan in a more expansionary direction. The staff seemed only to propose that the planned tightening of fiscal policies should be postponed until some additional sign of an upturn in private demand had become evident. In view of the expected decline in investment by large companies, he found that approach too cautious. Action was called for, not hesitation.

Regarding the exchange rate policy, he fully agreed both with the authorities and with the staff that the yen should be further strengthened, Mr. Tvedt considered. The need to strengthen the yen underscored the need for continued tight monetary policy, even though the level of the real interest rate was already historically high. In the circumstances, a change in policy mix might have to be considered. One possibility would be to combine a more expansionary fiscal policy with continued tight monetary policy in an effort to stimulate domestic demand and to achieve a more realistic exchange rate level. If desired, the policy mix could be changed once again when the yen had found a more appropriate level. Throughout 1982, the authorities had intervened heavily to support the yen in the exchange market. He fully supported that type of intervention, which seemed to be designed to counter disorderly market conditions and to signal the authorities' desire to see an appreciation of the yen.

He could also fully support the staff appraisal with respect to the need for Japan to play a leading role in reversing the protectionist tendencies currently plaguing the world economy, Mr. Tvedt concluded. The market-opening measures announced in 1982 were welcome; he hoped that there would be further measures along the same lines in future. Finally, the economic situation in Japan allowed for an increase in the flow of official development assistance along the lines earlier announced for the period 1981-85. In that context, it was worth noting that the aid provided by Japan was below the average for the DAC countries as a group, measured as a percentage of gross domestic product.

Mr. Feito commented that as a result of persistently increasing fiscal deficits, the ratio of outstanding government debt to GNP, which had been the smallest among the major industrial countries of 1972, had become larger than the equivalent ratio in Germany and the United States. Thus the correctness of the authorities' commitment to break the tendency by reducing the fiscal deficit was beyond any doubt. Nevertheless, there was a question as to the optimum pace for bringing about that adjustment. He shared the views of those who had supported the establishment of a medium-term objective for the gradual elimination of the fiscal deficit, rather than a shock adjustment. During the past two fiscal years, developments in the domestic economy had combined with adverse exogenous factors to frustrate the authorities' growth expectations, making it necessary to provide an increasing fiscal stimulus as a means of partially sustaining economic activity and employment. In view of the uncertainties regarding the timing of recovery in the world economy, and the doubts regarding the recovery of domestic demand, the authorities might be well advised to retain the flexibility that they had amply demonstrated in the management of fiscal policy. An additional argument for fiscal flexibility was the fact that Japan was not a price taker in the world economy. A reduction in the rate of growth of imports brought on by too restrictive a fiscal stance would have, however minimally, some negative effects on exports. More important, and most unfortunately, a reduction in the rate of growth of imports would have indirect negative effects on Japanese exports by arousing protectionist sentiments in the major competitor countries. In consequence, while he fully shared the authorities' concern with the size and persistence of the fiscal deficit, he also believed that too rapid a withdrawal of the fiscal stimulus to growth might be unwise in the current circumstances.

Commenting on the natural rate of unemployment in the Japanese economy, Mr. Feito remarked that the revised potential growth rate seemed to lie somewhere between 4 per cent and 5 per cent per year, so that the economy was performing close to its potential. It was astonishing to see the extremely low rate of unemployment--2.4 per cent--associated with a rate of growth that had not attained its potential. Even more puzzling was that, although the potential rate of growth was only half the rate recorded in the past, when the Japanese economy had been less secure, the associated natural rate of unemployment seemed to have remained unchanged. Clearly, the special institutions and arrangements operating in the Japanese labor market must be playing an important role. But it could perhaps also be said that the heavy investment in labor-saving equipment and the rapid pace of technological advance in the past decade had had a negative impact on the cyclical and structural unemployment rate. He would therefore like to ask the staff what its perception was of a natural level of unemployment at which the Japanese economy could attain its potential growth rate. He wondered how that level compared with the level in other major industrial economies, and how such great disparities could be explained.

Japan was more dependent on imported energy than other industrial countries, Mr. Feito observed; it should therefore benefit initially more from the positive terms of trade impact of lower energy prices. He would therefore like to join Mr. Schneider and Mr. Salehkhou in asking the staff for its views on the impact of lower oil prices on the prospects for the Japanese economy. He would also be interested to hear comments on the optimal strategy for dealing with a significant fall in the price of imported energy. He wondered whether it should mirror the strategy followed in connection with an increase in the price of energy--meaning that the domestic price should be equal to the international price--or whether the public sector should reap all the benefits of the improved terms of trade. In addition, he would like to hear views on the proper role to be played by demand management policies in the context of falling energy prices. It would be valuable to learn whether the Japanese Government had in mind some strategy for coping with the new energy situation, and he would appreciate further information from the staff on a point that the Executive Board would have to discuss in more detail, in connection with the forthcoming exercise on the World Economic Outlook.

Finally, Mr. Feito stated that he concurred with the staff's regret regarding the restraints that had been imposed on Japan's exports. The expected recovery of the world economy would help to ameliorate the situation, but it should not be a cause for retarding countries' efforts toward relaxing their protectionist stances.

Mr. Laske remarked that the Japanese economy had passed through a difficult year. The authorities had hoped that 1982 would bring a revival of economic activity founded in the main on the strengthening of private demand, for both consumption and investment. They had also expected that the external sector would contribute in some measure to stronger economic activity. Most of those expectations had been frustrated, primarily because of continued sluggishness in the domestic economy and in the world at large. Increasingly protectionist tendencies in a number of countries had also adversely affected the performance of the Japanese economy. The Japanese authorities had reacted by a major relaxation of fiscal policy. While it had been the intention of the authorities to reduce significantly the Central Government's fiscal deficit, the progressive weakening of both private domestic demand and foreign demand had correctly led them to change their objective. In consequence, the budget deficit as a percentage of gross domestic product was not expected to be much smaller in 1982/83 than in the two previous fiscal years. It would certainly be considerably larger than originally envisaged.

The high ratio of fiscal deficit to GDP had in the past been perceived as a potential threat to progress in structural adjustments and to the maintenance of financial stability, Mr. Laske recalled. The Japanese authorities were not alone in that view, and he sympathized with them in their desire to reduce the budget deficit in the medium term so as to make more room for private sector activity. Even when the authorities had been compelled by pressure of circumstances to postpone their plans for reducing the deficit, they had nevertheless made further progress in altering the structure of the central government budget. They had halted the growth of expenditure, and the revenue shortfall, caused by the overall sluggishness in the economy, had been offset by speeding up the implementation of public works programs, and by planning to expand government outlays later if the economy failed to pick up steam. With that flexible approach, the Japanese economy had achieved a growth rate of 2.7 per cent, which, though lower than the rates recorded in earlier years in Japan, was significantly higher than the rates in other large industrial economies.

A positive feature of developments in Japan, Mr. Laske considered, had been the further reduction in the level of inflation, which was low in comparison with that in many other industrial countries, and in comparison with the experience of Japan itself two years previously. The change had been greatly assisted by the advent of moderate wage increases in the face of a sharp depreciation of the yen, with its inflationary potential. Another positive element had been the low level of unemployment. It was rather baffling that the unemployment ratio had remained practically unchanged over a relatively long period, even when both economic activity and growth had slipped considerably. After Mr. Feito's interesting comments on the point, he would greatly look forward to the replies by the staff or Mr. Hirao.

The authorities had had great difficulty with their monetary policy during the past year, Mr. Laske went on, and he was not clear whether the difficult period had in fact completely passed. The authorities in other countries had been confronted with similar circumstances, in which the state of the domestic economy called for some measure of monetary ease, while the behavior of the exchange rate strongly argued against any such action. Despite favorable domestic fundamentals and a surplus in the current account of the balance of payments, the yen had started to display weakness as soon as the Bank of Japan tried to make interest rates conform better to the state of the domestic economy. It had become quite obvious over the past 18 months that the size of the interest rate differential against the yen placed an immediate limitation on the Bank of Japan's room for maneuver.

The reduction of the discount and other interest rates in December 1981 had had a depressing effect on the yen rate and had triggered massive movements of long-term capital out of Japan, Mr. Laske noted. Once interest rates in the United States had started to decline in the middle of 1982, Japanese rates had followed only with a considerable time lag. He wondered why the delay should have been so long and why the authorities had felt constrained to follow the American trend as closely as they had. Real interest rates in Japan were still quite high, even exceeding those in other industrialized countries, where some of the fundamentals--inflation and the current account--were not as favorable as those in Japan.

