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INTERNATIONAL MONETARY FUND

Minutes of #8 Executive Board Meeting 76/15

10:00 a.m., February 9, 1976

W. B. Dale, Acting Chairman

Executive Directors	Alternate Executive Directors
J. Amuzegar	C. P. Caranicas
P. Åsbrink	J. H. Kjaer
S. Y. Cross	T. Leddy
	H. G. Schneider
	M. Finaish
B. J. Drabble	D. Lynch
R. Gavaldá	
S. Jagannathan	W. M. Tilakaratna
A. Kafka	
K. Kawaguchi	M. Wakatsuki
B. Kharmawan	Sein Maung
P. Lieftinck	T. de Vries
	J. K. E. Cole, Temporary
	E. O. de Toledo
	E. Sacerdoti, Temporary
E. Pieske	G. Laske
W. S. Ryrie	P. J. Bull
F. Suárez	R. Guarnieri
J. H. Wahl	J. Foglizzo
R. J. Whitelaw	R. S. Deane
A. W. Yaméogo	

W. L. Hebbard, Secretary
D. H. Ross, Assistant

Also Present

Asian Department: Tun Thin, Director; W. J. R. Woodley, Deputy Director; J. Ahrensdorf, P. Chabrier, M. Ishihara, S. Kanesa-Thasan, A. A. Mattera, P. J Quirk, K. Saito, M. R. P. Salgado, S. M. Thakur, K. Yamamoto. European Department: A. Pfeifer, Deputy Director; T. Gudac, A. F. Mohammed, C. Wollan. Exchange and Trade Relations Department: E Sturc, Director; C. D. Finch, Deputy Director; D. K. Palmer, Deputy Director; M Dakolias, T. Sweeney. Fiscal Affairs Department: W. A. Beveridge, Deputy Director. Legal Department: J. G. Evans, Deputy General Counsel. Research Department: H R. Heller, D. J. Mathieson, S. Sussman. Treasurer's Department: A. Watkins. Western Hemisphere Department: J. Del Canto, Director; S. T. Beza. Personal Assistant to the Managing Director: D. W Green. Advisors to Executive Directors: F. K. Hussein, A. Malek. Technical Assistants to Executive Directors: V Alipui, V. Amiel, S. Arancibia, E. Avillez, C. J. Batliwalla, M. Berger, D. Berthet, I. M. Cobbold, M. Danusaputro, G. Heyden Q., R. Khonsary, H. Kuroda, E. Leung, K. Nakayama, A. B. Nymark, C. C. Ozumba, S. K. Panya, M. Pietinen, S. P Upasani, A. van Dorssen, L. F. Vílches, M. A. Wasfy, P. Zimmer, A. G. Zoccali.

1. APPROVAL OF MINUTES

The draft minutes of Meeting 75/161 were approved.

2. OIL FACILITY - YUGOSLAVIA - INTENTION TO REQUEST PURCHASE

The Executive Directors considered the intention by Yugoslavia to request a purchase under the oil facility, together with the staff's analysis and recommendation (EBS/76/42, 2/2/76).

Mr. Lieftinck said that Yugoslavia's energy policy was intended to conserve and develop domestic oil resources. The financial program that had been implemented by the authorities was designed to hold the growth of aggregate domestic demand below that of social product to provide room for an improvement in the current account of the balance of payments. Restrictions, which appeared relatively minor, had been thoroughly investigated by the staff.

Mr. Cross commented that Yugoslavia's restrictions seemed to be rather substantial, particularly since the import surcharge had been extended for a further year. He found it difficult to believe that the country's request was not inconsistent with the understandings set forth in the Rome communiqué.

Mr. Ryrie observed that Yugoslavia clearly met the balance of payments conditions for purchasing under the oil facility. However, like Mr. Cross, he was perturbed by Yugoslavia's level of restrictions, and particularly by the reference on page 10 of EBS/76/42, which said "there have been reports of the existence of arrangements requiring importers to arrange for export sales of a specified fraction of their import requirements...(and) such arrangements as exist are due to the efforts of the Yugoslav Chamber of the Economy, a nongovernmental body." He understood that the arrangements had originated from a decree from the Federal Executive Council. The measures could have a considerable practical effect on Yugoslavia's trading partners; in that context, the Yugoslav authorities should have discouraged the Chamber of the Economy from applying pressures on importers. The staff should further investigate the matter and keep the Executive Board informed about the practical effects of the restrictions.

Mr. Laske remarked that he could support Yugoslavia's purchase under the oil facility, since the country had a balance of payments need and had been following appropriate policies. The authorities had used about 5 per cent to 6 per cent of their reserves to finance the balance of payments deficit in 1975. Like Mr. Ryrie, he doubted the economic wisdom of implementing export-import linking arrangements, as they were unlikely to help in the management of the balance of payments.

Mr. Kharmawan stated that he supported Yugoslavia's request to purchase under the oil facility, as a balance of payments need clearly existed. The imposition of new restrictions by members was a troublesome matter, particularly if they were applied by a large country. He would not object to Yugoslavia's restrictions, as their impact on the world economy was likely to be minimal. Moreover, the authorities had made known their intention to phase out restrictions in the coming year. He could, therefore, agree with the staff assessment that the restrictions were not being maintained inconsistently with the understandings set forth in the Rome communiqué.

Mr. Caranicas commented that Yugoslavia's request was fully justified, and that he could support it. While he did not accept Mr. Kharmawan's argument that restrictions imposed by a small country were less reprehensible than those imposed by a large country, he understood the need for maintaining them.

Mr. Kafka supported Yugoslavia's purchase under the oil facility. The question of restrictions under the Rome communiqué should be interpreted according to a rule of reason. It was not a matter of exempting small countries from adhering to the understandings of the communiqué, but rather assessing the total impact of their restrictions on the world. While he had sympathy for Yugoslavia, he would be interested in having a staff analysis of the impact of the restrictions on the country's trading partners.

Mr. Cross said that he disagreed with the concept that the size of a country or the amount of its trade should govern the attitude of the Executive Directors toward restrictions; such an attitude would be inconsistent with the fundamental principles of the Fund.

