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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 82/18

3:00 p.m., February 17, 1982

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

Executive Directors	Alternate Executive Directors
	O. Kabbaj
	C. Taylor
	J. L. Feito, Temporary
	O. Üçer, Temporary
	P. D. Peroz, Temporary
R. D. Erb	T. A. Connors, Temporary
M. Finaish	T. Alhaimus
	S. R. Abiad, Temporary
T. Hirao	T. Yamashita
J. C. Iarezza	R. T. Salazar
	J. S. Mair, Temporary
	D. I. S. Shaw, Temporary
	G. Jauregui, Temporary
	V. Supinit
S. Kiingi	
	G. Winkelmann
G. Lovato	
	A. Alfidja
M. Narasimham	
	S. El-Khouri
J. J. Polak	T. de Vries
	S.-W. Kwon, Temporary
J. Sigurdsson	
Zhang Z.	Tai Q.

L. Van Houtven, Secretary
B. J. Owen, Assistant

Also Present

African Department: K. Yao. Asian Department: P. R. Narvekar, Deputy Director; A. Abadjis, J. T. Boorman, S. Kashiwagi, W. J. Mahler, S. M. Schadler. European Department: R. P. Hicks. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; M. Guitian, Z. Iqbal. Fiscal Affairs Department: V. Tanzi, Director. Legal Department: R. C. Effros, J. K. Oh. Middle Eastern Department: A. S. Shaalan, Director; A. K. El Selehdar, Deputy Director; S. H. Hitti, A. Kayoumy, M. C. Niebling, E. M. Taha, M. Yaqub. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: M. A. Janjua, K. V. Jännäri, F. A. Tourreilles, F. Yeo T. Y. Assistants to Executive Directors: H. Alaoui-Abdallaoui, E. M. Ainley, M. J. Callaghan, M. K. Diallo, A. Halevi, J. M. Jones, W. Moerke, V. K. S. Nair, Y. Okubo, D. V. Pritchett, M. Z. M. Qureshi, J. Reddy, J. Schuijer, H. Suzuki, J. F. Williams, A. A. Yousef.

1. JAPAN - 1981 ARTICLE IV CONSULTATION

The Executive Directors resumed from the previous meeting (EBM/82/17, 2/17/82) their consideration of the staff report for the 1981 Article IV consultation with Japan (SM/82/13, 1/18/82; and Sup. 1, 2/10/82). They also had before them a report on recent economic developments in Japan (SM/82/29, 2/5/82).

Mr. Abiad joined others in commending the Japanese authorities on the remarkable performance of the economy in 1981. Despite the difficult international economic environment, a reasonable rate of growth of real GDP had been achieved, and financial stability maintained.

The dilemma facing the Japanese authorities in the formulation of a balanced mix of domestic policies had been well identified in the staff report, Mr. Abiad continued. The staff's conclusion that fiscal policy should make a larger contribution to the growth of domestic demand seemed to be at some variance with the Fund's repeated calls for fiscal restraint and greater control of nominal demand in order to break inflationary expectations and to lay the groundwork for the recovery of sustainable economic growth. To a large extent, Japan's dilemma reflected the conflicting signals that it was receiving, a point mentioned during the discussion for the 1980 Article IV consultation. Japan was being requested to stimulate domestic demand--both for consumption and for investment--and at the same time to encourage the strengthening of the yen. It appeared from the staff papers that, in the Japanese context, the stimulation of domestic demand would require an additional fiscal stimulus, a further easing of monetary policy, and hence possibly lower interest rates. Given the prevailing level of high interest rates in a few industrial countries, the result would be a widening of interest rate differentials to Japan's disadvantage, and a weakening rather than a strengthening of the yen, which in turn could potentially lead to a greater rather than a smaller current account surplus.

It would be useful in that connection to know what policy prescriptions the staff had in mind for encouraging a further strengthening of the yen, Mr. Abiad continued. It seemed to him that while deliberate action to appreciate the yen might perhaps help to reduce the unevenness of external adjustment among industrial countries, it could also entail undesirable effects for the world economy at large. First, it would lead to a continued misallocation of resources arising in part from delays in restructuring the productive apparatus of some uncompetitive sectors in certain industrial countries. Second, it could result in higher import costs for many developing countries, which as a group accounted for almost 50 per cent of Japan's exports. Finally, it could also increase the cost of borrowing by developing countries in yen-denominated instruments.

The authorities' efforts to liberalize financial flows in the capital markets were praiseworthy, Mr. Abiad considered. Removal of remaining restrictions would permit greater participation by Japanese banks in international financing. While some regulation of the capital markets was required--as the authorities had indicated--in order to preserve the Government's ability to market its own bonds, it should not unduly hinder access to those markets. The Government's decision to increase its overseas development assistance expenditure by 11 per cent in the coming fiscal year, despite budgetary restraints, was welcome. However, he had taken note of Mr. Narasimham's observation that the ratio of Japan's development aid to GNP remained below both the average ratio for other OECD countries and the U.N.-recommended target of 0.7 per cent of GNP.

The Deputy Director of the Asian Department noted that one of several basic concerns of Executive Directors was that domestic demand--but not so much domestic output--had been growing slowly. Before considering the question of whether the stimulus to the economy should come from monetary or fiscal policy, it was necessary to establish that there was in fact room for stimulating the economy without provoking inflation. The staff had reached the difficult judgment that the risk of inflation was not great. The data on capacity utilization presented obvious difficulties. On a GNP basis, the utilization of capacity was probably high; however, taking the industrial sector alone, the situation would be somewhat different. Other indicators should also be considered, in particular the unemployment rate. The unemployment rate in Japan, which was low, especially by international standards, was nevertheless higher--at 2-2.5 per cent--than it had been during the 1970s, when the rate had been about 1.7 per cent. The existence of some slack could therefore be deduced, especially as it had been the practice in Japan for factories to adjust labor input, in response to slackening demand, not by discharging workers but by hoarding labor.

Above all, the ability of the authorities to bring inflation progressively under control had given their economic and financial policies credibility and had desensitized inflationary expectations, the Deputy Director said. Consequently, the staff had seen some scope for the authorities to achieve their objective of stimulating demand while placing less emphasis on the control of inflation. Of course, as Mr. Casey had said, the Japanese economy should be an anchor of stability in the world economy; but it could also perhaps be a catalyst for growth; many economies, particularly those of neighboring countries in Asia, had in fact benefited from Japanese economic growth.

In considering how to stimulate domestic demand and increase output, lessening at the same time the need for stimulus from the external sector, the Deputy Director observed that, because of the restraint on monetary policy imposed by exchange rate considerations, fiscal action was clearly indicated. It had not been an easy conclusion to draw because of the need to respect the sociopolitical objective of first reducing and then eliminating the fiscal deficit within a certain time. Nevertheless, given the slack in private demand, the staff had considered it desirable at the present stage to delay the timetable for achieving that objective--not to abandon the target, but to adjust the path by which it would be approached to the requirements of the domestic demand situation. At the time of the consultation discussions, the staff had foreseen a larger deficit than originally anticipated for the fiscal year ending on March 31, 1982: on the one hand, revenue would fall short of the original budget estimates due to slow growth, and, on the other, there would be some excess spending. As a minimum, it had been thought that the automatic stabilizers should be allowed to work, to the extent that the resulting larger budget deficit should not be offset by a reduction of expenditure or an increase in the tax effort. As the data in the staff report showed, the deficit for the current fiscal year would in fact be larger than had initially been projected in the budget.

For the coming fiscal year, the authorities had again planned a large reduction in the deficit, consistent with their long-run objective and based on the same desiderata; that approach, however, would clearly not give much support to domestic demand, the Deputy Director said. As to what the staff had specifically had in mind in advocating a slower reduction of the deficit, its position was generally neutral as between action on the tax side and action on the expenditure side. However, reducing expenditure at a somewhat slower pace might be preferable simply because tax cuts might leak partly into savings whereas a slower rate of decrease in expenditure would have a direct income effect and could also be designed to protect weak points of the economy.

In response to specific questions about fiscal policy, the Deputy Director noted that the Japanese authorities had over the years up to 1977 reduced tax rates in order to give the population the benefit of the growth in income, but that there was no tax indexation as such. More recently, the creep into higher tax brackets had had the effect of reducing disposable income and thereby restraining consumer demand. The staff had therefore seen some advantage in eliminating such fiscal drag, while drawing attention to the view of the Japanese authorities that their avoidance of indexation as such had probably been an important element in the successful performance of the economy over the years. It was the need for a larger fiscal deficit to stimulate domestic demand in the short run, rather than the disincentive effects of higher rates of income tax on savings, investment, or growth that underlay the staff view on the tax bracket creep.

On balance, the Deputy Director continued, fiscal policy and the deficits of the previous three or four years had supported aggregate demand, and there was at present no clear indication of any crowding out of private investment. Interest rates in real terms had increased sharply in 1979/80, more dramatically so at the short-term end than at the long-term end. The savings rate in Japan was also far higher than in other industrial countries, so that even though the Government used a larger proportion of total savings, a substantial amount of savings--both in absolute terms and as a percentage of GNP--was available for private investment. While the ratio of private investment to GNP had been falling in recent years, it was not clear that that could be attributed primarily to the increase in interest rates. Various other factors were at work, including many uncertainties in both the international and the domestic situation. There were the large oil price increases, the high volatility of exchange rates, and, yet another relevant factor, the marked change in the distribution of wages and profits in Japan over the previous 15 years or so. The proportion of wages in total income had risen by 12-15 per cent to a total of 50 per cent, and the share of profits had fallen accordingly.