The Japanese authorities had adopted, and at least partially implemented in the course of the past year, certain measures to widen foreign access to the domestic market, Mr. Laske observed. He would heartily welcome continued efforts by the authorities to open up the domestic market still further, since some foreign suppliers at least believed that they would have a competitive edge if they were not met by regulatory or similar impediments.

The Japanese policymakers were facing critical decisions, Mr. Laske believed. The priorities that they had set themselves--noninflationary growth of the domestic economy, reduction of the fiscal deficit, and further structural adjustment--were identical with those of the German authorities. If those goals were pursued within a reasonable time frame and with their repercussions on the rest of the world clearly in mind, the effects of such sensible policies would be beneficial to the world as a whole. For the coming year, the Japanese authorities had decided to press ahead with the reduction of the budget deficit. Even though they appeared to have abandoned their previous intention to eliminate the issuance of deficit financing bonds by FY 1984/85, the proposed austerity drive raised some questions. For instance, the degree of fiscal restraint seemed to be based on a rather sanguine view of the recovery of private domestic demand and of the expected increase in the volume of world trade. If those expectations failed to materialize, the growth projection of 3.4 per cent per year would be out of reach. Such a failure of performance would not be reassuring, since it might involve a dramatic strengthening of the current account, primarily because of sluggish imports.

The staff also seemed to harbor some doubts about the wisdom of the proposed restrictive fiscal stance, in view of the existing uncertainties in many fields, Mr. Laske went on. He would encourage the authorities to continue adapting their fiscal policies to the situation as it emerged in as flexible a way as they had done in the past. It might well turn out to be advisable for the Japanese authorities to accept a somewhat higher budget deficit, if private domestic demand turned out to be significantly less strong than they had been assumed when drawing up the policies for FY 1983/84.

He had taken careful note of the supplement to the staff report regarding the most recent data available from Japan, Mr. Laske stated. Although the data seemed to point in the right direction, it was clearly too soon to revise the official projections. It would be particularly interesting to see how the economy would develop in the near future. He could therefore endorse the emphasis placed by the authorities on constraints on the expenditure side of the budget. Nevertheless, some adjustments on the revenue side could strengthen the authorities' hand. The staff had noted a shift from goods to services in the pattern of personal consumption, thus implying a weakening of domestic revenues, since services were taxed only lightly, or not at all. Mr. Hirao seemed to make the same point in discussing the distribution of tax revenues between direct and indirect taxes. Nevertheless, he had been reassured to hear Mr. Hirao say that it might be advisable to consider a restructuring of the tax base to place greater emphasis on indirect taxes. Finally, he hoped that the Bank of Japan would use any room that might emerge on the external side for adjusting its monetary policy toward support for the recovery of the domestic economy.

Mr. Alhaimus commented that in the past the Japanese economy had performed remarkably well, even in the most difficult of circumstances. Perhaps the most admirable feature of the past decade had been the high degree of resilience and the ability to adapt to changing situations. Despite the various shifts in the global environment, the Japanese economy had combined one of the highest growth rates in industrial countries with the lowest inflation level, while maintaining a highly efficient and competitive structure. The global environment was currently expected to improve, thus giving the authorities more flexibility in addressing some of the major concerns regarding important aspects of economic policies in Japan.

It was interesting to note in that respect that the staff considered that the Japanese authorities had been conducting their policies during the past year in a manner consistent with the hopes and urgings of the international community, Mr. Alhaimus observed. Particularly relevant was Mr. Hirao's statement that economic growth in 1982/83 had been almost entirely the result of an increase in domestic demand, and that the policy objective for 1983/84 was that of achieving steady growth in domestic private demand, as well as maintaining price stability. He had noted the staff's call for caution to avert too rapid a withdrawal of the support provided to the economy by the government sector. Continued attention should also be paid to creating conditions more conducive to the appreciation of the yen. Mr. Hirao had shown the positive benefits that such an appreciation would bring in connection with the stabilization of prices, an increase in consumption, the improvement in corporate profits, and the stimulation of growth through improvements in the terms of trade. Naturally, however, factors affecting the value of the yen were not entirely within the control of the Japanese authorities.

Contemplating Japan's trade policies, Mr. Alhaimus remarked that he had been interested by the staff statement listing the various measures taken by the authorities in 1982 to open up the domestic markets to imports, including the reduction or elimination of tariffs on a number of items in April 1983. One aspect of import liberalization that deserved serious attention was the provision of greater access for the manufactured goods of developing countries. Such a change would improve trade with a large group of countries, while allowing Japanese industry to concentrate on the high-technology products in which it had a clear comparative advantage.

One important issue with a considerable bearing on the prospects for the Japanese economy, Mr. Alhaimus considered, was the impact of price changes of imported energy, particularly crude petroleum. He wondered whether a comprehensive assessment had been made of the effects of the change in oil prices on the external sector, and the likely course of domestic prices for energy products. An issue of more fundamental concern was Japan's interest in the maintenance of more stable energy markets, on which the economy remained highly dependent.

Mr. Kooymans stated that he could agree with the thrust of the staff appraisal. Japan's growth continued to be significantly stronger than that of other major industrial economies, despite the impact of high energy costs on an economy almost wholly dependent on imported energy resources. The success had been due in large part to high rates of saving and investment, a favorable industrial relations climate, relatively efficient use of productive capacity, a high degree of technical innovation, and a generally flexible approach to economic policymaking.

With respect to fiscal policy, Mr. Kooymans went on, he welcomed the recent flexibility shown by the authorities in supporting domestic demand. With monetary policy constrained by exchange rate considerations, flexibility had had to come from the fiscal side and had inevitably led to some retreat from the authorities' medium-term fiscal objectives. The authorities would probably agree that the size of the budget deficit was Japan's most serious domestic economic policy problem. He agreed that policy must be directed at reducing those deficits in the medium term, if only to restore flexibility to fiscal policy, to establish a sound financial basis for the expected increase in transfer payments in later years, and to avoid any future problem of crowding-out. While there could be no doubt that Japan's high savings ratio had so far helped the authorities to avoid the crowding-out problem and to finance the deficit in a noninflationary manner, care would need to be exercised in the medium term.

Assuming, as seemed likely in the short term, Mr. Kooymans said, that monetary policy continued to be constrained by external objectives, the authorities would have once again to pursue discretionary policies through fiscal action. He agreed with the staff that caution would have to be exercised to avert too rapid a withdrawal of the support that the government sector was providing to the economy, and that it would be prudent to await some additional evidence of the strengthening of private consumption and investment spending before deciding that those sectors would be capable of carrying the major burden of economic expansion.

It might be that the withdrawal of stimulus envisaged in the FY 1983/84 budget would prove to be too great, Mr. Kooymans observed. As the staff noted, there were both favorable signs and risks surrounding the outlook for FY 1983/84. He would be interested in any light that Mr. Hirao and the staff could throw on recent reports of a possible new stimulatory package to counter unemployment.

Discretionary components of expenditure had been restrained, the lack of progress in reducing the deficit being attributable mainly to revenue shortfalls reflecting slow economic growth and low inflation, Mr. Kooymans maintained. He agreed with the view expressed by Mr. Hirao that a fundamental re-examination of the tax structure, aimed at attaining approximate equity and promoting elasticity in the tax system, seemed to be advisable. He noted the vulnerability of tax returns to a cyclical downturn through the effect on company tax receipts, which accounted for a high proportion of overall revenues.

A cautious approach to monetary policy seemed appropriate, Mr. Kooymans stated, given the importance of exchange rate objectives. If some scope for easing were to emerge--something that would depend largely on developments in the exchange rate and U.S. interest rates--he hoped that the authorities would take advantage of the change to relieve the burden on fiscal policy and encourage business investment.

The recent appreciation of the yen--a move consistent with the fundamentals of the Japanese economy--was to be welcomed, Mr. Kooymans stated, particularly for its effect in helping to stabilize prices, reduce trade frictions, and assist the profit position of Japan's energy consuming materials industry. It was to be hoped that the trend, along with the expected moderate recovery in the world economy, would reduce pressures for voluntary restraint agreements and other trade limiting measures that had blunted the competitive advantage of Japanese firms.