The staff representative from the European Department indicated that when the staff learned about the official decree that might have provided the authority for some of the export-import linking arrangements, it had raised the matter with the authorities, who had informed the staff that the decree had not been implemented.

Mr. Lieftinck said that both the tariff system and the import surcharge scheme were under general review, and that some minor increases and reductions were anticipated in each. The measures were of a fiscal character intended to safeguard minimum tariff revenues for the authorities and were not meant to, or expected to, restrict imports.

He would welcome further staff studies regarding the scheme for linking exports to imports that had been arranged by the nongovernmental

Yugoslav Chamber of the Economy, Mr. Lieftinck continued. The Executive Directors should bear in mind, however, that there had been a considerable amount of decentralization of decision making, not only with respect to the republics and municipalities but also with respect to corporations and companies; under the new constitution, it would be difficult for the Government to intervene. While he could not condone new restrictions, it should be noted that Yugoslavia had suffered heavily from import restrictions imposed by the EC countries, about which the staff had said nothing.

The Executive Directors then turned to the proposed decision, which they approved.

The decision was:

1. The Fund has received a communication dated December 19, 1975 from the Government of Yugoslavia informing the Fund of Yugoslavia's intention to request a purchase equivalent to SDR 129.37 million under Executive Board Decisions No. 4241-(74/67), adopted June 13, 1974, No. 4634-(75/47), adopted April 4, 1975, and No. 4769-(75/133), adopted July 28, 1975. Yugoslavia has made representations in accordance with paragraph 5 of Decision No. 4241-(74/67).

2. As described in EBS/76/42 (2/2/76), Yugoslavia intensified existing restrictions on certain imports in April and June 1975. Of these, only the increases in rates of import surcharge remain in effect. In January 1976, certain tariffs on imports were reduced, while others were raised, and certain rates of import surcharges were increased pending a reform of the tariff structure. In view of the representations made by the Yugoslav authorities with respect to measures described in EBS/76/42, and in particular in view of the intention of the Yugoslav authorities to decrease the import surcharge by the end of 1976, the Fund finds that the actions of the Government of Yugoslavia are not inconsistent with the understandings set forth in paragraph 2 of the Rome Communiqué of the ad hoc Committee of the Board of Governors on Reform of the International Monetary System and Related Issues and Executive Board Decision No. 4134-(74/4), adopted January 23, 1974.

3. The Fund determines that the purchase would be in conformity with the decisions cited in paragraph 1 above, agrees to the purchase, notes the representations made by the Government of Yugoslavia in accordance with paragraph 5 of Decision No. 4241-(74/67), and grants the necessary waiver of the conditions of

Article V, Section 3(a)(iii) of the Articles of Agreement on the repurchase terms set forth in the communication dated December 19, 1975.

Decision No. 4953-(76/15), adopted
February 9, 1976

3. JAPAN - 1975 ARTICLE VIII CONSULTATION

The Executive Directors considered the staff report for the 1975 Article VIII consultation with Japan (SM/75/303, 12/29/75; Cor. 1, 1/8/76; and Sup. 1, 1/30/76). They also had before them a report on recent economic developments in Japan (SM/76/1, 1/7/76).

Mr. Kawaguchi made the following statement:

During the year under review, the Japanese economy underwent a difficult path of transition, adjusting itself to a new world economic environment in the search of a stable course of medium-term growth, while suppressing deep-rooted inflationary expectations. In the process of this transition, the Japanese economy demonstrated ample resilience and discipline.

Wholesale prices, which had at one point increased some 37 per cent over 1974, returned to virtual stability in the latter half of 1975, and consumer price increases achieved an official target of a below 10 per cent increase, ahead of the target date of March 1976. A serious concern over the wage negotiations last spring did not materialize and the incorporation of wage-price spirals was averted, thanks to the exhibition of moderation by both sides of industry which responded to an earnest appeal (not "intervention" as the staff termed it) and determined demand management policies by the Government. As inflation was brought under control, efforts to reinvigorate the economy were intensified by the adoption of four consecutive antirecession programs. Thus, signs of recovery became visible earlier than in most of the major industrial countries and, among them, Japan would be the only country which registered positive growth in 1975. A large balance of payments deficit, which was caused by sharp increases in oil prices, was considerably reduced by stepped-up efforts to increase exports to OPEC countries and without resorting to import restrictions.

In retrospect, the recovery in 1975 was admittedly weaker and slower than expected at the outset of the year, but this was a reflection of the magnitude of adjustment that the economy had to make to unprecedented changes in prices of a commodity so vital to the Japanese economy, the simultaneity of recession in major countries, and the persistence of inflationary expectations. Under the circumstances, the authorities' cautious and discreet policy implementation was inevitable and appropriate.

As to the prospects for the year ahead, the Government announced a fortnight ago its economic forecast and policy stance for fiscal year 1976, including the following two major policy objectives: first, to ensure a steady economic upswing and secure stability of employment; and second, to foster and solidify the foundation for a stable and balanced growth as the initial year of a new medium-term economic program.

My authorities believe, as seen in the first objective, that it is now possible and appropriate to put major emphasis on solidifying economic recovery in view of recent price movements and then judge that there is further room to stimulate the economy with less risk of rekindling inflation. In order to achieve this objective, the newly formulated budget for FY 1976 attaches strategic importance to capital outlays with a high demand-inducing effect. Expenditures on public works are budgeted to increase more than 20 per cent, while the increase in total expenditures is a little over 14 per cent, still exceeding the projected nominal growth in GNP of 13 per cent. It is also under consideration to concentrate the execution of public work expenditures in the earlier part of the fiscal year rather than stretching it throughout the whole year. In addition, the new budget includes a contingency fund for public works amounting to ¥ 150 billion, in order to deal with developments in the economic situation flexibly and promptly without further legislative action. Including this contingency fund, the increase in expenditures on public works would be 26 per cent above that in FY 1975.

On the side of monetary policy, the Bank of Japan lowered the bank rate four times since last spring; and effective from February 1, reserve requirement ratios were further reduced. Both long-term and short-term interest rates have been showing a considerable decline. Since the third quarter of 1975, money supply (M_2) has been maintained at an annual growth rate of around 14 per cent. The Bank's intention is to ensure reasonable monetary ease, both quantitatively and qualitatively, so that conditions are set for a smooth upswing.