The comparison of ratios of central government deficits to national savings in the footnote on page 46 of SM/82/29 was perhaps misleading, the Deputy Director commented, because the data showed the central government deficit as a proportion of gross savings, net savings figures being absent. It might be worth noting, however, that if the ratio of the central government deficit to household savings alone was considered, it would be about 36 per cent, compared to about 47 per cent in the United States.

As for the suggestion that taxes should be raised and the additional revenue used for social security expenditures, the Deputy Director observed first, that it was no longer true that social security coverage was less broad in Japan than in other countries, a factor that had been partly responsible for the high savings rate. At present, the Japanese population was somewhat younger than in other industrial countries, there being fewer people over the age of 65; however, that situation would change dramatically in the coming years. A second more general point was that a policy of simultaneously increasing taxes and certain expenditures was not compatible with present Japanese social, political, and economic objectives.

The question whether it was necessary to continue to encourage savings through the tax system had been raised by the staff, the Deputy Director continued, because there was obviously a surplus of savings over domestic private investment. The staff's tentative view had been that the tax system should be neutral as between savings and expenditure, and not give special incentives to savings. It was not the intention of the staff, in a medium-term context, to put forth any ideas about reducing the present rate of savings to any specific rate. Indeed, it was difficult in a capital-hungry world to talk about reducing savings in the economy; it would be much better to divert savings, to the extent that they could not be absorbed efficiently in Japan, to specific countries in the rest of the world where they could be used efficiently. Furthermore, any hypothesis about the future rate of savings would depend upon the extent to which the world was prepared to absorb those savings by using them efficiently, in the sense also of being able to accept the current account surplus and the trade flows underlying it that were at present giving rise to restrictions and protectionism. Another factor would be the performance of private investment in Japan, which had been weak in recent years for a number of reasons. Profits, exchange rate volatility, general uncertainties in the world, or a reduction--due to several constraints--in the natural rate of growth of the Japanese economy, given several constraints, might all have something to do with the weakening of private investment.

Referring to monetary policy, the Deputy Director of the Asian Department noted that a rate of monetary growth of 11 per cent for the coming fiscal year should not pose much of a problem if the official projections for the growth of output and price increases materialized. Although the growth of nominal incomes would be somewhat lower than 11 per cent, there was evidence of a decline in the velocity of money, as shown in Chart 14 SM/82/29. There was reason to believe that that trend might continue because there was some evidence of a tendency toward a rebuilding of financial assets. It was nevertheless necessary to bear in mind that the Japanese authorities had no target or projection for monetary aggregates, or for the expansion of M-2 and M-3, for the coming fiscal year or for any other period beyond the next quarter. A more important general consideration, however, was that the great flexibility and success of the Japanese authorities' financial policies should create confidence that monetary policy would not lead to excessive inflationary pressures.

From the point of view of increasing consumer demand, the Deputy Director remarked, it might seem attractive to consider a faster increase in wages for the next fiscal year because the moderate nominal wage increases over the past one or two years, together with other factors such as tax bracket creep and low social security payments, had kept real income stagnant. Another equally important aspect was whether or not the present profit situation would enable enterprises to bear the additional burden of wage increases. There was some evidence in the staff reports that profitability might improve, but not to such an extent as to suggest that business enterprises would be sufficiently strong or optimistic to enable them to sustain more than a limited wage increase. Of special concern were the smaller enterprises, and enterprises catering primarily to the domestic market, whose growth and profitability had been weak because of the lack of demand for their products. Negotiations on the next round of wage increases had already begun. Labor was asking for less than in the previous year, but so far more than employers were prepared to offer. The eventual outcome was uncertain.

Referring to commercial policy, and specifically to the protection of the agricultural sector, the Deputy Director observed that the authorities were constrained by political considerations from following an agricultural policy that would be economically efficient, from the point of view both of the world and of Japan itself. The Japanese agricultural sector was small but carried a disproportionate political weight for various reasons having to do with the electoral process and the organization of agriculture, which included powerful cooperatives that purchased all output and sold all inputs. Although agricultural protection had been reduced progressively over time, a hard core of restrictions remained on certain products (rice, citrus fruits, and beef). In the paragraph on page 14 of SM/82/13 to which reference had been made, the staff was alluding to the political realities stressed by the authorities. In its appraisal, by contrast, the staff had expressed the view that Japan, given the present strength of its economy generally and of its balance of payments position, ought to take the lead in liberalizing trade, especially in agricultural products.

Intervention in the exchange markets had not necessarily worked effectively in Japan or elsewhere in the past, the Deputy Director continued, although he would agree with much of what Mr. Polak had said. Despite fairly considerable intervention on the part of the Japanese authorities from late 1978 to early 1980, there had been no change in the basic tendency of the yen to depreciate during that period. At present, therefore, the Japanese authorities felt--probably correctly--that they could not by themselves intervene in the market to influence the trend of the rate. Even joint intervention might not, per se, help the authorities to offset the depreciating trend. It would no doubt be necessary to go much further with respect to other policy aspects in order to achieve an exchange rate structure that better reflected the real economic situation of the country and that was better related to trade flows. On the specific question of increases in reserves arising from interest earnings on reserves, the staff had not given more attention to the matter, because there was no general agreement on the use of such interest earnings for intervention in the market. To the extent, of course, that such an increase in reserves was allowed to take place in the present circumstances, it could be logically described as passive intervention in the wrong direction.

The present level of the exchange rate did seem to be giving rise to trade flows that were in turn leading to trade friction, the Deputy Director noted. The policy measures that could be taken to strengthen the yen would include, first, greater emphasis in the domestic financial policy mix on fiscal and less emphasis on monetary policy to stimulate domestic demand, thereby providing greater leeway on the monetary side to deal with exchange rate considerations. Second, the possibilities of coordinated international intervention could be explored. Third, more could be done to encourage capital inflows. In general, the Japanese authorities had recently opened up their capital markets significantly, not only to outflows--which of course did not have the desired effect at present--but also to inflows. To the extent that further inflows of capital could be encouraged, the yen would be strengthened. Of course, one could not be confident that any of those policies could have a sufficiently strong effect to counter the forces that were weakening the yen. Nevertheless, because of the great need to avoid exacerbating current severe protectionist pressures, the staff had departed from its usual practice of not making a policy recommendation--in the case of Japan, to bring about an appreciation of the yen--unless it could at the same time indicate how it could be implemented.

The staff was not in a position to comment on the possible use of the Lombard rate mechanism, the Deputy Director of the Asian Department noted. The Japanese authorities had announced that a special lending mechanism would be used if there was protracted depreciation of the yen arising from interest rate differentials. At the time of the staff mission, the yen had reached its highest rate since the beginning of 1981, ¥ 214/US$1, whereas at present it was at its lowest, ¥ 240/US$1. The potential use of that mechanism had therefore not been covered in depth during the consultation discussions. Moreover, in using the mechanism the objective of the authorities would have to be to raise the cost to commercial banks of loans from the Bank of Japan; however, the aggregate statistics available to the staff suggested that commercial bank borrowing from the Bank of Japan was at a very low level. In fact, 7 of the 13 large city banks were out of that market altogether. More generally, the question arose of how to separate the various interest rates as domestic money and capital markets had become integrated to a remarkable extent in Japan.

A staff representative from the Asian Department added that the impact of various measures relating to trade flows and imports into Japan was difficult to establish under current circumstances. Among the measures announced there was a foreign currency lending scheme, under which $500 million would be lent on special terms out of official reserves to importers. The effect on the net flow of imports was difficult to determine: if the full amount was used for imports that would not otherwise have come into the country, there would obviously be an addition to import flows; if the imports thus financed were in substitution for imports that would have been paid for as a result of purchases in the domestic market, there would be exchange rate effects and additional imports might be induced indirectly. Likewise, a program had been announced to increase crude oil stockpiles, by something on the order of 1.5 million kiloliters; at 1981 prices, the total cost would be approximately $340 million. The major additional measures concerned factors that other countries had brought to the attention of Japan concerning so-called nontariff barriers--customs and inspection procedures--and would affect primarily manufactured imports, which at present accounted for about 25 per cent of total Japanese imports.

As for the difference between the authorities' forecast of the demand for housing and the staff's somewhat more pessimistic view, the staff representative said that it was not quite clear what interest rate assumptions lay behind the authorities' own projections. The staff view was that interest rates could not be substantially reduced in the near future in Japan and, that as a result, relatively high or constant interest rates would preclude any new stimulus to the demand for housing. Likewise, there appeared to be no significant change in the structural factors that had tended to reduce housing demand over the previous several years, including extremely high and rapidly rising land prices in the cities--especially in Tokyo--and the rate of family formation. In addition, the reduction in public works expenditures in the budget might have an indirect negative impact, insofar as complementary social infrastructure would not be increasing as fast as in the past, and the supply of private housing might therefore be slowed down.