He greatly welcomed the recent progress by Japan in opening up its economy to imports, and he hoped that such progress could be continued, with special reference to agricultural products, as world recovery improved. Finally, he welcomed the policy of opening up the Japanese capital market, and in particular of improving access by foreign borrowers. The authorities were also to be commended for avoiding administrative controls aimed at stemming the capital outflow that had occurred in 1982; the introduction of such controls would only have harmed confidence in the long-term development of the capital market.

Mr. Polak stated that the Netherlands authorities, he himself, and his collaborators had paid careful attention to the state of the Japanese economy as it had developed over recent quarters, and of the complex interrelationship of short-term and medium-term considerations that guided the Japanese authorities in the use of the various elements of policy at their disposal. For that purpose, he had taken into account not only the papers by the staff and the statement by Mr. Hirao, but also the observations made in the recent discussion on Japan in Working Party 3 of the OECD.

He had concluded that his views and those of the Netherlands authorities had been fully, precisely, and with the correct nuances expressed in the staff appraisal. If there was one sentence that he wished to stress in particular, it would be: "Budgetary policy should continue to be implemented with an appropriate degree of flexibility, as it had been for the past two years."

Mr. Suraisry stated that he too was in general agreement with the well-balanced staff appraisal. The present discussion was important not only because Japan was a major industrial economy with a remarkable track record, but also from an international standpoint. The policies that Japan adopted would significantly influence the progress that could be made in reducing exchange market instability and reversing the trend to protection. He commended the authorities for their skillful management of the economy over the past year: real growth had been sustained at about 3 per cent; unemployment and inflation had been kept low; and the current account remained in substantial surplus.

However, although the economy had adjusted well, there had inevitably been a cost, Mr. Suraisry noted. Private investment, profits, and productivity had been affected adversely by the uncertain economic climate. The recent recovery of domestic demand remained fragile; and Japan's exports were subject to rising protectionist barriers. On the fiscal side, the authorities faced a dilemma in trying to reconcile the medium-term objective of eliminating deficit financing with the more immediate aim of restoring steady growth at a time of weakness in key domestic sectors. The authorities had shown commendable flexibility in the recent past, and similar flexibility might be required in the current year. There might be scope, as the staff suggested, for front-loading budgetary expenditures, an arrangement that could be reviewed and adjusted as necessary.

For the medium term, Mr. Suraisry stated, he would encourage the authorities in their efforts to reduce the central government deficit. Progress had already been made in limiting the growth of expenditure, and he hoped that the authorities would press ahead with plans for administrative reform. He also wondered whether anything could be done to improve the low elasticity of the tax system, which the staff said was one reason for the sizable revenue shortfall.

On the monetary side, Mr. Suraisry continued, the authorities had tried with some success to strike a balance between domestic and external considerations. The present fairly cautious stance seemed appropriate, at least until the recent strengthening of the yen had been confirmed.

Speaking on Japan's exchange rate, Mr. Suraisry noted the staff view that the low level of the yen against the U.S. dollar remained one of the most important problems in the international monetary system. Nevertheless, it might be as much a dollar problem as a yen problem, and he would be interested to hear the comments of Mr. Erb as well as those of Mr. Hirao. The Japanese authorities had made no secret of their view that the yen was undervalued and had given substantial support to the rate. Although the earlier depreciation had been partially reversed, further appreciation was clearly warranted, if only to lessen trade frictions.

Japan had a vital role to play in preserving the free trade system, Mr. Suraisry observed. He therefore welcomed the recent moves to reduce tariffs and to ease nontariff barriers. He hoped that those measures would be implemented quickly and effectively, and that doing so would lead to reciprocal action by Japan's trading partners. While much had been done to liberalize the import of manufactured goods, further advances could be made in removing the high level of protection on agricultural products, which caused considerable distortions in the domestic price structure.

Finally, Mr. Suraisry commended the steps taken by the authorities to open up the domestic money and capital markets to overseas participants, as well as to encourage private foreign investment. The removal of controls had made important new sources of financing available at a time when other avenues had closed. He also welcomed the increase in ODA in the new budget, and he hoped that the authorities would meet their target of doubling aid flows in 1981-85.

Mr. Jaafar commended the Japanese authorities for another remarkable year. Their performance was outstanding compared with that of many other countries during the same period. Another notable feature was their success in containing inflation. Price movements at under 3 per cent had been relatively stable over the past four years in succession, a remarkable achievement reflecting mainly the successful transformation of the Japanese economy since the first oil shock of 1973/74, when prices had been increasing at over 20 per cent per year. The Japanese authorities could no longer consider the need to combat inflationary price expectations as a main policy objective. Such a positive outcome should also be a source of satisfaction to other major industrial countries, which had been calling for more reliance by the Japanese on domestic demand and less on exports as the primary source of growth. The changes should also be gratifying to the Japanese authorities themselves, since they had been working to contain export expansion, which had been becoming a source of friction with other major trading partners. Nevertheless, Japan would certainly continue to gain market shares in the years ahead unless the other major economies underwent a process of structural adjustment leading to an improvement in their cost-price competitiveness. Measures calling for voluntary restraint in trade, which was contrary to the global objective of freer trade, could lead in the long run to inefficiency and misallocation of resources, while penalizing efficient producers unnecessarily.

The continued weakness of the yen despite Japan's improving current account surplus for the past two years was a reflection mainly of the uncertain conditions in the world economy, which had worked to strengthen the dollar vis-à-vis the yen, together with the lingering interest rate differential between Japan and the United States, Mr. Jaafar considered. The exchange rate intervention by the Japanese authorities to smooth out erratic fluctuations was in itself a useful task and should be encouraged, although it had become increasingly difficult for authorities to undertake such a role in view of the freedom of capital movements and the effect of expectations on the market. He was, however, rather concerned by the deliberate intervention of the authorities to prop up an excessively weak yen for a considerable period of time. If the value of the yen were artificially raised, the result would merely be to postpone the adjustment of less competitive industries in other countries, thus contributing to a worsening of the situation in the future. The weakness of the yen had largely been brought about by adverse performance elsewhere. For instance, fiscal imbalances in other major economies had led to the adoption of high interest rates, thus inducing capital movements out of Japan. Recent trends that had been working toward an elimination of those divergences should be encouraged.

He wished to draw particular attention to Mr. Hirao's remark regarding the need for an overall review of the structure of taxation, Mr. Jaafar went on. A move toward the 50:50 ratio from that of 70:30 between direct and indirect taxes should help to strengthen consumer demand by raising disposable income.

He was disturbed by the fact that the underlying forces generating aggregate demand, particularly private investment, appeared to remain sluggish, Mr. Jaafar stated. The authorities should be urged to relax their restrictive fiscal stance for FY 1983/84 in favor of a more expansionary policy. The long-term objective of reducing the government deficit was laudable and should be respected. Nevertheless, short-term considerations required more flexibility of the sort displayed in FY 1982/83. The pursuit of a more stimulatory stance was perhaps in order for FY 1983/84 in the light of the apparent slack in the economy. The authorities appeared to have more room for maneuver than they had had in previous years. There seemed to be some recovery in the world economy, particularly in the United States, and changes in the oil market should significantly contribute toward strengthening the yen. In particular, there ought to be substantial savings in the import bill, which should strengthen the expected current account surplus for FY 1983/84.

The authorities should take the opportunity further to liberalize imports, particularly those affecting the developing countries, Mr. Jaafar stated. He was glad to note that they had been working toward trade liberalization, and that Japan's tariffs on imports of industrial products had been among the lowest of any in the industrial world. Nevertheless, he would like to urge the adoption of a more liberal policy for agricultural imports, particularly for foodgrains such as rice, which continued to be protected. Finally, he commended the authorities for maintaining close economic cooperation with the surrounding area. He hoped that the relationship would continue, to the benefit of all parties.

Regarding the flow of official development assistance, Mr. Jaafar remarked that the authorities' intention to continue increasing the amount of resources devoted to ODA was laudable. They should be encouraged to continue raising the level of assistance until they reached the United Nations' target.

Speaking of Japan's long-term capital movements, Mr. Jaafar stated that such movements in the form both of direct investment and of loans had played important roles in the economic development of the less developed countries, and should be encouraged. For the less developed countries, direct investment would help both Japan and the host countries by satisfying the demand for capital resources and the transfer of technology to local industries as well as providing substantial employment. In Japan, direct outward investment would secure a source of income on satisfactory cost-price terms.