With these fiscal and monetary policies, and assisted by other measures, the Japanese Government is confident that a real growth of 5.6 per cent will be achieved for FY 1976 while a reasonable degree of price stability will be maintained.

The staff, however, expresses concern about the strength of recovery and the extent to which further recovery is dependent on higher consumption. Based on its GNP gap estimates, the staff also suggests adoption of a more expansionary fiscal policy for 1976 and efforts to narrow the gap before the short-term and medium-term rates of growth converge. This difference of view between the staff and my authorities was taken up at the Board discussion on the World Economic Outlook last December, IS/75/6 and IS/75/7(12/30/75 and 12/31/75) and also at the Interim Committee meeting in Jamaica. The difference, to some extent, stemmed from the fact that the staff's visit to Japan was before the formulation of the budget for FY 1976; hence, not much was known around the outline of the budget. But, with the announcement of the draft budget which intends to ensure the recovery, I believe that the differences will be considerably narrowed. Indeed, in my authorities' view, the budget was one of the most expansionary budgets for 1976 among those of major industrial countries. The ratio of central government deficit to GNP in FY 1976 is estimated to reach about 7 per cent (9 per cent, if that of local governments are included) which is by no means a small figure by international comparison. The portion of total government expenditures to be financed by bond issues now reaches 30 per cent as compared with 26 per cent in FY 1975. My authorities are not concerned with government deficits as such, but they think that there is a certain limit beyond which confidence in government finance is adversely affected and the expansionary effect becomes self-defeating. Adoption of a further expansionary budget needs to be carefully considered on the balance of these conflicting effects. My authorities feel that the size of the government deficit for FY 1976 is not far from the limit.

Furthermore, the recovery will not necessarily be consumption-led. It is true that, unlike in earlier cycles, private fixed investment would not be a major leading force, but government expenditures, housing construction and private inventory investment are all expected to increase at higher rates than that of aggregate GNP, and exports will also play no insignificant role in leading the recovery.

The staff argument for adoption of a more expansionary policy to narrow the gap of unused resources needs to be viewed in relation to the second objective of my Government for FY 1976. As is often pointed out, the GNP gap analysis is a very elusive concept and this macroeconomic approach tends to fail to reveal the divergence between individual sectors within the economy. Moreover, the emergence of multiple medium-term growth constraints, such as environmental problems, changes in supply conditions of natural resources and labor shortage inevitably means a reduction of Japan's growth potential in the forthcoming years--from 10 per cent to 11 per cent in the previous decade to around 6 per cent. Other than the reduction in growth potential, it is considered that there occurred a downward shift of productive capacity in the course of the "oil crisis." (For instance, some industries became economically not viable due to higher energy prices.) My authorities are, therefore, skeptical about the validity of the illustration in Chart 1 of the staff report (SM/75/303). Also, past experiences in Japan often indicate that once the economic upswing is set in motion, slacks are absorbed at a much faster rate than expected and bottlenecks quickly emerge, thereby creating inflationary pressure. As late as 1972, when Japan adopted an expansionary policy based on an estimated large GNP gap, inflationary pressure emerged at an early stage.

In any event, under the present circumstances where uncertainties still prevail and cost factors have not been fully passed through to prices, too swift an absorption of slacks would not be advisable lest it should release the latent pressure to revitalize inflation. In FY 1976, as the first year of a stable medium-term growth, my authorities prefer aiming at a steady approach to the orbit rather than a hasty boosting (and, therefore, possibly sharp application of brakes afterward). This approach would be beneficial both to Japan and its partner countries for the sake of avoiding volatile boom-recession cycles. On the other hand, achievement of the projected growth rate in the initial year is also essential to the medium-term objective, and my authorities are prepared to take additional measures if necessary in order to ensure its achievement.

On the external side, no major policy changes are envisaged in 1976. As to the balance of payments, there appear signs of gradual recovery in our exports, especially to some of the industrial countries and some of those in the communist bloc. Our imports are expected to recover faster than exports as industrial production picks up, and the trade and current balances will show larger deficits than the staff's estimates. Long-term investment will become active again, and even after assuming a buoyant inflow of foreign capital, the basic balance deficit will reach roughly $5.0 billion in FY 1976. Nevertheless, my authorities do not regard the balance of payments as a major constraint in the pursuit of its policy objectives.

Our foreign exchange policy will remain the same as in the past year, namely, basically to follow the market forces with ironing out operations of short-term erratic fluctuations. The understanding reached at Rambouillet concerning exchange rate management is in my view essentially consistent with what my authorities have been following in the past few years.

As regards development aid, our official development assistance showed a continued increase in 1975, and the proposed budget for

FY 1976 provides for further increases in development assistance, in spite of a very difficult budgetary situation.

Last, but not least, I would like to pay very high tribute to the staff for its excellent analysis of the Japanese economy. My authorities find the frank exchange of views with the staff most constructive and useful.

Mr. Kafka commended the Japanese authorities for the efficient way in which they had managed the economy. To have been the only major industrial country to have achieved a positive rate of growth in 1975 while significantly reducing the rate of inflation was laudable. The improvement in the trade balance should also be considered a success, particularly as it had been achieved without reliance on increased import restrictions. Japan illustrated the advantage enjoyed by the wealthier countries in combating inflation; they could, with relative impunity based on their ample social assistance schemes and without resorting to restrictions, interrupt or reverse the growth process, an option that was either more painful or sometimes impossible for developing countries.

The speed of the Japanese recovery from recession had been less than in the United States, and the pattern had been rather similar to that which had developed among the European countries, Mr. Kafka continued. However, he applauded the authorities for their rigorous antirecession policies implemented through the budget, and for the stimulating fiscal and monetary policies that recently had been adopted. He sympathized with Mr. Kawaguchi's strictures on the staff's GNP gap analysis. Macroeconomic analysis could be misleading in the context of structural change, and Mr. Kawaguchi had mentioned some of the reasons why the staff's gap estimates were likely to be excessive. Nevertheless, whatever might be said about the appropriateness of present policies, it appeared clear that flexibility with a bias toward expansion would be required throughout 1976.