Several Executive Directors had mentioned the possibility of inverting the yield curve, the staff representative continued, by increasing short-term interest rates for exchange rate purposes while at the same time holding long-term rates, presumably at their current level or without much of an increase, so as not to weaken investment demand further. Previous attempts to twist the yield curve in other countries had been unsuccessful. In Japan, in present circumstances, it was doubtful whether the underlying conditions would permit such a course of action; it would have to be assumed that there was some segmentation of markets, so that short-term rates could in fact be increased without dragging long-term rates up as well. Unquestionably, in the previous year or two in Japan, there had been much wider swings in short-term interest rates than in long-term rates. The liberalization of domestic financial markets had integrated financial markets to a much greater extent than ever before, and the sympathetic movement of rates across the term structure was probably more likely to occur than it had in the past. The degree to which such an inversion of the yield curve would be successful would presumably depend upon the extent to which it would be acceptable to risk an increase in long-term interest rates and the consequent possibility of deleterious effects on domestic investment in an already weak situation.

Inflows of short-term capital had remained substantial in 1981, the staff representative noted, although they had fallen dramatically since the previous year. In 1980 total short-term capital inflows had been on the order of $13 billion, but in 1981, they had been almost halved to about $7 billion. Usually, the bulk of short-term inflows went into the Gensaki market, but in 1981 most of the net inflow had probably come from so-called impact loans, which were foreign currency loans for Japanese corporations and residents brought in through the banking system. That type of loan had doubled from $10 billion at the end of 1980 to about $20 billion at the end of 1981.

Mention had also been made of the impact of relative prices or the exchange rate on trade flows, the staff representative from the Asian Department recalled, and a specific question had been asked about the reason for the apparently rapid increase in manufactured imports into Japan over the previous several years. Imports of manufactures had increased significantly in 1978 and 1979, but had then fallen off. The elasticity of imports of manufactures with respect to relative price movements was quite significant; the appreciation of the yen during 1977 and 1978 had led to a rapid rate of increase in manufactured imports, which in general were the most responsive of all import categories to exchange rate and relative price movements. Other categories of imports, such as crude oil and raw materials, were more directly affected by the level of domestic activity. Similarly, the elasticity of exports to relative price movements was significant but with a rather substantial lag; thus, 75 per cent of the eventual impact on export volume of an exchange rate or relative price change would be felt only after about one year. The result was the J-curve effect, which could aggravate an imbalance in the current account at a time when the exchange rate might be moving in the proper direction.

The staff representative from the Exchange and Trade Relations Department referred to the view expressed by Mr. Hirao in his statement that invisible trade barriers did not fall within the realm of the Fund. That was of course true by a narrow interpretation of the Fund's jurisdiction. However, if the issue was viewed in the context of the Fund's role as an institution which, in its consideration of members' policies, was to foster the international process of adjustment, then such barriers would indeed be part of the business of the Fund, a point that had been forcefully made during the discussion of trade policy in the context of the previous review of the world economic outlook. At that time, Executive Directors had emphasized their desire that the Fund, in promoting international adjustment, should become more active in encouraging countries to reduce and to avoid recourse to restrictions; they had also called for the Fund to pay attention to trade policy in all its forms during the regular Article IV consultations with members.

Mr. Hirao said that he was grateful to the Executive Directors for their pertinent and useful observations and comments. The staff had covered almost all the questions that had been raised, and he would concentrate his own remarks mainly on policy-oriented issues.

A number of Executive Directors had made comments about Japan's growing current account surplus, Mr. Hirao continued. He would simply present the facts. First, a substantial reduction in the use of energy and raw materials had been one of the major elements turning the deficit into a surplus; the 10 per cent reduction in oil imports alone represented a shift of $6 billion. Second, the rate of growth in export volume had been declining steadily, from 13 per cent in the first quarter of 1981 down to 4 per cent in the last quarter. Third, as Mr. de Groote had noted, the rate of growth of exports to European countries had decelerated rapidly in 1981 compared with the previous year: after growing by 36 per cent in the first quarter and by 18 per cent in the second, it had fallen by 1.5 per cent in the third, and by 2.6 per cent in the last quarter, reflecting the strengthening of the yen against major European currencies in both 1980 and 1981 after the depreciation in 1979. Fourth, the volume of imports, other than of oil, had been steadily increasing since mid-1981.

Referring to policy issues, Mr. Hirao recalled that Mr. de Maulde and other Executive Directors had expressed the view that the growth rate of 5.2 per cent forecast for 1982/83 might be too optimistic. In particular, they had wondered whether domestic demand would be as strong as the authorities appeared to believe. The main differences between the staff forecasts and those of his authorities were in the estimates for private consumption and fixed investment, two of the most important elements. As to private consumption, his authorities projected a 3.9 per cent growth in real terms in the next fiscal year. There were several reasons to believe that a quickening in the recovery of private consumption would take place. First, there would be a pickup in production, due to the need to accumulate inventories, because inventory adjustment had been completed. Second, the profits position of business had been recovering markedly since the latter half of 1981. Third, those two factors, together with an increased level of fixed investment, would improve the employment situation. Fourth, employment income would increase as overtime earnings and bonus compensations increased. Fifth, the stability of the consumer price index would also strengthen the base for an increase in consumption.

Reference had been made by Mr. de Maulde to a vicious circle whereby, given the high rate of saving, low consumption led to low investment by small to medium-sized businesses, Mr. Hirao noted. In fact, the investment activities of those businesses in particular had remained sluggish during the current fiscal year, due to the slower than expected recovery in consumption, the slow recovery of profits, and the persistence of high real interest rates. However, indications were that business profits had recovered quite markedly in the latter half of 1981. The current profits of industries as a whole had dropped by 18 per cent in the first half of 1981 over the corresponding period of the previous year, but had increased by 25 per cent in the last half of 1981. Current profits in manufacturing industries had increased by 32 per cent, and in service industries by 13 per cent. The upturn in profits would contribute greatly to the firm recovery of investment activities, as Mr. Winkelmann had pointed out. In addition, the economy was in the upward part of a medium-term investment cycle of about ten years. The demand for investment remained strong, in pursuit of technological innovation and energy conservation. Furthermore, the expectation was that investment activity by small and medium-sized firms would pick up as the interest rate fell and profits recovered. Therefore, his authorities foresaw a strong autonomous recovery in 1982/83, as recognized by Mr. Casey and other Directors.

Continuing, Mr. Hirao remarked that Mr. Polak, Mr. Anson, and other Directors had asked whether fiscal policy--including the need to reduce fiscal deficits--could not be more flexible, given the high level of savings. As he had explained in his opening statement, Japan's fiscal deficit had been at an abnormally high level, and top priority was being given to reducing it in the budget for FY 1982/83, as in the past two fiscal years. Outstanding issues of national bonds would amount to about ¥ 93 trillion at the end of FY 1982/83, or about 33.5 per cent of the nominal GNP projected for FY 1982/83. That was a strikingly high percentage compared with the corresponding figures in the United States (27.6 per cent in FY 1980), in Germany (15.1 per cent in FY 1980), and in France (4 per cent in FY 1979). Japan's debt service payments for 1982/83 were in fact larger than total expenditures on public works.

To summarize all those adverse effects, Mr. Hirao recalled first that the rapidly growing cost of servicing debt had introduced an increasingly inflexible element in the budget, undermining the function of the proper allocation of resources. Second, painless deficit financing, unlike tax increases, would lead to an expansion of budgeted expenditures, leading to a misallocation of resources. Third, huge issues of government bonds could not continue for long without undermining the functioning of the capital market. In fact, in July and August 1981, the authorities had been forced to cancel a bond issue. At the present stage, there appeared to be no alternative but to attain the authorities' medium-term objective. As for the implementation of the FY 1982/83 budget, after its parliamentary approval, his authorities would keep a close watch on changes in private economic activity and would be ready to implement the budget flexibly.

In response to Mr. Polak's question about the reason for treating construction bonds and deficit-financing bonds differently, Mr. Hirao explained that whereas the former had their counterpart in real public assets, such as port facilities, with an estimated durable life of 60 years, the latter covered only the deficit on current expenditures.

The question had been raised by Mr. Nimatallah whether consideration should be given to reducing taxes to stimulate private consumption, Mr. Hirao observed. It should be noted, first, that the authorities projected a steady growth in private consumption for various reasons. Second, top priority was being given to the restoration of a sound fiscal position. Third, the personal income tax burden in Japan was relatively low by international standards. Therefore, no tax reduction was envisaged for FY 1982/83. It could be argued, however, that fixed tax brackets for a prolonged period would not be appropriate, and might cause a certain degree of fiscal drag. At the same time, it was imperative to eliminate deficit-financing bond issues by FY 1984/85. Therefore, any policy to reduce taxes in future would--appropriately--remain constrained by budget deficit considerations.

In addition, Mr. Hirao noted, Mr. de Groote had wondered whether an increase in taxes might not conceivably give greater scope for fiscal maneuver. Arguments had been advanced in favor of the introduction of new excise taxes. His authorities were not contemplating any concrete proposals at the present stage. The suggestion, however, would continue to be kept under consideration.

The question had also been raised whether, given the high level of savings, income tax incentives to personal savings were appropriate in present circumstances, Mr. Hirao continued. Because the nominal amount of tax-free savings for small savers had not been adjusted since 1974, the benefits in real terms had been substantially eroded in the past several years. The situation was expected to remain unchanged, and no reform was envisaged in that area, but it should be noted that legislation had already been passed to eliminate, in 1984/85, the option of taxing interest income separately.