Mr. Mtei stated that he was in full agreement with the staff appraisal. There was no doubt that the Japanese authorities ought to be commended for the way in which they had managed the economy over the years. Their response to the adverse exogenous developments in the recent past had been admirable. It was particularly noteworthy that since the previous Executive Board discussion on the economy of Japan, the authorities had tried to conduct their policies in line with the hopes of the international community, recognizing the impact that they had on the rest of the world. Naturally, they understood that it was difficult to ensure symmetry between the evolution of the Japanese financial and monetary system and that of Japan's trading partners. Unduly high interest rates abroad must have contributed to the depreciation of the yen, for example. Similarly, massive current account surpluses in Japan's balance of payments had caused concern elsewhere.

Although the yen had started to appreciate vis-à-vis other major currencies in recent years, he was disturbed to note that the staff had stated that some 14 per cent of Japan's exports were subject to protectionist measures by importing countries, or so-called voluntary restraint. At home, although the staff had stated that Japan's tariffs on imported goods were among the lowest in the world, and that the authorities intended to eliminate them, there could be little doubt that the Japanese market was still comparatively confined. Nontariff barriers to trade should be dealt with in the same spirit as tariffs themselves.

He had been glad to see that, despite revenue shortfalls, the authorities in Japan intended to increase official development assistance by some 8 per cent in the coming year, Mr. Mtei concluded. Like Mr. Salehkhou, he hoped that the Japanese authorities would raise their ODA toward the UN target of 0.7 per cent of GNP per year. At present, Japan's contribution was less than one half of the average contribution by DAC members. In view of the excellent performance of the Japanese economy and the reliance of Japan on imports by low-income countries, he was sure that the authorities would take action along the lines that he had suggested. He would, however, also like to echo Mr. Salehkhou's concern regarding the geographical distribution of Japan's official development assistance.

Mr. Anson remarked that the economic performance of Japan since the previous Article IV consultation had indeed been impressive compared with that of other industrial countries. Moreover, he welcomed the steps taken by the Japanese authorities to meet the concerns expressed by the Executive Board rather more than a year previously.

The revival of domestic demand, particularly from the private sector, remained an important objective, Mr. Anson noted. Such a change should permit the economy to continue to expand without excessive dependence on the external sector. However, raising domestic demand would not be easy, and he was glad that, when it had failed to revive spontaneously in 1982, the authorities had taken the step of announcing in October 1982 a supplementary program of public spending.

The staff paper suggested, Mr. Anson stated, that the public sector as a whole could not contribute to the growth of the economy in the coming year. In view of the uncertain prospects for private activity, he shared the staff's concern that the fiscal stance for FY 1983/84 might prove somewhat too restrictive. The question arose, as the staff had noted, whether a rather larger growth target than 3.4 per cent should be envisaged. The news that consumer spending had recently proved to be rather stronger than expected was encouraging; he hoped that the trend would continue. Nevertheless, the authorities should be prepared to take what fiscal steps were needed to sustain the economic expansion if in fact it turned out that the growth of private sector activity alone was insufficient to do so.

He welcomed the authorities' acknowledgment of the need for a fiscal stimulus by their agreement to cut income tax, Mr. Anson stated. However, given the high savings ratio in Japan, he wondered how long it would take for such a move to be transformed into increased demand. The authorities had shown their ability to make swift adjustments in public expenditure, which would appear a more effective instrument to apply stimulus to domestic demand.

He was certainly not suggesting, Mr. Anson went on, that the authorities should abandon their goal of reducing the central government deficit over the medium term. But such a goal needed to be pursued gradually over time. In the meantime, it should be possible to finance budget deficits internally without straining the credit market, by tapping private savings, which, as mentioned by other speakers, seemed relatively high by comparison with flows in other major economies. He welcomed the replacement of annual targets for the reduction of the budget deficit by the new approach to fiscal reconstruction over the medium term.

When the authorities came to examine the tax structure, Mr. Anson remarked, they might also consider introducing a tax on services. A new expenditure tax of that sort might give the authorities greater scope for raising revenue to compensate for shortfalls in receipts.

Taking up the monetary policy of Japan, Mr. Anson remarked that the immediate problem was to revive domestic demand while encouraging investment. It was natural to wonder whether it would be appropriate to supplement any fiscal efforts with a somewhat stronger use of monetary policy. While sound monetary policy could secure favorable underlying conditions for a revival of activity, its potential as an active stimulant to the domestic economy was limited, as the staff had acknowledged in SM/83/36. In those circumstances, there appeared to be little advantage at present in aiming for easier credit conditions and lower interest rates. Indeed, the staff had suggested that the authorities might have experienced difficulty with their funding program during the summer of 1982, as institutions showed reluctance to invest in government debt at the comparatively low rates offered. Even though real interest rates were historically high in Japan, and comparatively higher than in other OECD economies, the authorities were right in refraining from a return to the expansionary monetary policy attempted at times during 1982. It was important that monetary policy should not inhibit the yen from reflecting the competitive strength of the economy.

Despite the strong appreciation of the yen from the low point of November 1982, it still seemed to be undervalued in the sense that Japan's relative unit labor costs were low in comparison with the levels of the past decade, Mr. Anson commented. In that respect, he would endorse the views of the staff that the low value of the yen against the dollar remained one of the most important problems in the international monetary system, and that a further strengthening of the yen remained appropriate.

He welcomed the staff's attention to capital flows in SM/83/36, Mr. Anson stated. Capital outflows resulting from portfolio adjustment by financial institutions following the abolition of exchange controls in 1980 had been another factor contributing to the weakness of the yen since that time. The authorities were to be congratulated on their restraint in not resorting to the emergency powers provided for under the Exchange Control Law. In particular, he was glad that they had permitted significant growth of external yen lending, through both credits and bonds, despite the weakness of the currency. The Japanese banks had played a most responsible role in maintaining support for international borrowers. He hoped that the limit set by the authorities on new lending in both yen and foreign currency would afford the banks sufficient room to continue playing an important part. Over the longer term, a greater internationalization of the yen should help to increase demand for the currency and offset some of the weakness caused by the initial capital outflows.

He welcomed the series of trade liberalization measures that the authorities had taken, and he endorsed the views expressed by the staff on that point, Mr. Anson stated. The market-opening measures announced during the past year were an encouraging sign, and he agreed with the staff that they should be implemented as a matter of urgency. Along with a more realistic valuation of the yen, such measures should not only facilitate imports into Japan, but should also help to reduce protectionist sentiment in other countries. He hoped that the authorities would also continue their work on dismantling nontariff trade barriers, and he wondered whether Mr. Hirao or the staff could offer any hope of further progress in that field during the coming year. While he had suggested that attention would continue to need to be given to policies affecting the exchange rate and the encouragement of domestic demand, he wished to underline the impressive achievements of the authorities and the flexibility that they had shown in the past year in the interests of the international community.

Mr. Malhotra said that he was in broad agreement with the thrust of the staff report. The performance of the Japanese economy had been remarkable in many ways, and the standard of management of the economy had been of a high order. His remarks would only be for the purpose of emphasis.

A number of speakers had raised the general point of whether the Japanese economy did not have room for a more expansionary policy, Mr. Malhotra noted. His own feeling was that the room for maneuver available to Japan was higher than that available to some other industrial economies: the rate of inflation had been low; the current account had been in nominal surplus; and the rate of savings remained high. Consequently, the latest stance of fiscal policy appeared rather too restrictionist. Several speakers had said that they hoped that the authorities would continue to approach the matter with the flexibility that they had displayed in 1982. His own view was that it would be proper to urge a rather more active role for fiscal policy in Japan. Similarly, while he could understand the dilemma facing the Japanese authorities in trying to strengthen the yen--something that implied maintaining interest rates in line with those in the United States and other industrial countries--he wondered whether the latest developments, especially in the oil market, would not improve the terms of trade for Japan so greatly as to allow it scope for reducing interest rates. There seemed to be scope for following more expansionary policies both on the fiscal side and on the monetary side.