The Government had done much to stimulate public investment, Mr. Kafka remarked. While he accepted that the recovery of private investment could not be substantial in 1976, it was difficult to understand why the authorities had not, even at the cost of some slight deterioration in the budget, given an additional stimulus to private demand. In fact, for the first time in 16 years the Government had not granted an income tax reduction, which could have had a positive psychological effect even if the reduction had been insubstantial.

The approach of the Japanese authorities to the question of raw materials and energy appeared realistic, Mr. Kafka considered. A basic change in economic and social priorities and a consequent adoption of policies would reduce the medium-term rate of growth from the average of 10 per cent to 11 per cent achieved in the previous decade to around 6 per cent per annum in the coming five years.

Two countries in his constituency were the largest beneficiaries of the outflow of Japanese private capital; they welcomed the decision of the authorities to further increase the flow of those resources to developing countries in 1976. On the other hand, two other members of his constituency noted that the amount of official development assistance given by Japan was low.

Mr. Schneider commented that in 1975 Japan had undergone a successful but painful adjustment and stabilization, as both inflation and the balance of payments had been brought under control. The $8.6 billion deficit in the basic balance of payments in 1974 had been reduced to $1 billion in 1975. The rate of increase in wholesale and consumer prices had been reduced from more than 31 per cent and 24.5 per cent, respectively, to 1.5 per cent and 10.5 per cent. In addition, GNP, which had declined by 1.8 per cent in 1974, had risen by 1.5 per cent in 1975. Recovery was still rather weak, and prospects for acceleration of activity in 1976 were uncertain. He understood the fears of the Japanese authorities about a resurgence of inflation; however, in view of the weakness of the recovery in the private and external sectors and the high level of capacity underutilization, he wondered whether a stronger stimulus than had been envisaged by the authorities would not be advisable.

The staff had noted that the effect of the budget for fiscal year 1975/76 on aggregate demand appeared to be relatively limited, Mr. Schneider observed. The General Account deficit, as measured in terms of its ratio to nominal GNP, was expected to rise to a postwar peak. But the deficit was, to a large extent, due to cyclical factors; the staff view that a stronger fiscal stimulus and more expansionary policies would accelerate recovery, thereby contributing to a reduction of the budget deficit, appeared reasonable.

Although he was impressed by the shift in the public's attitude to accepting slower growth, Mr. Schneider wondered whether both the Japanese authorities and the Japanese people might not be going a little too far in halving the country's potential for economic growth from 11 per cent to 6 per cent in the coming five years. The arguments regarding forced growth, especially in the case of industrial countries, were familiar to him, but the shift in Japan was most striking; perhaps the authorities should not set such a modest growth target. Finally, he asked how the last sentence in the staff appraisal in SM/75/303--"the staff doubts that there would be major resistance to permitting the exchange rate to reflect marked changes in the payments situation, either actual or prospective"--should be interpreted.

Mr. Kharmawan remarked that there had been a difference of opinion between the staff and the Japanese authorities regarding the adequacy of the antirecession measures implemented by the authorities in 1975, and particularly in fiscal 1975/76. The staff felt that the recovery could have been more pronounced and, consequently, that there would be a need in 1976 for more expansionary measures, especially in the fiscal field. In his introductory statement, Mr. Kawaguchi had benefited from having more recent data than the staff, and had revealed his authorities' view that "there is further room to stimulate the economy with less risk of rekindling inflation."

Japan was an important industrialized country and its economy had a wide impact on the world in general and on the economies of its Asian neighbors in particular, Mr. Kharmawan commented, so that the Asian countries had a considerable interest in the performance of the Japanese economy. Due to national and international developments the rates of growth of the past could no longer be expected. While he understood the attitude of the authorities, he hoped that once conditions changed growth might be more vigorous than presently envisaged. As to 1976, he was inclined to support the view of the Japanese authorities that a real rate of growth of about 5.6 per cent would be reasonable in the light of the much lower rate of growth achieved in 1975. Of course, faster growth would be welcome, but he valued steady growth with price stability more than erratic growth. In passing, he noted that Japan was a substantial exporter of capital and technology and a major aid donor, and that many Asian countries had benefited from cooperation with Japan.

In the past, Japan had succeeded in overcoming its labor problems more satisfactorily than many other industrial countries, Mr. Kharmawan considered. In 1975, wage claims had been kept at levels that had avoided a wage-price spiral. The degree of price stability that had been achieved in 1975 as a result of appropriate demand management policies had played an important role in the success of the settlement that had been reached between industry and labor. Of course, the concept of "lifetime employment" that was rooted in Japan's culture and society had been a moderating factor. The close relationship between entrepreneur and worker was a significant factor in explaining the competitiveness of Japanese enterprises. However, even Japanese workers could not remain insulated from what was happening in other industrial societies, with their more militant and less communal attitude toward management. If inflation began to erode real earnings, it might be difficult to avoid the emergence of cost-push factors. He could, therefore, endorse the authorities' preference for growing more slowly and more steadily than previously and for preserving price stability.

Mr. Cross said that he admired the Japanese authorities for their successful management of the economy. The Government and the Japanese people should be commended for recognizing that the high rates of growth attained during the previous decade would not be feasible in the near future. Japan appeared to be one of a few countries that have been able to alter public expectations regarding what would be a reasonable rate of growth in the wake of the dramatically altered energy situation, recent stagflationary experiences and other factors with which the world economy had had to contend in recent years. Moreover, lowering public expectations to a more reasonable level was likely to enhance the Government's ability to control inflationary pressures.

A real rate of growth of 5.6 per cent in 1976 would be a good performance, Mr. Cross believed. He might have been inclined toward the staff argument about the need for more stimulatory policies if it had not been so dependent on GNP gap analysis. The staff's excessive devotion to the concept during the 1971-72 period might have contributed to the world's problems, as the analysis had shown that there was more slack in the world economy than had, in fact, existed. A more sophisticated sectoral examination of the economy was required.

The policy of the Japanese authorities with respect to the exchange rate had been to intervene to deal with erratic fluctuations, Mr. Cross continued. However, the exchange market was already severely restricted by various capital controls, and the remaining fluctuations were therefore of a rather minor character. The staff appeared to approve of the present policies of the authorities as a reasonable way in which to manage the exchange market; it should, however, pay more attention to the effect of capital controls.