Some reference had been made to the contribution by the foreign balance to the growth rate for FY 1980/81, Mr. Hirao commented. In FY 1982/83, the authorities projected that, out of an overall growth of 5.2 per cent, 4.1 per cent would be accounted for by higher aggregate domestic demand.

If the issue of external adjustment were to be addressed by asking what policy instrument would be most effective in correcting external imbalances, Mr. Hirao said, the answer would be that changes in the exchange rate were more effective by far. There was clear witness to that in the rapid adjustment of Japan's external balances in 1979 and 1980, following the appreciation of the yen in 1977 and early 1978. As he had said in his opening statement, the strengthening of the yen at that time had led to a desirable restructuring of industries, price stability, and improved profits for intermediate-goods industries. The most important and effective means of adjustment at the present time was again exchange rate change.

Many Directors had raised the question of how the yen was to be strengthened, Mr. Hirao recalled. First and foremost, the fundamental economic conditions would have to be improved. Among other conditions, price stability was the most important; during 1981, prices had stabilized and the external balance had improved. In addition, a number of other possibilities had been explored during the year in order to shore up the value of the yen. In that regard, he expressed gratitude to the monetary authorities of Saudi Arabia for support in strengthening the yen by their continued purchases of yen-denominated assets. But in spite of those developments and efforts, the yen had weakened against the U.S. dollar during the past year, and among the several factors cited were high interest rates abroad and unfavorable political developments.

In response to inquiries by Mr. Sigurdsson and others about his authorities' views on foreign exchange market intervention, Mr. Hirao went on, under the floating rate system, the exchange rate was primarily to be determined by market forces. The exchange rate policy of his authorities had been to operate under the Fund's guidelines, and that policy would continue. Active intervention in the market was effective and desirable in disorderly market conditions, although his authorities knew that it might not always be of sufficient strength. If such intervention were carried out in concert with the authorities of major currency countries, speculative forces in the market could be countered all the more effectively, not so much because of the magnitude of the actual intervention but because of the announcement effect of a determined effort by various monetary authorities in close cooperation, backed up by enormous resources sufficient to negate expectations of short-term profits. In his personal judgment, that sort of concerted intervention could be justified and would have to be pursued not only if the market were disrupted by the pressure of massive speculative forces with consequent wild fluctuations in exchange rates, but also if the market rate, under similar pressure, went far beyond the level that could be warranted by underlying economic conditions. In the latter case, concerted action could achieve its goal only if supportive measures to correct the underlying economic conditions had been put in place or at least were expected to be in place in the near term. The significance of securing such cooperation had certainly increased with the secular trend toward a multicurrency reserve system.

Many Directors had raised the question whether there was any effective means of adjusting exchange rates while the market was overwhelmingly dominated by large interest rate differentials, Mr. Hirao added. Admittedly, insofar as market perceptions were dominated by widening interest rate differentials and by the concern that those differentials would be further widened, there was little prospect for exchange rate adjustment. But as had been observed in the latter half of November 1981, even though interest rate differentials might remain large, any signs of their narrowing could break expectations that they would continue, bringing prospects of favorable exchange rate movements as the market turned its attention more toward the underlying economic conditions. Some Executive Directors had wondered if the special lending facility would be used to shore up the value of the yen. His authorities were keeping a constant and close watch on market developments and were prepared to use that facility if necessary.

Several Executive Directors had commented on the timing of the reduction in the official discount rate in December 1981, Mr. Hirao noted. Early in the month, the data then available for the third quarter of 1981 had shown a decline in aggregate domestic demand. There were strong voices pushing for stimulative policies. On the other hand, the exchange rate of the yen had been strengthening against the U.S. dollar toward the end of November, although there had been a certain degree of uncertainty in that respect at the beginning of December. No other policy options being available, the official discount rate had been reduced. An unofficial study had disclosed that the result would be additional growth of real GDP of 0.5 per cent in FY 1982/83, and a 0.7 per cent increase in fixed investment. Much attention had been focused on the effect that it would have of encouraging investment by medium and small-sized firms that relied heavily--by more than 60 per cent--on borrowed funds for investments.

Mr. Casey had inquired about the current trend in monetary aggregates, Mr. Hirao noted. The money supply in Japan had been increasing steadily, reaching an annual growth rate of about 10 per cent toward the end of 1981. The increase basically reflected the recovery--albeit slow--of domestic economic activity. As such, the authorities did not regard the current rate of growth in the money supply as being out of line, but they would continue to follow future developments in that area closely.

A further question by Mr. Casey concerned the higher estimates relating to residential investment in FY 1982/83 of the authorities compared with those of the staff, Mr. Hirao said. His authorities believed that the higher rate of growth in real disposable income and the stabilization of construction and house purchase costs were expected to provide a more favorable environment for residential investment. In addition, in order to help boost housing construction, some additional financial measures had been provided for in the Fiscal Investment and Loan Program for FY 1982/83. The Housing Financing Cooperation was expected to provide loans for the construction of 540,000 housing units; some relaxation of the conditions for such loans was also envisaged.

In response to Mr. Winkelmann's question about possible wage increases, Mr. Hirao observed that labor unions were asking for an increase of about 9 per cent, whereas business management was hoping to hold the increase down to less than 7.7 per cent, the average percentage increase in 1981. Most observers predicted that the wage increase settlement in 1982 would fall into the 6-7 per cent range. It could be argued that a higher wage increase would favor increased consumption; but the overall effect on the economy would be adverse because of the resulting squeeze on profits and slowdown in investment.

The easing of foreign access to domestic markets in Japan had been the subject of comments by Mr. Iarezza and other Executive Directors, Mr. Hirao recalled. While his authorities believed that the Japanese market for manufactures was as open as that of most other industrial countries, he shared Mr. Sigurdsson's view that his country, being the second largest economy with a strong competitive edge in some industrial sectors, should take the lead in promoting an open trading system. He was pleased to note that that perception was being more widely acknowledged by policymakers in Tokyo, as reflected in his Government's recent decision to accelerate the implementation of tariff cuts and also to further simplify customs procedures and modify testing standards, thus satisfying more than 70 per cent of the complaints received. It might be noted that the average tariff rate in Japan was the lowest among industrial countries. With respect to 22 of the agricultural commodities currently on the list subject to residual import restrictions, quotas had been substantially enlarged. He hoped that further progress would be made, although it would probably be gradual because of the important political considerations involved.

Views could differ as to whether or not interest earnings on foreign exchange reserves should be sold to the market to shore up the yen, Mr. Hirao considered, because it was his understanding that no major monetary authority made a practice of selling interest proceeds automatically to the market. Rather, decisions to intervene in the market should be made based on a careful analysis of various market forces and trends.

As to Japan's policies with respect to the internationalization of the yen, to which reference had been made by Mr. Sigurdsson, Mr. Hirao stated that his authorities were willing to accept wider use of the yen in international transactions as a natural consequence of the increasing share of the Japanese economy in world trade and payments. However, their caution about a rapid increase in the holding of yen by foreign monetary authorities stemmed from their concern that the growth of yen transactions in exchange markets might induce the switching of holdings of one currency to another, thus destabilizing international currency markets.

In conclusion, Mr. Hirao said that he had listened with interest to Mr. Casey's suggestion that Japan might increase its lending to the Fund. He could not anticipate the reaction of his authorities but he would certainly convey the suggestion to them in Tokyo.

The Chairman considered that the discussion had been extremely interesting, since it showed the difficulty of the Fund's surveillance function in present circumstances.

He had several remarks to offer, the Chairman added. The first concerned the rapidity with which a country's situation could change, and sometimes in an unforeseeable way. At the time of the 1980 Article IV consultation, the staff had been forecasting a $6 billion deficit in the current account of Japan's balance of payments, but in the report for the 1981 consultation it had revised that figure to forecast a

$6.5 billion surplus, a rapid shift. The thrust of the summing up of the discussion for the 1980 Article IV consultation had been to commend the Japanese authorities for accepting what had been considered a fairly sustainable current account deficit at that time and to welcome the strengthening of the yen. One year later, there was concern about the development of a large current account surplus and a weak yen.

Second, the Chairman remarked, although it had been generally stated that Japan faced a policy dilemma, it could be said that all countries had constantly to deal with dilemmas. Economic policies had to fluctuate, weighing greater moderation of inflation or of the behavior of prices on the one hand against more economic growth on the other. In Japan, however, the dilemma was not how to choose, in simple terms, between inflation and growth. The dilemma was that the relaxation of monetary policy, although possible in terms of anti-inflationary domestic targets, would conflict with external factors, particularly at a time of high international interest rates, and would have repercussions on the exchange rate.

His third remark, the Chairman added, was that in the rather inelastic exchange rate environment brought on by the present interest rate situation, each move that Japan made toward better price performance increased the competitive edge of Japanese exports, as long as the exchange rate did not appreciate, and the international adjustment problem was thereby compounded. In response to Mr. Erb, he would note that the high rate of personal savings as a percentage of disposable income in Japan explained why a more deficit-oriented fiscal policy would have less of a crowding-out effect than in other countries, such as the United States, where the personal savings rate was about 4.9 per cent compared with about 20 per cent in Japan. Thus, even if budget deficits absorbed a greater proportion of savings in Japan, enough resources were left to finance the private economy. The basic issue dealt with during the present discussion was that Japan, a major trading country with a high rate of savings and a good cost performance, was living in an environment of higher rates of inflation and lower savings rates. In the normal course of events, the increased competitiveness of Japanese products should be reflected in an appreciating exchange rate which, over time, and after all the J-curve effects had been felt, would correct the current account of the balance of payments. That was not happening for a number of reasons, as the staff had tried to explain. Meanwhile, in the absence of such a correction, the undervaluation of the Japanese currency was posing a problem and was increasing international commercial tensions and protectionist tendencies.