As to official development assistance, Mr. Malhotra stated that he noted with satisfaction Mr. Hirao's observation that the Japanese authorities intended to double official development assistance over a period of years. In that connection, he would like to associate himself with the statements by Mr. Salehkhou, Mr. Tvedt, and others. For some years, the multilateral development institutions had been facing an extremely difficult situation. While he understood the difficulties arising from burden-sharing, there was surely scope for Japan to play a more active role in those institutions. Perhaps the Japanese authorities could play a major part in changing the current atmosphere of gloom that prevailed in multilateral agencies.

Japan had been extremely responsive to the concerns of its major trading partners, Mr. Malhotra considered; its attempts to strengthen the yen were one area where that concern was effectively reflected. Moreover, tariffs in Japan were low, and he welcomed the statement that the administrative procedures would be further simplified. While Japan had voluntarily agreed to restrict its exports to various countries, the development was in itself not at all healthy for the world trading system. It would be far better to recognize the competitiveness of Japanese industry. At the same time, there appeared to be legitimate concerns by other trading countries as to whether access to the Japanese market was properly open. Action to improve the situation could be taken in several fields: maintaining a proper exchange rate for the yen; allowing greater access to the domestic market in Japan; and the elimination of voluntary restraint by Japan's trading partners would all make a valuable contribution.

He would also encourage the Japanese authorities to give special encouragement to the access of manufactures from developing countries. He noted with satisfaction the changes that had been brought about in Japan's capital market: it had become much more outward looking, and the authorities had allowed foreign borrowers to raise capital in Tokyo. Nevertheless, he would suggest that the authorities should liberalize still further the access of developing countries to the capital market in Japan.

Mr. Pickering remarked that the quick response of the Japanese economy to the second oil shock was evidence of the ability of the authorities to overcome severe structural dislocations. They continued to be successful in maintaining a low rate of inflation, in the face of not only high inflation elsewhere but also the significant weakening of the yen, and the maintenance of low unemployment in the face of worldwide recession. Moreover, the current performance of the Japanese economy was even more striking when compared with that of other industrialized countries. He was in broad agreement with the staff appraisal and had only some minor points of emphasis.

On fiscal policy, Mr. Pickering went on, his view was that the introduction of major stimulatory measures of a discretionary kind at the present moment would be in the interest neither of Japan nor of a balanced world economic recovery. The authorities had already introduced some flexibility into their medium-term objectives in order to counter the weakness in domestic demand. Their statement that any further slippage in the fiscal deficit for 1982/83 would have raised concerns about the probable impact on financial markets and on interest rates showed that they had probably gone far enough. The 1983/84 budget appeared to be broadly appropriate, allowing as it did for some slight reduction in the Government's borrowing requirement. On balance he agreed with the staff that, to the extent possible, planned expenditure should be front-loaded so as to give a temporary boost to demand within the overall tight stance of fiscal policy. Mr. Hirao had said that efforts would have to be made to increase the efficiency of the allocation of government resources. He wondered, however, in view of the small size of the government sector in Japan relative to that in other industrial countries, whether the rewards would not be greater if the authorities made more effort to increase revenues as opposed to limiting expenditures further. For instance, the personal income tax had not been reformed in the past five years.

There seemed to be three areas of uncertainty in the overall fiscal stance, Mr. Pickering said. First, recent reports suggested that the authorities were considering income tax cuts. It was not clear how large a tax cut was planned, or whether it would be partly offset by other revenue measures or by expenditure cuts. Second, Appendix II in SM/83/17 contained the observation that the Central Government's accounts did not give an accurate picture of overall public sector investment. Furthermore, the staff appraisal only referred to central government deficit; however, the figures for the central government financial balances for 1982 and 1983 in the latest OECD papers on Japan suggested that concern over the size of the government deficit might be somewhat exaggerated. Third, in view of the recent OPEC announcement on oil prices, it seemed likely that the main benefits to Japan would be limited to an increase in the external current account surplus, although there might be other important benefits such as raising the level of potential output and giving the authorities some room for maneuver on the fiscal side.

On exchange rate policy, Mr. Pickering observed, although the staff made frequent mention of the detrimental impact of a weak yen on the Japanese economy, he had the impression that the effects of depreciation had been significantly reduced by the way in which inflationary expectations could be desensitized in the economy. There were many other factors to consider in examining the weakness of the yen during the past year, but one source of that weakness, particularly in the first half of 1982, appeared not to have been largely beyond the control of the authorities. The real interest rate differential for both short-term and long-term maturities had undoubtedly been a major factor contributing to the increase in net long-term capital outflows in 1982 as well as to the weakness of the yen. The sharp deterioration in the real interest rate differential might have been more quickly offset by a tightening of Japanese monetary policy. On balance, in view of the recent improvement in the yen, the current exchange rate policy would appear broadly appropriate.

From an international standpoint, Mr. Pickering went on, the large current account surplus might be viewed by some as constituting a potential problem. However, the counterpart of those large surpluses was a large net capital outflow. The capital exports, whether they were in the area of foreign direct investment, other long-term capital, or short-term capital, had provided an important source of financing for other countries. One notable example, as could be seen from Table XVIII in SM/83/17, was that the flow of financial resources from Japan to developing countries had increased significantly during the past few years.

Finally, commenting on the trade policies of Japan, Mr. Pickering urged the authorities to continue their efforts to open up the economy to international trade. Despite recent measures--such as improving the approval procedures and relaxing import restrictions on agricultural products--more needed to be done. On agricultural policies, as the staff had noted, the agricultural sector in Japan remained protected to a considerable extent; domestic wholesale prices had exceeded international prices by over 100 per cent for rice, soybeans, and butter. The policy of high domestic prices resulted in greater cost to the Japanese consumer and probably contributed to overproduction of those goods, thus increasing the balance of payments surplus.

Mr. Teijeiro commented that continuous economic growth even in a world where stagnation was the rule, the degree of price stability, and the structural adjustment following the oil shocks, all showed the success of Japanese economic management. The Japanese authorities certainly deserved commendation. His only comment would be on the question of protectionism. He welcomed the decision of the Japanese authorities to increase the degree of liberalization of imports for manufactured goods.

Without denigrating the importance of the steps already taken, he believed that a similar policy should be applied to agricultural products, for which in some cases the domestic prices were almost three times the international price. The agricultural sector was heavily protected through direct payments from the budget, import quotas managed by state trading companies, and import tariffs. In addition, Japan's food distribution system could be regarded as constituting another informal barrier. The particular treatment of the agricultural sector chosen by the authorities had led to a high degree of self-sufficiency for several products, though at high cost; it had also led to a situation in which the total income of farmers on average exceeded that of industrial workers.

He shared the staff view, Mr. Teijeiro went on, that, as one of the main beneficiaries of a free trade system, Japan ought to play a leading role in reversing the protectionist tendencies currently plaguing the world economy. Nor should action in that field be limited to areas where pressure from abroad could be strong, like restrictions on manufactured goods in other industrial countries; it should also apply to areas like the agricultural sector where the pressure might be relatively weak. As a leading country in the world economy, what Japan did with trade liberalization could have a crucial influence on the protectionist policies of most less developed countries.

Miss Le Lorier warmly commended the Japanese authorities for the skillful management of their economy and for the success that they had registered, both in achieving almost all their major goals and in taking into account the main preoccupations of the rest of the international community. She acknowledged the contribution made by the authorities' successful containment of inflation, the support of domestic demand, and the other actions taken to keep the current account surplus from becoming intolerable.

The particular case of the Japanese economy to some extent ran counter to the belief that improving the fundamental factors operating in an economy would be sufficient to bring about a recovery in investment, Miss Le Lorier observed. Japan was one of the rare countries that had achieved the much envied combination of growth, employment, a surplus in trade, and minimal inflation in present world economic conditions. Yet investment remained depressed. It could of course be argued that the desensitization of inflationary expectations was too recent or that the large fiscal deficit had impaired investors' confidence. On the other hand, she was by no means certain that the notion of inflationary expectations was of much relevance in the Japanese economy. Moreover, there was little evidence that the financing of the fiscal deficit had caused any difficulties in the markets: the weak prospects for the growth of domestic demand were perhaps a more satisfactory explanation for the path of investment. If so, the support that might be given through the fiscal deficit to domestic demand and to investment by small and medium-size enterprises in particular would appear fully appropriate.

It was important to take into account the time lag with which changes in oil prices could benefit domestic demand in Japan, Miss Le Lorier went on.