Mr. Gavaldá remarked that economic recovery in the industrial countries was a matter of particular interest for the international community in general. For the less developed countries, it was encouraging to learn that the Japanese authorities intended to put major emphasis during fiscal year 1976 on perpetuating and accelerating economic recovery. He hoped that the success that the authorities had achieved in fighting inflation in 1975 would be matched by a similar performance in reaching the target of 5.6 per cent real growth in 1976. Finally, he was pleased to note that the authorities would continue to consider development aid as an important element of their responsibility to the international community.

Mr. Cole said that, after several years of remarkable achievements, particularly in terms of growth and price stability, the Japanese economy had suffered a major setback in mid-1973, when there had been a sharp deterioration in overall performance. By the adoption of tight demand management policies, and particularly through restrictive monetary policy, inflation and the balance of payments had been brought under control by early 1975. However, the apparent cyclical turnaround in the economy had only a marginal impact on private investment and industrial production, both of which had failed to respond positively and vigorously to the more favorable economic climate.

The Japanese authorities were to be commended for achieving, in a relatively short time, a rapid deceleration in the rate of domestic inflation, as reflected in the decline in the rate of increase of the GNP deflator from 21 per cent in 1974 to an estimated 7 per cent in 1975, Mr. Cole continued. An appropriate demand management policy and the authorities' success in curbing higher wage demands with the minimum of labor strife, while allowing the relatively modest wage increases awarded in the 1975 "Spring offensive" to become effective only gradually, had been the main factors in their success.

The improvement in Japan's overall balance of payments between the end of 1973 and the end of 1975 had reflected favorable developments in its terms of trade and in export and import performance, Mr. Cole indicated. The trade account had continued to be in sizable surplus in 1974, due to strong export demand and a declining volume of imports, reflecting the depression in domestic industrial production. The surplus rose sharply in 1975 as import prices--which had been increasing quite steeply in the second half of 1973 and in 1974--stabilized, while the volume of imports continued to decline significantly and the value and volume of exports were maintained.

The failure of industrial production and private, nonresidential, investment to respond either to the relaxation of monetary controls and restrictions or to the cautious but expansionary stance of fiscal policy, had prompted the staff to urge the authorities to pursue a more vigorous expansionary fiscal policy through substantially larger budget deficits, Mr. Cole observed. The staff view had been based both on the need to reduce existing unutilized capacity in the Japanese economy, and on the need to encourage private, fixed investment in order to stimulate a more rapid rate of growth. While he agreed with the staff that fiscal policy could play a more positive role in accelerating the rate of recovery of the economy, he had sympathy for the Japanese authorities' objective of achieving a lower but sustainable rate of growth in the short term and medium term. The consequences of the recent high level of inflation were still imprinted in the minds of the authorities, and they were rightly anxious that a larger budget deficit would set in motion another round of serious inflationary pressures. Moreover, the authorities were hopeful that the stimulus provided by the relaxation of monetary controls and the pursuit of a cautious fiscal policy would result in a marked increase in private investment as domestic demand strengthened and evidence of a strong recovery in Japan's major trading partners became more visible. In addition, he agreed with the authorities that financing an enlarged budget deficit would place severe strains both on available resources and on financial markets.

The difference between the views of the staff and those of the Japanese authorities was basically one of emphasis, Mr. Cole considered.

Nevertheless, given the uncertainties associated with the rate and the momentum of recovery in the economies of Japan's major trading partners and the prospect of renewed inflation, he endorsed the authorities' cautious and flexible stance on fiscal policy. In fact, the staff had rightly anticipated the authorities' economic forecast and policy stance for fiscal year 1976 when it had stated that "a possible scenario is that expenditures as budgeted for fiscal year 1976/77 are accelerated during the first half of the year and then, depending upon the outlook for private activity, re-enforced by a sizable supplementary budget. There is sufficient uncertainty about forecasts of the pace of recovery that maximum flexibility should be maintained." Taking all factors into consideration, the authorities' policy stance seemed sound and sensible, particularly in view of the two major policy objectives of the Government, referred to by Mr. Kawaguchi.

Finally, Mr. Cole thanked the Japanese authorities for their generous assistance to the developing countries.

Mr. Lieftinck noted that there had been a difference of opinion between the staff and the Japanese authorities on the policies to be followed in the immediate future. In fact, he had expected the staff to have modified its appraisal in SM/75/303, Supplement 1. The new budget included a contingency fund for public works amounting to ¥ 150 billion in order to deal with developments in the economic situation flexibly and promptly without further legislative action. He considered the fund to be important, and he would welcome staff comments on it. He congratulated the authorities on the success that they had achieved in reducing the rate of inflation from more than 20 per cent to about 7 per cent to 8 per cent. He welcomed the switch in policies to aim at a lower overall rate of growth, by changing priorities and by taking into account a number of limiting factors that had arisen in the Japanese economy, particularly a water shortage and the dangers of pollution.

It was notable that there appeared to be no difference of opinion between the staff and the authorities regarding the five-year program, Mr. Lieftinck remarked. They agreed on a rate of growth of around 6 per cent, on a balance of-payments on current account almost in equilibrium, and on a price deflator of around 5 per cent. The program appeared to be sound and reasonable. On the other hand, the staff was somewhat less optimistic than the authorities about an early recovery and more optimistic about reducing inflation; it therefore favored a more expansionary policy in both the fiscal and monetary field. The staff had reported that a fiscal expansion would be desirable as it would increase required liquidity rather than create tensions in the financial markets. However, he had had the impression that liquidity had been satisfactory, and that there was no reason deliberately to increase it.

The staff was too easily satisfied by a rate of inflation of 8 per cent, Mr. Lieftinck said. It seemed to have adopted the position that inflation was no problem for the time being, and that the major issues were to increase the rate of growth and to reduce the amount of unutilized capacity. The Japanese authorities were correct in trying to avoid a renewed upsurge of prices. In the past several months, consumer prices had increased; moreover, there appeared to be a backlog of wholesale price increases that had still to be reflected in the consumer price level. In addition, the authorities had yet to adjust administered prices in order to cope with the cost increases that had taken place. He agreed with 1
the authorities that their policies might result in a maintenance of the present rate of inflation, or perhaps a slight increase of prices. Japan had been used to a minimal rate of inflation, and consequently had been strongly affected by a high rate; business confidence would probably improve markedly if the rate of price increase were to slow.