The variety of prescriptions, which were sometimes conflicting, and the many comments and questions posed by the Executive Directors, were also a good reflection of the complexities of the present international situation, the Chairman said. The inescapable conclusion was that an Article IV consultation with a country like Japan could not be, and had not been, conducted in isolation from the outside world, whereas it could be for a small country in which developments had no bearing on the international situation. Thus, the ideal approach to the Fund's surveillance function was one that would be integrated with the review of the world economic outlook.

Mr. Erb commented that one of the reasons why he had raised his question was to demonstrate--as the Deputy Director of the Asian Department had recognized--that assessing the consequences of a deficit, its implications for "crowding out," and its impact on overall demand was not easy, because several different factors had to be taken into account. He himself had not expressed a view as to whether the staff was right in urging the Japanese Government to follow a more expansionary policy. His judgment was probably closer to Mr. Casey's in that it was necessary to be careful in pressing a country in the direction of expansion if the country decided that as a matter of policy it would prefer not to take the risk.

The Chairman responded that the staff approach had in fact been cautious. An effort had been made to avoid giving the Japanese authorities the impression that their only course was to continue to record budget deficits. The approach had been rather to mention that, while the staff did not question at all the authorities' medium-term aim of restoring a balanced budget, it felt that in present circumstances, they could time its pursuit in a flexible way.

The Chairman then made the following summing up:

Executive Directors noted that against the background of the difficult conditions in the world economy, the performance of the Japanese economy in 1981 was commendable. Inflation was reduced with only a moderate increase in unemployment. However, since late 1979, domestic demand has remained weak. In particular, in the past year personal consumption has been weaker than expected, and, partly as a result of this, investment by small and medium-sized enterprises has become sluggish.

Directors noted the important role played by the moderate wage increases accepted by Japanese workers in the past two years in reducing inflation. However, now that the rate of price increases has slowed substantially, some Directors wondered if somewhat higher real wage increases might not be appropriate in order to help to stimulate consumer spending. Directors commended Japan for its rapid technological advance and successful structural adjustment policies which, in combination with energy conservation, had permitted a sharp reduction in energy use in relation to GNP, and had made a significant contribution toward stability in world oil markets. The energy conservation effort had been an important factor in the swing in the current account from a deficit of almost $11 billion in 1980 to a surplus of almost $5 billion in 1981.

Directors supported the gradual easing of monetary policy as inflation subsided. It was also felt that persistently high interest rates abroad had made it difficult for Japan to set domestic interest rates at levels more appropriate to the country's circumstances. However, a number of Directors said that an easy monetary policy and low interest rates were at present contributing little either to the needed strengthening of domestic demand or to the desired appreciation of the yen.

There was broad support for the medium-term objectives of fiscal policy, as reflected in the effort to curtail government expenditure and to reduce the budget deficit. However, some Directors noted that in the second half of the 1970s substantial increases in budget expenditure and deficits had made a significant contribution to economic growth and that their impact need not be adverse as long as domestic savings greatly exceeded private investment. In light of the weak domestic growth, the recent adjustment in the revised budget for 1981/82 to allow for a larger deficit than originally planned was regarded as appropriate. For fiscal 1982/83 many Directors advocated a more flexible stance in light of the continuing weakness of private domestic demand.

There was agreement on the desirability of a more rapid expansion of domestic demand and on the fact that the value of the yen, at least vis-à-vis the U.S. dollar, has not yet reflected the improvement in the underlying conditions of the Japanese economy. In connection with the latter, the view was expressed that coordinated intervention could play a useful role. The views put forward by the Japanese Executive Director on this issue in his opening statement and in his comments on the discussion are noteworthy. Directors expressed concern about the rapid shift from a current account deficit to a surplus and about the substantial improvement in the relative competitiveness of Japanese industry associated with the weak yen, a development which could aggravate already strong protectionist pressures in Japan's export markets.

Directors welcomed recent measures to reduce some tariffs and to ease nontariff barriers in an effort to enhance access of foreign firms to Japanese markets and urged the continuation of the process of liberalization of imports, including agricultural imports.

Japan's capital markets have played an increasingly important role in international finance, and particularly in recycling oil money to developing countries. Directors emphasized the desirability of further liberalization of those markets in order to make Japan's capital markets more attractive to foreign investors as well as to ensure an efficient transfer of the savings reflected in the current account surplus.

Executive Directors hoped that domestic demand would recover in 1982, as expected by the Japanese authorities, that inflation would be contained further, and that the current account surplus would remain moderate. While Directors were sympathetic to the effort to curtail the budget deficit in the medium term, many Directors wondered whether this objective would be appropriate if the expected autonomous recovery of domestic demand did not occur and if further relaxation of monetary conditions continued to be constrained by high interest rates abroad. Most Directors, thus, advocated some shift in the mix of fiscal and monetary policies, but a number of Directors added that the feasibility of such a shift would depend in part on the implementation of a more appropriate policy mix in other industrial countries. The view was also expressed in the Board that it would be appropriate to maintain the firm commitment to a rapid reduction of the budget deficit as a medium-term objective.

Several Executive Directors commended the Japanese authorities for the priority given to foreign aid expenditure in the new budget and the commitment to more than double official development assistance outlays in the five-year period commencing in FY 1981/82. However, it was also pointed out that official development assistance, as a percentage of GNP, remained below the average for developed countries. The substantial increase in direct foreign investment during the past year was also considered appropriate in light of the emerging current account surplus, and as a means for Japan to contribute effectively to industrial adjustment and development in other countries.

2. KUWAIT - 1981 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1981 Article IV consultation with Kuwait (SM/82/14, 1/19/82). They also had before them a report on recent economic developments in Kuwait (SM/82/25, 2/4/82).

The Deputy Director of the Middle Eastern Department said that two minor corrections should be made to the staff report. First, at the end of the first paragraph of Section 2 on fiscal policy on page 4, the reference should be to rising "direct and indirect" government subsidies. Second, at the top of page 6, the two types of ceilings to which consideration was being given were a higher--rather than a lower--ceiling on medium-term and long-term loans offered by nonbank financial institutions and a lower--rather than a higher--ceiling on short-term loans offered by commercial banks.

Mr. Finaish made the following statement:

The main focus of domestic economic policies in Kuwait in recent years has been the utilization of its enlarged financial resources derived from oil exports for strengthening and broadening the economy's productive base as well as raising the level of economic welfare of the people. The pursuit of these objectives entailed a substantial increase in public expenditures during the mid-1970s, resulting in high rates of growth in the non-oil sectors. However, the accompanying high rates of liquidity expansion contributed to a substantial intensification of inflationary pressures.

This led to a reorientation of financial policies toward greater restraint, beginning in 1978/79, with a view to bringing economic expansion more in line with growth in absorptive capacity. Policies in subsequent years have continued to emphasize the need for maintaining a reasonable level of financial stability in pursuit of the country's growth and welfare objectives.

In the oil sector, the country's financial requirements and the conservation objective have come to exercise an increasing influence on production policies, though market conditions and the needs of the international community remain important considerations. Since early 1980 the responsibility for the implementation of the country's petroleum policy has rested with the Kuwaiti Petroleum Corporation (KPC), which was established in January of that year, absorbing the various national companies handling the different segments of the petroleum industry. The functions of KPC include the marketing of both crude oil and refined products as well as the direction of state investments in the petroleum industry. An important objective of Kuwait's investment strategy is to increase the domestic value added of its petroleum exports. To this end, substantial investments have been made in oil refining and the production of petrochemicals. Based on the country's chief natural resource and generally requiring highly capital-intensive techniques of production, these industries are obvious choices for leading the process of industrial development in the country. The petrochemical industry has now started to move from fertilizers into more sophisticated products. Opportunities for investment in petroleum industry abroad are also being pursued. These include joint ventures in refining and petrochemicals, and investment in oil exploration, particularly in other developing countries.

In addition to the petroleum-based industries, some other types of manufacturing industries have also grown in varying degrees. Growth in services, a traditionally important area of the economy, and in sectors such as construction and transportation has further contributed to the diversification of the productive base. Recently, Kuwait's industrial development policy has undergone a shift of emphasis from rapid growth to improvements in productivity and capacity utilization. More selective criteria are currently being applied to proposals for the establishment of new industries.

The emphasis placed by the authorities on minimizing inflationary pressures and achieving a sustainable growth rate is reflected in the continuation of a relatively cautious fiscal policy. Net domestic expenditure of the Government increased by 14 per cent during 1980/81, which was about one third of the average rate of increase during 1974-77 and a little over one half of the increase during 1979/80. Reflecting the restrained fiscal stance, the real growth rate of non-oil GDP has been of the order of 5-6 per cent during 1979-81, as compared with the average rate of 13 per cent during 1974-77. The increase in government expenditure is expected to decelerate further during 1981/82, reflecting in part the authorities' intention to cut down waste and to give priority to the completion of ongoing projects while subjecting new ones to closer scrutiny.