If the time lag was significant, it might be worth ascertaining to what extent some of the benefits for domestic demand might be brought forward by the use of the fiscal instrument. For instance, it had been suggested that the decline in oil prices could be used partly to alleviate the burden of direct taxation, while allowing for some increase in indirect taxes, and ending up with some fiscal stimulus. She would have been interested to hear the staff speak further on the sequence of effects that the change in oil prices might have on the growth potential of the Japanese economy in 1983 and 1984.

There was also the related difficult question of the relation of the exchange rate to changes in oil prices in Japan, Miss Le Lorier observed. She fully shared the difficulty of the Japanese authorities in understanding why the yen had failed so greatly to reflect the fundamentals of the Japanese economy. She commended the consistent manner in which the authorities had tried to smooth day-to-day fluctuations in the rate for the yen; the sums involved had been substantial. She could also agree with the authorities that coordinated intervention would probably have had a greater effect than isolated action. As part of the Fund's surveillance function, she wondered whether it might be appropriate to give further thought to the rather puzzling phenomenon of the yen's behavior by carrying out a detailed study, perhaps with the assistance of the Research Department. If that idea were adopted, it might be useful to give at least as much attention to developments in the capital account as to those in the current account of the balance of payments.

Whatever the real reasons for the unexpected weakness of the yen in most of 1982, Miss Le Lorier observed, the main pitfall that the Japanese authorities ought to try to avoid in 1983 was an insufficient absorption of domestic or foreign goods and services, which might well lead to the accumulation of such a large trade account surplus that the rest of the international community might not be prepared to accept it.

The use of fiscal policy appeared to be the main means by which the need to stimulate economic activity could be met without conflicting with external objectives, Miss Le Lorier considered. The apparent relaxation of the medium-term objective of eliminating the current account deficit seemed a welcome development; but it was doubtful whether the restrictive stance of fiscal policy for FY 1982/83 was equally commendable, especially as private demand might well be overestimated for two reasons. First, corporate profits, particularly in the sectors dependent on imports, were not expected to improve soon, a circumstance that would surely have a bearing on future investment. Second, wages--and therefore household consumption--might also suffer not only from the growing imbalance in the labor market, which, even if still low by international standards, was high by Japanese standards, but also from the trend in profits, which in Japan were a major key to wage increases because of the widespread use of the bonus system.

The overall public sector deficit was still moderate compared to savings in Japan, Miss Le Lorier stated. She therefore wondered what sort of contingency plans the authorities would like to consider if domestic demand did not come up to expectations, and if a restrictive stance of fiscal policy were no longer suitable. Apart from an eventual reduction in direct taxes, would it be conceivable, for instance, to allow an increase in social benefits, the overall social budget being still in surplus?

On monetary policy, she would support the recommendation made by Mr. Laske that the time between the adjustment of interest rates in Japan and a decline in interest rates abroad should be made as short as possible, Miss Le Lorier remarked. If it were not always feasible to make the domestic interest rates in Japan follow interest rates abroad for exchange rate reasons, there might be room in the interest rate structure to allow for a further decline in long-term interest rates while preserving the present level for short-term rates. Such an arrangement might have favorable effects on domestic demand, and more specifically on investment.

Finally, like other speakers, Miss Le Lorier said, she would strongly encourage the authorities to increase their efforts to provide official aid to developing countries. She also supported the staff in its belief that there was a need to continue the opening up of the Japanese economy by addressing the question of nontariff obstacles to imports, something that should be made easier by the reduction in the oil import bill.

The Deputy Director of the Asian Department remarked that a number of views had been expressed regarding the correctness of Japan's basic financial policies in the present circumstances. Mr. Tvedt had however specifically suggested that the staff was being too cautious, and two or three comments might be of value. First, the staff had thought that the Japanese authorities ought to adopt flexible policies that would allow them to be reasonably stimulatory because inflationary expectations were not a serious problem in Japan. Moreover, there was a certain amount of slack in the economy, so that it would be appropriate to consider bringing about some increase in demand. However, there were a number of constraints on the policy that could be adopted by the authorities. Monetary policy, for instance, was tied down by exchange rate considerations, and, in view of the importance attached by the staff to keeping the yen strong, the staff was unlikely to change its position on that point. On the budgetary side, over the medium term, some degree of concern regarding the budget position was appropriate. Thus, the staff considered that a policy of increasing the budget deficit for the purpose of stimulating demand to any great extent might be risky.

Considering the potential rate of growth of the economy also, the Deputy Director observed, the staff had been rather reluctant to come to the conclusion that it should recommend a more stimulatory role for fiscal policy. There could be no question that the potential rate of growth of the Japanese economy had declined sharply over the years from 10 per cent or so in the 1960s to somewhere between 3 per cent and 5 per cent. The factors responsible for the decline included a reduction in the rate of growth of the labor force and a lessening of the possibility of shifting labor from agriculture to industry. Then, Japan had caught up with the technology that it had previously imported from abroad, thus slowing down the rate of improvement, and the higher prices for energy had reduced the profit maximizing level of output. Moreover, there had been a shift in preference toward pollution control and other such objectives. Even with those explanations, however, it was difficult to make a precise judgment on the rate of growth at the present time. The Ministry of Finance had published an estimate of roughly 3 per cent.

In reply to Mr. Schneider, who had asked the staff to indicate the assumptions underlying the estimate, the Deputy Director explained that the growth of technology would provide something like 1 per cent; the growth of labor 0.6 per cent, and the growth of capital stock the remainder. The differences between the Ministry of Finance and other agencies of the Government, which believed that the potential rate was higher, were primarily related to differences regarding the contribution of technology. The staff did not have the expertise to come to a firm judgment in the matter. In consequence, the staff had considered it reasonable not to suggest a stimulatory financial policy for the purpose of raising the rate of growth if the potential rate of growth had indeed fallen to the conservative 3 per cent estimate.

Recalling that Mr. Erb had suggested that the staff should produce a more detailed framework for analyzing the problem of crowding-out, the Deputy Director remarked that, given the slack in the economy and taking the view that the question of crowding-out could be interpreted to mean whether the Government was consuming too many of the nation's resources, the staff's judgment would be that there was no great crowding-out. The mission's discussions with the authorities in Tokyo about the effect of government borrowing on the capital market had led to the same conclusions. While the table on page 53 of SM/83/17 certainly showed that there was a large volume of savings available for the private sector, it did not lead to any further conclusion because private investment itself was high. As to whether the Government's expenditure was the main factor responsible for the decline in private investment, the staff's judgment would be that it was not an important factor. Elsewhere in its paper the staff had given other reasons for believing that crowding-out was not a serious phenomenon in Japan at the present time.

Regarding the stimulatory package reported in the press during the past few weeks, the Deputy Director remarked, so far as the staff knew no action had yet been taken. For some time, there had been considerable discussion about reducing the discount rate as one element in the package. On that point, the Governor of the Bank of Japan had said firmly that unless the yen developed a firmer trend, he would be cautious about reducing the discount rate; the staff agreed with that view. Considerable discussion was also taking place in Japan about whether a tax reduction would be appropriate. The staff had no information as to the official position on that point. While in Japan, the staff had discussed the question of front-loading government expenditures; at the time of the mission, the authorities had considered that it was not yet opportune to announce such a course, especially as the new fiscal year had not yet begun.

In answer to Mr. Schneider's question regarding the possibility of reducing the special tax incentives for savings, the Deputy Director remarked that the point had been raised in 1981 because the Japanese tax system had provided greater incentives for savings than that of any other major country, and it had been thought that the high level of savings created pressure on the balance of payments. On the other hand, it was difficult to recommend, in a capital-poor and savings-poor world, that aggressive steps should be taken to reduce the rate of savings. While it might be possible to make a case that Japan was saving too much in the short run, that could hardly be claimed for the longer term. The Japanese population was rapidly aging. While the proportion of older people was currently lower than in other major countries, the proportion was growing more rapidly than had happened elsewhere. Such a trend would both increase the need for savings and reduce the savings ratio. There were also other factors--such as the slow growth of disposable income and the stability of prices--that would make the staff cautious in suggesting that specific action should be taken to reduce the rate of savings in the interests of bringing the balance of payments more into equilibrium.