On fiscal policy, Mr. Lieftinck observed that in Table 2 of SM/75/303, Supplement 1, the general account deficit as a percentage of nominal GNP in 1976/77 had been given as 4.3 per cent, while Mr. Kawaguchi had reported that the ratio of the central government deficit to GNP would be around 7 per cent; he wondered whether his higher figure included the contingency fund. The deficit was a record, but the question still arose as to whether it should be further increased. The staff proposed, at least for the immediate future, that it should not.

The staff had recommended that the authorities should speed up the rate of implementation of investment programs and concentrate them in the first half of 1976, Mr. Lieftinck continued; from Mr. Kawaguchi's statement, it appeared that the authorities would follow such a policy. If a sufficient upsurge was not being achieved, the contingency fund could be tapped to boost the economy. While he did not exclude the possibility that the economic upturn might be slower than the authorities expected it to be, they were ready to take additional measures. If more expansionary measures were required, his Netherlands authorities believed that they could best be implemented by a tax reduction, rather than by higher public expenditures. Personally, he was attracted to a program of public expenditures--particularly investment--since Japan needed a better economic infrastructure.

The staff and the authorities differed about the size of the general account deficit, Mr. Lieftinck noted. The staff assumed a deficit of ¥ 5-6 trillion in the general account compared with the authorities' estimate of ¥ 7.3 trillion; the divergence was largely due to a difference in revenue estimates. It was difficult to judge whether the staff figure was a more reliable estimate than the one presented by the authorities. He was inclined to give the authorities the benefit of the doubt, unless the staff could make a strong case that there had been an underestimate of revenues in the general account by the authorities.

Finally, the staff expected recovery to emanate more from increased domestic demand than from an upsurge in the export sector, Mr. Lieftinck commented. However, he agreed with Mr. Kawaguchi that the export sector could make a considerable contribution to economic recovery, as Japanese enterprises were internationally competitive and eager to participate in an upsurge of the world economy. In fact, he belived that Japan would benefit more than other countries from a general expansion of world demand.

Mr. Pieske said that he had been impressed by Japan's achievements, since the economy had been harder hit by the oil price increases of 1973/74 than most other countries. It had done better than most other industrial countries on almost all counts; in fact, apart from Norway, it had been the only industrial country to have registered a positive rate of growth in 1975, and it had achieved by far the largest reduction in the rate of inflation among the industrial countries. However, he agreed with Mr. Lieftinck that an 8 per cent consumer price increase was still too high and should not be condoned. Nevertheless, the unemployment rate of 2 per cent had remained enviably low, even if one were to add another 1 or 2 percentage points for hidden unemployment.

He had sympathy for the cautious approach that the authorities had adopted, Mr. Pieske remarked. Perhaps, the term "cautious" was an understatement for a policy stance that implied a public sector deficit of 9 per cent of GNP and the financing of 30 per cent of total government expenditures by bond issues. He agreed with Mr. Kawaguchi that there were limits to the use of both fiscal and monetary policy for stimulating the economy; fiscal policy had to serve other purposes besides that of stabilizing economic activity. An excessive public sector deficit might become counterproductive for a variety of reasons, some of which had been mentioned by Mr. Kawaguchi. It was not easy to change policies and reduce deficits once the need for cyclical spending had passed. In addition, excessive easing of monetary policy would encourage capital outflows and would lead to downward pressures on the yen; an undervalued yen would not be in the interests of anyone. A particular problem in the field of monetary policy appeared to be the role that it played in the financing of the budget deficit. He had seen reports that the Bank of Japan had taken some of the burden of low interest government bonds off the shoulders of the commercial banks through open market operations. He would be grateful if the staff could comment on those reports and on whether such operations, particularly if they continued in 1976, could result in the creation of excessive domestic liquidity.

The Fund should attach considerable weight to the national consensus regarding economic priorities, Mr. Pieske considered. If the Japanese people and the authorities shifted emphasis from quantitative growth to the improvement of the quality of life, the Fund should respect such a decision. After all, the further an economy moved away from poverty levels the looser the relationship became between growth of production and growth of welfare. Indeed, he wondered what statistical series of output and growth meant in terms of living conditions and welfare; the Fund should pay more attention to the subject in future. In that context, he had been particularly struck by the estimate that antipollution investment would rise to around 20 per cent of total investment in the near future, compared with around 3 per cent in the early 1970s. He wondered whether the staff could provide information regarding the distribution of that kind of spending among economic sectors and time horizons, and the relationships between antipollution investment and economic growth.

He agreed with those Executive Directors who regarded Japan's present policy stance as broadly appropriate, Mr. Pieske indicated. Although the outcome of wage negotiations was still uncertain, it was encouraging to note that the "Spring Wage Offensive" that was about to begin was expected to bring relatively modest wage increases. Even so, a victory over inflation had not yet been won. While the reduction of the rate of inflation had been impressive, he hoped that further progress would be made in 1976. On the other hand, the Japanese authorities were prepared to take additional measures if they were considered necessary to ensure the achievement of their growth target.

The pace of the Japanese recovery had an important impact on countries in Asia, Mr. Pieske observed. Of course, they would look forward to the stimulus that would come to their economies from expansion in Japan, but price stability was as important a benefit to them as economic growth.

Finally, Mr. Pieske commented, Japan's trading and competitive position had improved markedly in 1975. Even if economic recovery were to lead to some deterioration in the current account balance of payments, it would not be a cause for concern, as Japan's ability to finance such current account deficits and capital outflows appeared to be adequate. The authorities had been able to manage their capital account in a way that had considerably reduced the use of reserves in recent years.

Mr. Drabble congratulated the Japanese authorities for the way in which they had dealt with the difficult situation that had confronted them in 1974. Their performance in reducing the rate of inflation from more than 20 per cent to 8 per cent was particularly commendable; and the benefit would be enjoyed by the whole international community, as Japan was a major trading nation. In addition, he admired the way in which the authorities had tackled the problems that had resulted from the market shift in the relative competitive positions of certain industries arising from the higher costs of energy and increasing environmental difficulties.