Government development expenditure continued to be lower than budgeted during 1980/81. Part of this shortfall is attributed by the authorities to certain unavoidable delays in the allotment of land for projects and in the procurement of needed equipment. Part of the shortfall, however, was only apparent as it reflected the transfer of oil-related development expenditures to KPC, whose accounts are kept separate from the general budget. At the same time, the authorities have been taking measures to encourage greater private sector participation in the development process. These have included, among other things, the establishment of necessary socioeconomic infrastructure, facilitating an adequate flow of credit for productive investments and, in many cases, direct government participation in joint ventures with private concerns.

Since the Government's net domestic expenditure constitutes the main component of the growth of domestic liquidity, the lower rate of expansion of the former since 1978/79 is reflected in a lower average rate of growth of the latter over this period than in the preceding few years. Together with an easing of supply constraints, this was instrumental in keeping the rate of inflation during the period since 1978/79 within the range of 5-8 per cent, representing a considerable moderation of the inflationary pressures built up over the mid-1970s. Bank credit to the private sector has, however, assumed a greater role in domestic liquidity expansion over the last two years. Thus, while the increase in net domestic government expenditure slowed down further during 1980/81, domestic liquidity grew at about the same rate as during the previous year. A sizable proportion of bank credit to the private sector is believed to have gone into financing speculative activities, particularly in the domestic stock market. In order to restrict this, banks have been directed by the Central Bank to reduce the ratio of overdrafts to their total credit to 45 per cent by end-1981--down from a high level of about 80 per cent during 1979--with a corresponding increase in their term loans. Furthermore, a minimum cash reserve ratio of 3 per cent was introduced in mid-1980, thereby adding to the instruments of monetary control at the disposal of the Central Bank. On the other hand, the Bank has continued its policy of providing adequate liquidity to commercial banks through swaps and rediscount facilities in order to enable them to meet the credit requirements of productive activities. There are indications that these measures, supplemented by moral suasion and close supervision of commercial bank operations by the Central Bank, are beginning to achieve the desired results: private sector credit expansion slowed down in the third quarter of

1981 and there has been a substantial reduction in overdrafts as a proportion of total bank credit in favor of term loans; term loans increased from 29 per cent of total bank credit in 1979 to 45 per cent in September 1981. Another development that has helped to channel a greater proportion of financial resources to productive activities has been the increasing role that specialized financial institutions and investment companies have come to play in Kuwait's financial system. The overall financial system in the country itself has grown considerably since the mid-1970s.

With respect to interest rate policy, the authorities are of the view that the containment of inflation in recent years at relatively low levels, the stability in the value of the Kuwaiti dinar, and the desirability of ensuring an adequate supply of funds for private investment at a reasonable cost are important considerations to be taken into account when assessing the appropriateness of the level of interest rates in the country. They believe that, in view of these considerations, the present level of interest rates on domestic bank credit remains broadly appropriate. While the authorities recognize the significance of interest rate differentials as an influence on capital outflow, they feel that, given the large and volatile fluctuations that have taken place in major international financial markets over the last two years, rates in these markets may not necessarily serve as a correct guide for setting the level of interest rates in Kuwait. In such circumstances, in their view, it may be necessary to shield the domestic economy from the destabilizing effects of such fluctuations. Besides, as indicated above, some other measures have been taken to tighten credit extension for speculative purposes. But all this does not mean that the authorities have a rigid policy with respect to the level of interest rates. As mentioned in the staff report, the Central Bank is empowered to vary interest rate ceilings when it thinks that such a move is called for. As a matter of fact, consideration is already being given to introducing two types of interest rate ceilings on domestic bank credit, in place of the present single ceiling, as a step toward a more flexible interest rate policy. This change will involve placing a higher ceiling on medium-term to long-term loans--in order to encourage the banks to increase investment credits to the private sector--and a lower one on short-term loans.

As a surplus country, Kuwait continues to pursue responsible external financial policies helpful to the functioning of the international monetary system and the adjustment process. It has maintained a liberal trade and exchange system and has provided substantial financial assistance to other developing countries, with a wide geographic distribution. Aid flows to developing countries have averaged about 7-8 per cent of GNP in recent years. Moreover, the large number of expatriate workers in the country--about three fourths of the total labor force--has helped to strengthen the services account of the balance of payments of several developing countries. In addition, the authorities have followed a prudent policy with respect to management of the country's foreign assets, avoiding large and abrupt movements of funds in response to short-term changes in interest or exchange rates.

Finally, I wish to point out that the Kuwaiti authorities feel that that the preliminary figure for 1981 current account surplus given in the staff report may be significantly overestimated because the assumed price premia on total crude oil exports may be higher than actual, given the downward pressure on oil prices during the year. They also consider that the rate of recovery in oil production assumed for 1982 balance of payments projections could be too high.

Mr. El-Khouri observed that the Kuwaiti authorities had been following prudent domestic and international financial policies, for which they were to be commended. A notable sign of the success of their domestic policies had been the strong and steady performance of the economy in recent years, which was especially noteworthy, because there had sometimes been sharp fluctuations in exports and budget revenues. During the period 1979-81, the annual rate of growth of nonoil GDP had averaged about 6 per cent, while the annual average rate of inflation had been about 7 per cent. To achieve that strong and steady performance, the authorities had had to conduct both their supply and their demand management policies in a skillful manner. The supply policies involved the successful implementation of programs to expand infrastructure, to encourage private investment in construction, and to regulate the inflow of expatriate labor. In fiscal policy, budget expenditures had had to be adjusted to a fluctuating revenue base, while taking account of the productive requirements of the economy and the welfare of the population.

The Kuwaiti authorities faced the type of interest rate policy dilemma that his chair had referred to frequently in the past in discussions of the Executive Board, Mr. El-Khouri continued. The issue arose when there was pressure on a country to raise interest rates at home, not because the domestic economic situation warranted it, but because of high interest rates abroad. In Kuwait, domestic considerations dictated the need for relatively low interest rates, due to the low rate of inflation and the desire to increase private investment and promote growth. Higher interest rates abroad were resulting in a significant outflow of capital, making domestic capital scarce, and frustrating further the efforts to increase domestic investment. To cope with that situation, the authorities had taken a number of successful measures to reduce credit extension for financing speculative foreign investments. However, despite all the difficulties involved, the authorities were keeping an open mind on the question, and were considering some changes in their interest rate structure.

In terms of international financial policies, Mr. El-Khouri noted, the authorities had been managing their foreign assets in a prudent and responsible manner. They had also been providing sizable financial assistance to developing countries, about two thirds of which was in the form of grants. Official development assistance during the five-year period 1976-80 had amounted to about $6 billion, or approximately 7 per cent of GDP. It was a remarkable performance, and he hoped that it would serve as an example to rich industrial countries.

Mr. Alfidja noted that for several years the Kuwaiti economy had been performing well. After a period of expansionary fiscal policy and overheating of the economy, a sustainable and significant rate of growth had been promoted successfully by the authorities, while inflationary pressures had been contained at a remarkably low level by present standards. From 1977 to 1980, non-oil GDP at constant prices had increased by 6 per cent a year on average, and the cost of living index had recorded a 7 per cent annual increase. Those developments had resulted in a welcome broadening of the productive base of the economy together with a substantial improvement in the well-being of the population.

Through a sizable increase in net domestic expenditures and through its land purchase policy, Mr. Alfidja continued, the Government had removed the major infrastructure and supply bottlenecks that had hampered the smooth functioning of the economy. Economic diversification was under way, with the private sector playing an increased role. The Kuwaiti authorities were to be commended for that achievement. The absorptive capacity of the country however remained limited, a factor that, together with the social and political consequences of a liberal immigration policy, largely explained why the authorities were rightly reluctant to embark again on a more expansionary fiscal policy.

In the monetary field, Mr. Alfidja added, the measures taken by the Central Bank to restrain credit expansion that supported speculative activities, and the introduction of a minimum cash reserve ratio, were welcome. He shared the views expressed by Mr. Finaish and by Mr. El-Khouri on interest rate policy. A developing economy, even one as open and well endowed with natural resources as Kuwait, had to limit capital outflows at the same time, and ensure an adequate supply of funds for productive investment at a reasonable cost. He also agreed with the Kuwaiti authorities that the large and volatile fluctuations of interest rates prevailing in major international markets might not necessarily be the correct guide for setting the level of interest rates in Kuwait. However, the authorities were showing flexibility with respect to interest rate policy and should be encouraged to take any further steps they considered appropriate and consistent with the specific needs of their economy and with their well-known responsible attitude toward the international adjustment process and development assistance.

Mr. Taylor said that he could generally endorse the staff appraisal. It was clear from the staff report that economic policy in the past few years had been well conducted and that the economy was in good shape. Kuwait had a significant current account surplus and a stable real rate of growth of 5-6 per cent a year in the non-oil sector, and the authorities had successfully wound down what might have been excessive levels of activity and inflation. In recent years, they had had considerable success in expanding and diversifying the productive base in a manner consistent with domestic financial stability and the absorptive capacity of the economy. Oil revenues had been invested prudently and responsibly, and the level of official development assistance had been impressive.