A number of speakers had raised questions about the natural rate of unemployment in Japan, the Deputy Director recalled. Studies in Japan had indicated that the natural rate of unemployment had risen over the years from 1 per cent to 2 per cent. Not only had the changes in the structure of the economy increased frictional unemployment, but investment for labor saving purposes had risen as well. Mr. Feito and Mr. Laske had expressed surprise that the actual rate of unemployment was so low and had not increased despite the drop in the potential rate of growth of the economy. One way of answering the question might be to say that the definition of unemployment was different in Japan from that used elsewhere; if adjustments of definition were made, the Japanese rate of unemployment might seem noticeably higher. Second, for various historical and institutional reasons, Japanese enterprises intended to recruit labor aggressively and to retain their labor force even during periods of recession. There was therefore a considerable degree of what might be called hoarding of labor, with implications not only for the published figures of unemployment, but also for the profitability of enterprises, and hence for tax revenues. In summary, it was difficult to say what the natural rate of unemployment might be; published unemployment figures should be received with a good deal of caution.

As to the effect of the reduction in oil prices, the Deputy Director remarked that it would be difficult to be at all precise regarding the sequence of events. As far as the balance of payments was concerned, the staff had mentioned that the expected balance of payments surplus of Japan during 1983/84 had been estimated at about of $14 billion. Assuming an oil price decline of 10 per cent--since that had been the decline for the fourth quarter of 1982--an assumption of a fall of 8 per cent for the year as a whole would be reasonable. As the price elasticity of demand for oil was low, the net savings on the oil import bill might be some 6 per cent. The total oil import bill was about $50 billion, so that the net savings would be roughly $3 billion. Naturally, if world demand picked up as the result of the fall in oil prices, even though Japan's exports to Middle Eastern countries represented a larger proportion of total exports than did those of other industrial countries, and even if the price of raw materials rose somewhat, the overall impact of those factors would be relatively small, and it would be safe to stay with the estimate of $3 billion. Thus the estimate of Japan's current account surplus might be raised to $17 billion.

He would have expected the exchange rate for the yen to have risen sharply as a result of the decline in oil prices, but it had not done so, the Deputy Director remarked. Were the exchange rate in fact to rise appreciably, the immediate effect would be an improvement in the current account because of the J-curve effect; over the longer run, however, the strength of the current account would probably be dissipated. It was difficult to estimate the impact on the capital account; there had for instance been press reports about a reduction of Saudi Arabian investment in Japanese securities in the recent past. The impact on gross national product would probably be small. The model used by the Japanese Economic Planning Agency showed that with a 10 per cent decline in the price of oil, gross national product would increase by 0.23 per cent in the first year, and there would be some slackening of inflation. In the following year, gross national product might increase by perhaps 0.6 per cent. Naturally, what the policy response should be would depend on how permanent the change in the price of oil proved to be. The best course at the present time would probably be not to allow the decline in prices to pass through completely to the final consumer for fear of dissipating recent oil conservation efforts. The decline in the price of oil and the possibility of raising taxes further complicated the problem of demand management.

Regarding the rate for the yen vis-à-vis other currencies, the Deputy Director of the Asian Department recalled that in 1981, even when the yen had depreciated strongly against the dollar, it had remained strong against European currencies. That strength had been reflected in a particularly large fall in exports to Europe. In 1982, when the yen had depreciated against the U.S. dollar, it had depreciated against other currencies as well, but not to the same extent.

The staff representative from the Asian Department commented first on Mr. Erb's observation regarding the investment pattern in Japan and the capital/output ratio. The investment pattern had changed quite dramatically since the mid-1970s, with a far larger proportion of domestic private investment going to what was called rationalization investment, meaning investment for energy saving and labor saving, and a smaller proportion going for capacity expansion. The shift could be called structural; implicit in it was a change in the capital/output ratio.

As to the funding of government debt--a point raised by Mr. Erb--the staff representative remarked that there had been dramatic changes in the financial markets in Japan, coincident with a large increase in the government deficit and the expansion of outstanding public debt. In the past 18 months, for instance, the interest rates on government debt issues had risen faster than on some categories of private domestic debt, indicating that an alignment of the interest rates on government securities was taking place in the market rather rapidly. One of the main causes was the modification of the syndicate mechanism through which public debt in Japan had typically been funded. Until recently, the commercial banks, through syndication, had taken a large share of all government bonds issued. More recently, because of the increased size of those issues, as well as the coincident development of other parts of the financial market, particularly the aggressive development of securities houses, a smaller proportion of government debt was being taken up by the commercial banks.

While there had been other technical changes in the financial markets, in two instances during the past 12 months the syndicated banks had, for all practical purposes, rejected overtures from the Ministry of Finance for particular issues at particular times, the staff representative recalled. In those cases, the authorities had found other ways of issuing those particular bonds. In one case, they had arranged a private issue with a higher rate of interest than had been proposed for the original issue to the commercial banks. In the second instance, in February 1983, the authorities had arranged a 15-year bond issue, which had been sold primarily to insurance companies and other nonbank financial institutions. The 15-year bond issue was not indicative of a permanent change in the range of maturities offered on government bonds; it had been viewed in Japan as an additional possibility because of the temporary difficulty encountered in marketing regular maturities through the syndicate system. His conclusion was that government bond rates were in fact aligned reasonably well with rates for other securities in Japan. The staff had no indication as to what the Government's intention might be about issuing yen-denominated bonds overseas.

On the question of whether it would be possible or reasonable to introduce lower long-term interest rates for domestic purposes while raising short-term interest rates, the staff representative remarked that neither the staff nor the authorities believed that there would be much scope for such a maneuver. It had been tried by a number of other countries in the 1960s but had not been particularly successful. The Japanese authorities appeared to have attempted such a maneuver in April 1982, when short-term market interest rates had been raised through operations by the Bank of Japan while some long-term rates had been borrowed; for, within less than two months, the full increase in short-term interest rates had been arbitraged through to the long-term rates. The experience suggested that there was little opportunity for twisting the yield curve in that maneuver, something that would require a segmentation of the markets.

Regarding the decline in oil prices, the staff representative from the Asian Department commented that evidence obtained from simulations and other exercises suggested that it would take comparatively long for the effects to show in the domestic economy. The simulations by the Economic Planning Agency, which allowed for the effect on the exchange rate, suggested that in the first year, gross national product might rise by 0.25 per cent and in the second year by 0.6 per cent or 0.7 per cent. The change in the exchange rate itself might be assumed to have a relatively rapid but rather small impact on imports, if only because the size of the exchange rate change was bound to be comparatively small: a 10 per cent decline in the price of oil might affect the effective exchange rate for the yen by about 4 per cent. The pass-through effect on exports could be expected to be rather slower. The lags on export adjustments to exchange rate changes were fairly long in Japan, experience showing that four or five quarters elapsed before any major impact was passed through. Consequently, during the first year, the J-curve effect could be expected to dominate in Japan's current account.

The Deputy Director of the Exchange and Trade Relations Department recalled that Mr. Zhang had asked that the Board should have an opportunity to consider the prospects of the industrial countries in a coordinated fashion. As could be seen from the Managing Director's statement on the work program, the Research Department together with the area departments would be preparing two papers: one of those, updating the World Economic Outlook, would be available in April 1983; a main issues paper, more policy-oriented, would be issued later.

Mr. Hirao observed that more speakers had concentrated on fiscal policy than on other aspects of Japanese economic life. His authorities were worried about the persistent deficits in current expenditures. They naturally wished to bring about a balance in current outlays in due course. The main question, the one put by Mr. Feito, therefore concerned the best timing for reaching that objective. He recalled that in the early 1970s, when there had been an increase in the size of the Government, a campaign had been launched to prevent the Government from growing rapidly. The need to maintain flexibility in the fiscal position had been stressed, the purpose being to avoid jeopardizing fiscal balance 10 years later. Ten years had passed, and the large government deficit certainly constituted a constraint on the use of fiscal policy. Consequently, it was evident that policy planners should be vigilant in maintaining flexibility, not only for the current year but also for future years. Short-lived stimulatory policy should be weighed with great caution against the risk of creating adverse conditions for the economy later. Three other points might be relevant: first, rapidly increasing debt service had already narrowed the scope for discretionary measures; second, easy deficit financing allowed for an expansion of budgetary expenditure, leading to a misallocation of resources; third, large government bond issues had weakened the smooth functioning of the capital market.