Regarding the present performance of the economy, Mr. Drabble said, a few elements were disturbing. For instance, he wondered what exactly had been happening to business inventories. The improvement in industrial output earlier in 1975 had apparently led to some involuntary accumulation of inventories. The staff was concerned that that might have led to some renewed liquidation in the second half of the year. Since July 1975, the change in industrial production had been positive only in one month--September; in fact, in November it had declined by 1.1 per cent. Those figures raised inevitable questions about how firmly on course the present recovery was.

He had sympathy with those Executive Directors who had expressed doubts about GNP gap analysis, Mr. Drabble remarked. In 1972 and 1973 problems had arisen in a number of countries as a result of overestimating the amount of slack in the economy. In the case of Japan, due to environmental problems and the downward shift of productive capacity resulting from the oil crisis, the existing measures of capacity in certain sectors were no longer a valid indication of what might be an appropriate growth path in the period ahead. A rate of growth of 5.6 per cent in 1976 appeared reasonable, but he understood that the staff was worried about whether the target would be realized, given the uncertainties about private consumption and inventory investment. While he sympathized with the desire of the authorities to move cautiously in the present phase of the expansion, he shared some of the staff's anxieties as to whether the growth target would, in fact, be met. The contingency fund would enable the authorities to boost the economy if necessary, but fiscal policies--even in the area of government expenditure--took effect only after a time lag.

Unit labor costs had increased by approximately 25 per cent in 1975, while the GNP deflator had risen by 6.8 per cent, Mr. Drabble noted, and that implied a considerable profit squeeze. Even with a more modest growth target for the economy, Japan would still need a high level of investment to finance antipollution measures--estimated at 20 per cent of total investment--and to finance restructuring of the economy. Perhaps some fiscal measures such as specific investment incentives, should be implemented to ease the liquidity constraints on the business sector. He would be interested in any comments that the staff and Mr. Kawaguchi might have about the present rate of return in Japanese industry.

It was unclear what monetary targets the authorities regarded as crucial, and to what extent they had geared their policies to monetary targets or to measures of bank credit, Mr. Drabble commented. He wondered what weight the authorities attached to interest rates. Finally, the switch that had taken place in 1975 to financing the current account deficit and capital outflows, arising either from official development assistance or from investment by Japanese industry abroad, by long-term borrowing abroad and by foreign investment in Japanese securities seemed entirely appropriate.

Mr. Ryrie said that, as the recession had been different from previous ones in its longevity and its intensity, it was reasonable to argue that the pattern of recovery should be different from that of past recoveries. The present recession had been characterized by high inflation, large budget deficits--which were a consequence of recession rather than an attempt at countercyclical policies--and by the apparent paradox of high rates of personal savings.

He admired the Japanese authorities for the success that they had achieved in stabilizing the economy and in reducing inflation in 1975, Mr. Ryrie continued. Moreover, both a strong balance of payments and a strong currency appeared to provide a sound base from which to expand the economy. The Executive Directors ought to accept and respect the Japanese view that the growth rate in future should be moderate, that it was no longer appropriate to think in terms of annual growth rates of 10 per cent and above, and that if those rates could be achieved they would be associated with unacceptable social consequences. Japan was one of the most important economies in the world, and its rapid growth during the past two decades had put it in a position where what happened in Japan would be of major interest to the rest of the world. The country's prosperity and rapid growth in the past 20 years had depended heavily on its export trade, but future prosperity would be tied closely to the prospects of other countries, including the industrial ones. It was, therefore, important for Japan to pursue a policy of recovery from the recession that would make it possible for other countries to increase their exports to Japan.

He could generally endorse the staff appraisal, Mr. Ryrie indicated. Regarding the balance of payments, he was pleased to note Mr. Kawaguchi's remark that his authorities would not regard the balance of payments as a major constraint in the pursuit of its policy objectives. However, achieving a rate of growth of 5.6 per cent in 1976 appeared to depend largely on expectations of increased exports; the Japanese authorities should be prepared to accept some lower growth of exports in the general interest, and also to accept some reserve loss. In the past, the authorities had experienced little difficulty in financing substantial deficits on current account through the capital account; he expected the same to be possible in future. He agreed with the staff that a rate of growth in excess of 5.6 per cent in the short term could still be consistent with the objective of moderating growth in the long term; he would welcome Mr. Kawaguchi's comments on the matter. A higher targeted short-term rate of growth appeared to be warranted in view of the present business situation, the considerable squeeze on profits and the general hesitancy and lack of confidence among the business community. In addition, there seemed to be some reason for uncertainty as to whether a 5.6 per cent rate of growth would actually be achieved, given the record of the second half of 1975. In the early stages of recovery from recession evidence of an upswing was often variable, but there were few examples in recent years of a recovery petering out. The weakness of growth of output and demand in the latter part of 1975 suggested, however, that the recovery might be aborted. Some fiscal stimulus had been required and some measures had been implemented in the latest budget, including a contingency fund for public works to deal with developments in the economic situation flexibly and promptly without further legislative action.

The authorities might be overanxious about the size of the budget deficit, Mr. Ryrie commented. Its size was largely the result of a decline in revenue; a fiscal stimulus resulting in more rapid growth might, in fact, reduce the deficit. Moreover, in the particular circumstances of Japanese industry, the danger of inflation could perhaps be greater if the recovery was delayed or if it was too slow.

Mr. Wahl noted that the economic recovery that had begun in the spring of 1975 had not continued to develop during the course of the year. However, Japan had been the only major industrial country to register positive growth--1.5 per cent in real terms--in 1975; the authorities should be commended for their management of the economy. Nonetheless, for a country that had achieved an annual rate of growth of around 10 per cent during the previous decade, performance had been rather disappointing. In fact, the economy had been characterized by a persistently low level of economic demand, despite the implementation of a variety of anti-recession measures. The present recession had had some positive effects, particularly with regard to prices and the external account. On the other hand, it had adversely affected the productive sector, increased public sector deficits, and reduced confidence in the household sector.