In fact, Mr. Taylor observed, Kuwait's structural surplus seemed to have become rather firmly established. Investment income had grown in relation to oil receipts, and in 1981 represented over one third of current account earnings. In contrast, the share of oil receipts had fallen to just over one half. Income from investments was now significantly greater than the cost of imports and indeed was higher than current government expenditure. Even allowing for a possible reduction in international interest rates, a significant part of the current account surplus would apparently no longer be closely dependent on oil and oil-related export receipts. That trend might well continue, at least in the immediate future, Mr. Taylor remarked. The rate of growth of imports had declined markedly in 1981, due in part to the slowdown in development spending, which seemed unlikely to pick up again because most necessary infrastructure had been put in place and more emphasis was being put on improving productivity and the utilization of existing capacity.

The modest increase of 2 per cent in total budgetary expenditure in the 1981/82 budget suggested that the slowdown in import growth might not be reversed in the near future. Such a pattern of economic development seemed prudent; oil was after all an exhaustible resource. But the policy also raised questions of interest in the international context. Thought should perhaps be given in due course to the implications of such an established structural surplus on the part of an oil producer for the concept of adjusting away a current account surplus as opposed, say, to recycling it. He hoped that the forthcoming paper on economic policies of oil exporting countries would provide an opportunity to explore the interesting and important question of how to deal, in an international context, with the durable surpluses of those fortunate oil producers with economies that did not show a clear tendency to import on a scale that made full use of their revenues.

In that general connection, Mr. Taylor added, it might be interesting to consider the type of statistical information that was likely to be of particular help in analyzing the issue. He welcomed the improvement that had been made in Kuwait's data base, in particular the provision of revised national income data, in constant and in current prices. The staff had however pointed out that the coverage and timeliness of official statistics could be improved yet further, especially the trade and balance of payments figures. For instance, the summary of the balance of payments of Kuwait in Table 19 of SM/82/25 included a large figure for errors and omissions. It would also be useful if the omission from International Financial Statistics of data on the Government's holdings of foreign assets could be remedied, particularly as Kuwait's investment policies had an important impact on the world economy.

He could certainly endorse the moderately expansionary fiscal stance for the current financial year, Mr. Taylor continued. It took full account of the need to avoid a re-emergence of inflationary pressures and to maintain a stable, sustainable rate of growth in the non-oil sector. Although development spending had been substantially lower than budgeted in 1980/81, it was encouraging to note that the authorities were adopting a more selective approach to development and were also taking steps to tighten up administrative and planning procedures.

The Central Bank had made effective use of some of the monetary instruments available to control the growth of private credit, Mr. Taylor went on. The controls adopted on some kinds of private borrowing seemed sensible and necessary in the circumstances. But even more welcome was the move toward greater interest rate flexibility. The proposed introduction of differentiated lending ceilings could, as the staff suggested, be a step in the right direction and provide an incentive for nonfinancial intermediaries to step up longer-term investments. Operations in the Kuwaiti dinar bond market had recently become more active, while remaining carefully regulated, and he understood that some more recent issues had been set to yield a rate of over 10 per cent, or had carried coupons of about 10 per cent.

Despite his general observations about the broadly well-established position of Kuwait's current account surplus, Mr. Taylor said, the outlook for oil production and the balance of payments in 1982 might be slightly less favorable than it had been when the staff had held the consultation discussions with the Kuwaiti authorities. The recent cuts in oil prices and the general softening of the world oil market might allow Kuwait little scope to increase production from average levels of just over 1 million barrels a day in 1981 to the somewhat higher target to which the authorities had been looking forward. If the market weakened further, there might be greater pressure on oil producing countries to lower prices. Mr. Finaish had cast some doubt on the staff's estimate of the surplus in 1982; he shared the doubt. Without suggesting that there would be any problems on that score, or that the budget situation would be seriously affected, he noted that there might be grounds for raising what seemed to be rather low prices for oil products in the domestic market, which had been a factor behind the fairly rapid rise in domestic oil consumption. A modest adjustment in the authorities' energy pricing policy might be timely and would certainly be in line with their declared conservation strategy.

Mr. Shaw stated that his chair was in full agreement with the conclusions outlined in the staff appraisal, and in addition wished to congratulate the Kuwaiti authorities on their conservative and, it should be added, quite successful economic policies. The adoption of financial policies geared toward greater restraint in 1978-79 had prevented a rate of growth exceeding the absorptive capacity of the economy.

In short, Mr. Shaw continued, he personally admired the Kuwaiti authorities' prudent management and allocation of both domestic and external resources. A notable policy initiative in that area was the financing of oil exploration in developing countries by the Kuwait Petroleum Company. Canada was making a beginning in the same direction through its national oil company, Petro-Can, and could perhaps learn from the experience of the Kuwaiti authorities. Kuwait might perhaps also consider loans to the Fund to be prudent investment.

The economic prudence of the authorities was also demonstrated by the deceleration of government expenditure levels forecast for 1981/82, Mr. Shaw noted, in general line with the reduction in revenues resulting from lower production levels and lower prices for oil. In that respect, he sought further clarification from the staff of the indication given by Mr. Finaish at the end of his statement that estimates of oil production in 1981 might be too high. His authorities also believed that an average level of output of 1.14 billion barrels a day might be on the high side, based on reports in the press during the latter part of 1981.

A further reason for congratulating the Kuwaiti authorities, Mr. Shaw added, was their encouragement of greater private sector participation in the development process, particularly in the establishment of the socioeconomic infrastructure, as outlined in Mr. Finaish's statement. That was yet another illustration of the cautious and conservative fiscal stance of the authorities.

On monetary policy, Mr. Shaw said, the lower rate of expansion of monetary aggregates since 1978/79, along with the easing of supply constraints, had kept the rate of inflation at 8 per cent in 1980. With respect to interest rates, he had been encouraged by Mr. Finaish's comment that the authorities were considering the introduction of two types of interest rate ceilings, which would correct the imbalance that an inverse yield curve had produced in Kuwaiti domestic capital markets.

Referring to the external sector, Mr. Shaw joined Mr. Taylor in drawing attention to the large figure for errors and omissions in Table 19 of SM/82/25. The figure had risen over the past few years and was estimated to reach KD 1 billion in 1981, which at the current rate of exchange was $3.5 billion. In fact, errors and omissions accounted for over 20 per cent of the current account surplus. He asked the staff whether it could identify the reason for the large size of that item in the balance of payments. Was it connected with the relatively low interest rates prevailing in the domestic market in Kuwait? The problem might possibly be due only to the lack of timely statistics. In that respect, he noted that the Central Bank and the Ministry of Finance and Planning had made some progress in improving the economic and financial data base.

Mr. Kabbaj considered that the main feature of Kuwait's economic policy since 1977 was the considerable caution of the authorities in managing the substantial resources that they drew from oil. Indeed, the development policy adopted in the aftermath of the first surge of oil prices in 1973 had resulted in a high inflation rate and considerable monetary expansion. The authorities had subsequently had to reorient economic policy toward a slower paced development effort and the maintenance of domestic financial stability. The results had been encouraging; domestic liquidity expansion had been reduced by one third, and inflationary pressures had moderated considerably.

Appropriately, Mr. Kabbaj continued, another aim of economic policy in Kuwait was moderate growth in the non-oil sector, despite the availability of considerable financial resources for investment. That policy had its origin partly in the imbalances experienced between 1974 and 1977 and partly to the limited absorptive capacity of the economy. The new caution prevailing in the management of public expenditures had not however prevented the authorities from continuing to implement their original program, aimed at broadening the productive base of the economy and strengthening the development of a welfare state.

In connection more specifically with the 1981 Article IV consultation, Mr. Kabbaj went on, the Kuwaiti authorities should be commended for their moderate objectives and for the measures taken in order to restrain the expansion of credit by commercial banks by reducing the ratio of overdrafts to total credit from 80 per cent to 45 per cent, and by introducing a minimum cash ratio of 3 per cent. Like the staff, he believed that the variation of that ratio could potentially become an effective monetary policy instrument. However, he wondered whether the 3 per cent level was too low to have any impact on the expansion of commercial bank credit. He would also be interested in learning from the staff how effective the legal interest rate ceiling on domestic credit extended in Kuwaiti dinars had been since its adoption.

Referring to the last sentence of Mr. Finaish's opening statement, Mr. Kabbaj asked why there was disagreement between the staff and the Kuwaiti authorities on the oil production figures and, more specifically, why, as indicated in footnote 2 to Appendix II of SM/82/14, the staff was using press reports to estimate oil production--the main component of Kuwait's economy--for nine months of the year. Finally, he commended the Kuwaiti authorities for pursuing responsible external financial policies, and particularly for their substantial assistance to developing countries, to which they dedicated the equivalent of 7-8 per cent of the country's GNP.

Mr. Narasimham joined other Directors in commending the Kuwaiti authorities for the prudent way in which they had managed their economy and for the success that had attended their efforts at diversifying its structural base. The development of petroleum-based industry, with high added value, and the emphasis on improvements in productive and capacity utilization were clearly steps in the right direction.