Taking up the crowding-out issue, Mr. Hirao remarked that it was difficult to say whether there had in fact been any crowding-out. There had been no serious problems in financing private investment so far. However, because of the heavy pressure of large government bond issues, there had been a number of occasions on which possible foreign borrowers on the Tokyo capital market had canceled their placement because the terms offered by underwriters had been unsatisfactory. For the 1983/84 budget, the authorities had taken great care not to withdraw any stimulus, while remaining within the overall budgetary constraint. Public works expenditures were to remain at the level of the previous fiscal year, but public works spending had been selected with a view to its contribution to growth. For instance, public works for which land acquisition had already been made were given priority consideration. On balance, the budget for fiscal year 1983/84 could be viewed as neutral to growth. However, the budget would be seen to be well balanced in terms both of the current year's needs and of flexibility for future years.

Regarding the monetary policy of Japan, Mr. Hirao commented that the staff had made it clear that there was little room for maneuver in the present circumstances, in which the authorities were mainly concerned with the rate for the yen. The real interest rate was high, and some business circles frequently demanded reduction. If policy decisions were based wholly on domestic considerations, clearly it would be desirable at certain times to lower interest rates to help the economy pick up. However, because of exchange rate considerations, his authorities had been taking a cautious approach to monetary policy. Nevertheless, at the proper time they would seek to lower the official discount rate if they were assured that the strengthening trend for the yen was well established.

Speakers had inquired whether aggregate output could be increased beyond 3.4 per cent per year with the policy stance that he had described, Mr. Hirao recalled. He had already listed a number of favorable factors contributing to the autonomous expansion of the economy. The largest item in domestic demand was private consumption, for which the increase in real terms had been low both in FY 1980/81 and in FY 1981/82 despite relatively large increases in wages. By contrast, there had been a marked increase in private consumption during FY 1982/83, when wage increases had been relatively low. The implication was that price had been of special importance in strengthening private consumption. The recent survey of household expenditures, and the preliminary estimates of private consumption during October-December 1982, confirmed the trend, which was likely to continue throughout FY 1983/84, in company with stable prices.

Regarding plant and equipment investment, Mr. Hirao explained that surveys indicated that--despite recent downward revisions of investment plans in some industries, including steel and oil refineries--business investment could be viewed as generally firm. In the past decade, the composition of investment had changed radically, reflecting the increased need for energy savings, labor savings, and replacement investment. Capacity expanding investment had been reduced from two thirds to one third of the total. Consequently, even with the high level of investment from 1978 through 1980, businesses did not feel that they had excessive capacity. Investment was sensitive to the profit situation. Hence, the prospects seemed encouraging, as corporate profits were expected to improve gradually during the course of FY 1983/84.

It was too soon to comment on the implementation of the budget, which had not yet been approved by the Diet, Mr. Hirao mentioned. Nevertheless, as suggested by the Prime Minister in his response to the budget committee, his authorities would keep a close watch on changes in private economic activity, and would continue to implement the budget flexibly.

Taking up the question of the composition of tax revenue, Mr. Hirao indicated that the Japanese authorities were giving priority to reviewing all budget expenditures in the hope of restoring fiscal balance before resorting to a tax increase. Meanwhile, arguments had been advanced in favor of introducing a new broad-based excise tax to increase the relative weight of indirect taxation. His authorities were not contemplating any concrete proposals at present but would continue to keep the suggestion under consideration.

Insofar as personal income taxes were concerned, Mr. Hirao explained that an informal agreement had been reached in February 1983 between the ruling party and the opposition parties. The understanding was that personal income tax would be reduced during FY 1983/84, but that no additional bond issues should be envisaged. The Government had had no part in the negotiations between the political parties, although it would try to conform to the agreement if the funds became available to cover the proposed tax cut in due course. His authorities had no plan for cutting taxes at the present time; they would nevertheless keep a watch on the trend of tax revenues during the next fiscal year.

The savings ratio in Japan was high by international standards, Mr. Hirao explained, but it would not be appropriate to consider reducing the present rate of savings to any specific rate, since there was still a need to promote business investment in view of the high capital investment ratio and the need to finance large continuing government deficits. In addition, a large volume of savings had been transferred abroad in the form of direct investment, official development assistance, and long-term capital outflows.

Regarding the relationship between the natural unemployment rate and the comparatively low growth rate, Mr. Hirao mentioned that during the 1960s, when growth rates had been high, the average unemployment rate in Japan had been between 1.1 per cent and 1.5 per cent; by comparison, the present rate was high. On the other hand, during the 1970s, marked structural changes had taken place in industry. More resources, including human resources, had shifted from secondary industry to tertiary industry. The newly expanding industries could certainly accommodate a relatively larger labor force, while the growth of productivity in tertiary industries was much lower than that in manufacturing industries. The combination of the low unemployment rate with the modest growth rate could probably be explained thereby.

A number of comments had been made on the exchange rate for the yen, Mr. Hirao recalled. His authorities took the view that interest rate differentials played an important role in determining exchange rates. While short-term differentials might have only a limited influence, if any, on the trend in exchange rates--because the bulk of short-term capital transactions were carried out on a covered basis--long-term interest rate differentials certainly had an important bearing on exchange rates. He was not in favor of introducing differentials between short-term and long-term interest rates as a means of strengthening the yen. The continued large net outflow of long-term capital in 1981 and the first three quarters of 1982 was undoubtedly one of the largest factors causing the weakening of the yen. Between 1980 and 1981, there had been an outflow equivalent to $12 billion, while another $10 billion at an annual rate had left the country in the first three quarters of 1982, largely because of long-term interest rate differentials. Naturally, his authorities realized that the relative importance of interest rate differentials in determining exchange rates did vary from time to time.

As to trade policy, Mr. Hirao recalled that his authorities believed that trade liberalization was essential as a means of improving the efficiency of the economy and assisting the international adjustment process. To illustrate the point that the Japanese market for manufactured goods was as open as those in other industrial countries, it was worth mentioning that a U.S.-based consulting firm had recently shown that the number of industrial products still subject to quantitative ceilings in Japan had been reduced to five, while those in other major industrial countries ranged from six to twenty-seven. Another study by a German economic institute had stated that only 3.1 per cent of Japanese imports of finished products were subject to nontariff barriers, while the corresponding figure for the European Communities was 5.4 per cent. Nevertheless, his authorities were continuing their efforts to liberalize the market further. For FY 1982/83, they had decided that import tariffs on 215 items were either to be eliminated or substantially reduced. A further tariff reduction was scheduled for FY 1983/84.

Replying to the comments about the possibility of issuing Japanese government bonds in overseas markets, Mr. Hirao observed that the argument that so doing would alleviate the difficulty in placing a large volume of bonds in the domestic market while serving to strengthen the yen was an interesting idea; but his authorities did not have any plans for floating government bonds in overseas markets. First, long-term interest rates were considerably higher abroad than in domestic markets; second, the yen could be strengthened by increasing sales of domestic bonds to nonresidents. Executive Directors might wish to note that the draft budget for FY 1983/84 did envisage an increase in the floating of government-guaranteed bonds in overseas markets. Regarding the appropriateness of using the deficit on the General Government Consolidated Account, rather than some other deficit, the staff had provided a useful analysis of the point in Appendix II of SM/83/17. Nevertheless, two other comments might be made: first, even if state and local governments and social security funds were consolidated with the central government account, the picture would not change significantly. The fiscal deficit would remain at roughly 4 per cent of gross national product for FY 1980/81. A modest surplus in the social security fund would have been more or less offset by deficits of the state and local governments. Second, policy issues were centered around the Central Government's fiscal position and were less associated with general government.

In conclusion, Mr. Hirao stated that he would convey the valuable comments that had been made to his authorities, who, he was certain, would find them helpful in formulating their policies.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/47 (3/11/83) and EBM/83/48 (3/18/83).

2. DISTRIBUTION OF TWO EXTERNAL DEBT PAPERS TO DEVELOPMENT COMMITTEE

The Executive Board approves the proposal set forth in EBD/83/58 (3/9/83) regarding the transmittal of documents to the Development Committee.

Adopted March 14, 1983

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/83/78 (3/11/83), EBAP/83/79 (3/14/83), and EBAP/83/80 (3/15/83) is approved.

APPROVED: August 23, 1983

LEO VAN HOUTVEN
Secretary