Some of the more interesting parts of the staff report and the report on recent economic developments concerned the discussion on monetary policy and monetary instruments, Mr. Narasimham considered. It would be useful to learn more from the staff about the experience of the Kuwaiti authorities with their understandable objective of insulating the domestic economy and interest rate structure from the destabilizing effects of volatile interest rates abroad. While he could appreciate its significance for credit control, he wondered what impact the proposed introduction of the two-tier ceilings on interest rates would have on that objective.

Reference had been made to the commendable external assistance record of Kuwait, Mr. Narasimham remarked, both in relation to quantity and quality. Kuwait's overseas development assistance amounted to 7-8 per cent of its GDP, providing an example that should inspire developed countries. The openness of Kuwaiti markets and the presence of a large expatriate work force had also benefited the trade and service accounts of several neighboring developing countries. Altogether, those developments constituted a set of helpful and responsible external sector policies.

Mr. Connors said that his chair supported the analysis in the staff appraisal, and congratulated the Kuwaiti authorities for their good management of the economy. As Mr. Taylor had remarked, further improvement in the collection and provision of more complete financial data would be desirable.

The Deputy Director of the Middle Eastern Department, referring to the last paragraph in Mr. Finaish's opening statement, said that the staff certainly agreed that the balance of payments estimates in the staff report did appear, in light of the developments in oil markets in the previous four months or so, to be overstating the current account surplus in 1981 and, more important, in 1982. When the consultation discussions had taken place, neither the authorities nor the Fund staff members, who had worked together on those estimates, had had the benefit of knowledge about developments in the last quarter of 1981. On the basis of data that had since become available, it was clear that the volume of oil exports in 1981 would be lower than indicated in the staff report; mainly for that reason, updated balance of payments estimates would probably show a reduction of about $500-600 million in the current account surplus. The matter was of even more importance in relation to the balance of payments outcome for 1982. For a country that depended so highly on oil, and in the uncertain markets of recent months, it was difficult to make a balance of payments projection that had a high degree of certainty. On the assumption that oil exports would average about 1.2 million barrels in 1982, compared with the 1.3 million barrels a day that the authorities had had in mind at the time of the consultation discussions, and on the assumption that the average unit price of oil exports prevailing in January 1982--$31.47--held in nominal terms for the balance of the year, Kuwait's current account surplus would probably be $2 billion less than the estimate in the staff report, namely, in the neighborhood of $13 billion instead of $15 billion.

As for the structure of Kuwait's balance of payments, the Deputy Director continued, investment income had been rising considerably year after year until it had exceeded the cost of total imports in 1981. That rise in investment income, together with other elements affecting the current account, had suggested to Mr. Taylor that developments in the oil sector could not reverse the surplus position on the current account. While that interesting scenario was not unlikely in the medium term, it would probably be premature to assume that Kuwait could count on a current account surplus that would not be greatly affected by oil export developments or changes in other elements of the balance of payments, including the rate of return on foreign assets. However, the question was interesting enough to be considered in relation to the adjustment process in the medium term.

Part of the reason for the shortfalls in development expenditure in relation to budget appropriations, the Deputy Director added, was that the major boom in government investment to develop infrastructure had already taken place. In fact, the process had been going on for some 20 years, although with an added spurt after the oil price rise in 1973-74. The development program had consisted basically of a list of projects, to which budget expenditures had been directed according to certain priorities and the availability of expertise. The possibility of quite a large increase in development expenditure over the coming five or six years should not, however, be ruled out. Some sectors of the economy were in need of overhaul, and there was thus scope for further investment, particularly in oil-related and gas-related industries, in the medium term.

The continuing rise in domestic oil consumption by a yearly average of 15 per cent was of concern to the Kuwaiti authorities, the Deputy Director noted. So far, no specific measures had been proposed to adjust energy prices for oil, for electricity, or for any other energy source.

The use of press reports by the staff as a source of data on oil production had been necessary, the Deputy Director explained, because developments in the oil sector were to some extent confidential in Kuwait. Despite efforts by the staff to gain direct access to better data, it had had to rely on non-Kuwaiti sources of information, which had however been checked with the authorities.

The large figure for net errors and omissions in the balance of payments was largely due to the need for further improvement in the data on which the balance of payments estimates were based, the Deputy Director commented. Few data on private capital movements were available to the authorities. The surveys that were made of some types of private capital movements were inadequate, and improvements in estimating techniques were needed. The staff's view was that net negative errors and omissions represented to a large extent private capital outflows.

The introduction of a reserve requirement of 3 per cent would probably not have a significant impact on the domestic credit expansion, the Deputy Director said. It should be noted however that the Kuwaiti central monetary authorities had not moved in that direction before, and, the reserve requirement was potentially an important monetary instrument for the Central Bank.

The authorities' attempt to insulate domestic short-term interest rates from what were sometimes significant fluctuations in international short-term rates was based primarily on their desire to alleviate the impact on the cost of living, the Deputy Director of the Middle Eastern Department reiterated, because most short-term credit in Kuwait was for import financing. Their success in that respect had been achieved at a certain cost, however. The Central Bank had provided loans to commercial banks at rates considerably below the market rates in order to support the low level of domestic interest rates in the short term; an indirect subsidy from the budget was involved, because the Central Bank financed its loans by obtaining foreign exchange from the Government.

Mr. Finaish thanked Executive Directors for their comments, which he would convey to the Kuwaiti authorities. On the question of government spending, particularly on development, he considered that Kuwait's fiscal policy should be characterized as moderately expansionary rather than relatively restrained. As he had mentioned in his opening statement, part of the shortfall in development expenditures was only apparent, because it reflected the transfer of oil-related development expenditure to the Kuwait Petroleum Corporation, whose accounts were kept separate from the general budget. While the authorities were of course concerned about inflation, their intention was to maintain a healthy real growth rate in the future, diversify the economy's productive base, and also encourage the private sector to take a more active part in the development process.

On the question of staff estimates of the current account surplus, Mr. Finaish observed that the staff's preliminary estimate of the surplus for 1981 could be significantly on the high side because the assumed price premia on total crude oil exports might be higher than the actual premia in view of the downward pressure on oil prices during the year. Furthermore, the 14 per cent projected increase in oil production in 1982 could also turn out to be too high. Therefore, the current account surplus for 1981 and 1982 might be even lower than the Deputy Director of the Middle Eastern Department had indicated in the revised estimates that he had put forward.

As for the interest rate policy in Kuwait, Mr. Finaish noted that in light of the prevailing conditions of relatively low domestic inflation stability in the value of the dinar, and the desirability of guaranteeing an adequate supply of funds for private investment at a reasonable cost, the authorities considered the present ceilings on lending rates to be at about the right level. However, they were keeping an open mind on the question, and interest rates were less rigid than generally believed; the Central Bank was empowered legally to vary interest rate ceilings. Indeed, the ceiling of 7 per cent on domestic credit extended in Kuwaiti dinars had been increased to the existing 10 per cent. Interbank rates were not regulated but moved in line with changes in both international rates and domestic liquidity. Furthermore, recent issues of bonds denominated in Kuwaiti had been set to yield a rate of over 11 per cent.

As for the effect of ceilings on bank lending rates on the profitability of the banks, Mr. Finaish noted that it had been a matter of discussion with the staff. A large proportion of banks' total deposits--about one fifth--were interest-free demand deposits; the maximum interest rate on savings deposits was much lower than the rate on time deposits. Another factor was that banks were generally in a position to borrow from the Central Bank at a rate that was much lower than the interbank rate and the rate that they paid on time deposits. Thus, the argument about the effect on the banks' profitability did not appear to be very strong.

The authorities were aware of the need to reflect their overall energy conservation policy in domestic oil prices, Mr. Finaish stated. Some steps had been taken to contain consumption by state-run entities, such as utilities. Feasibility studies for new industrial projects were also being based on international energy prices in order to guard against the building of inefficient industrial units.

The Kuwait Petroleum Corporation was the one government entity in charge of almost all oil-related activities, Mr. Finaish noted. The aim of the Corporation was to become an internationally integrated company, which would deal with the five stages of the oil industry: exploration, production, transportation, refining, and marketing. The Corporation had become active in almost all those areas. In 1981, it had acquired several leases for oil exploration abroad, both in industrial and in developing countries. The Corporation had also undertaken joint activities with other companies.

The Managing Director made the following summing up:

Executive Directors were generally in agreement with the views expressed in the staff report for the 1981 Article IV consultation with Kuwait. They commended the authorities for pursuing demand management and related policies that had contributed to good growth rates and improved economic diversification in recent years, while reducing substantially inflationary pressures from the high levels of the mid-1970s. With the economy relatively free of supply constraints, the moderately expansionary stance of fiscal policy in 1982 was thought to be appropriate.

Directors commended the authorities for taking measures to reduce credit expansion for financing speculative activities. Given the situation in international financial markets, Directors welcomed the indication that the authorities were considering the adoption of a more flexible interest rate structure in order to enhance the role of monetary policy and the development of capital markets in Kuwait.

With respect to external financial policies, the prospect of a possible further reduction in the current surplus in 1982 was noted. The Kuwaiti authorities were commended for their adherence to liberal systems of exchange and trade, a continued high level of financial assistance to less developed countries, mainly in the form of grants, and their prudent reserve and investment management policies. These policies contributed positively to the international adjustment process.

Finally, the desirability of further improvement in statistical data on the Kuwaiti economy was noted by Executive Directors.

APPROVED: July 6, 1982

LEO VAN HOUTVEN
Secretary