The Japanese authorities and most economic observers agreed that the recovery, generated by public investment programs and increased external and domestic demands, would increase at a slow pace before accelerating during the second half of 1976, Mr. Wahl remarked. However, the size of the public deficit and the deterioration of the financial situation of Japanese firms was alarming. Despite the rapid deceleration of inflation in 1975, for which the authorities were to be commended, it appeared likely that inflation could again become a major concern of Japanese economic policymakers.

The staff seemed to underestimate the risk of a resurgence of inflationary pressures in 1976, Mr. Wahl stated, when it forecast a consumer price increase of 1 per cent and a quasi-stability in both import and export prices. More likely, import prices and wage costs would increase moderately in 1976. With an expected 8 per cent to 10 per cent rise in salaries, the reduction of the deficits of the public sector--state, local government and public enterprises--and the easing of the financial position of Japanese firms would only be possible if adjustments to public utility prices and industrial prices were made. The projected increases--

20 per cent to 30 per cent for public utilities--tended to cast some doubt on the staff expectation of a deceleration of inflation in 1976.

As to the staff projections for the balance of payments, Mr. Wahl considered them to be too optimistic. Although the financing of the balance of payments deficit would not result in serious problems, it might be necessary to engage in long-term borrowing or to slightly reduce official exchange reserves.

Despite the relatively disappointing results of the antirecession programs, implemented by the government in 1975, Mr. Wahl commented, the staff continued to believe that the launching of the economy called for a more expansionary public investment policy. From the information provided by Mr. Kawaguchi about the newly formulated budget for fiscal year 1976, it appeared that the staff recommendation would be followed in order to ensure a steady economic upswing and to achieve stable and balanced growth. In the present circumstances, qualitative incentives for consumption, either tax reductions or an increase in social transfers, were likely to achieve immediate and lasting results in stimulating domestic demand and activity.

Referring to interest rates, Mr. Wahl indicated that he had been surprised to read on page 15 of SM/75/303 that the interest rate structure appeared to be broadly satisfactory at the present time. The level of interest rates, particularly in the short-term range, remained high compared with rates abroad, and their resistance to any downward trend was considerable. The situation might be explained either by the complexity of the Japanese credit system or by the so-called "banking cartelization" or by both. For example, between April and November 1975, the average interest rate on loans granted by banks to their customers had declined by only 0.6 per cent whereas, during the same period, the official discount rate had been reduced by 2.5 per cent.

Finally, the staff had endorsed without reservation the exchange rate policy of the Japanese authorities, Mr. Wahl observed. He would have preferred a more detailed formulation of the policy since, on the one hand, the floating of the yen had been managed for several months and, on the other, there had been an agreement to avoid erratic movements of exchange rates due to disorderly market forces.

Mr. Whitelaw wondered whether the staff or Mr. Kawaguchi could provide background information regarding the difference between them on their estimates of consumer price movements in the period ahead. The staff had predicted an increase of around 6 per cent for the coming fiscal year, while the authorities had estimated a rise of 8.8 per cent. In addition, the OECD had forecast an increase of 9.75 per cent for the calendar year 1976.

The producers' inventory/shipment ratio seemed to be particularly high, Mr. Whitelaw commented. Could a high ratio be consistent with a 10 per cent increase in the volume of imports in fiscal year 1976? Like Mr. Wahl, he believed that in the present world situation it was somewhat strange to assume virtually stable prices for both imports and exports for 1976. Of course, if the projections turned out to be incorrect, the estimates for the trade balance and the current account would have to be revised.

Previously, the staff had believed that economic growth would be achieved by concentrating on a consumption-led recovery, Mr. Whitelaw noted, whereas Mr. Kawaguchi had suggested that emphasis should be laid more on public authority expenditures and works. In the light of past experience, he wondered whether the authorities should have concentrated on public investments, since their effect on total demand was limited. There seemed to be a long built-in time lag between the decision to implement a program of public works, the letting of contracts, the employment of people and the creation of actual demand. The contingency fund of ¥ 150 billion would be of little use in dealing with developments in the economic situation effectively unless the fund could quickly be translated into effective demand.

Every member country should be free to set its own targets with respect to prospective rates of growth in the medium term, Mr. Whitelaw considered. However, he questioned whether the radically altered expectations regarding growth in Japan would not result in problems for the maintenance of internal economic and social equilibrium, as the country had previously experienced many years of rapid economic growth. While the ecountry had suffered two years of severe recession without too much disturbance, could it successfully adapt to a different type of economy from the one it had had during much of the postwar expansion?

The Japanese authorities maintained a managed exchange rate, Mr. Whitelaw remarked. They should keep the rate under review and watch the related movements in the balance of payments, which had often moved rapidly into surplus with undesirable consequences for Japan's trading partners.

More generally, Mr. Whitelaw said, he was grateful to the staff for a paper in which it had stated a point of view different from that of the Japanese authorities. As the representative of countries that were exporters of primary products and raw materials he had been initially disposed to side with the staff. However, he could also appreciate the argument presented by Mr. Kawaguchi. The most important consideration was for the staff to continue to voice its reservations about members' policies when it had them. While there were deficiencies in GNP gap analysis, he doubted whether any other concept could be as useful if one wished to make what he regarded as valid comparisons. Overall, he had been impressed by the ability of the Japanese authorities to make appropriate adjustments to deal with such problems as a large balance of payments deficit, a rapid rate of inflation and a large increase in the price of imported oil. Although stability was a valuable export, in the period ahead the authorities should pay attention to the consequences for the rest of the world of their economic policies.

Mr. Åsbrink commended the Japanese authorities for the impressive results that had been achieved by their economic policies. The central issue in the discussion between the staff and the authorities had been the assessment of the strength of the recovery and the policies required to sustain it. The staff had expressed some doubt as to the adequacy of the stimulative actions taken by the authorities. His own authorities tended to share the view of the staff; in particular, they believed that in the short term a higher priority should be given to pulling the economy out of the recession and to achieving a more satisfactory level of capacity utilization. A faster short-term rate of growth would not contradict the objective of a medium-term rate of growth lower than the rate that had prevailed during most of the postwar period. In addition, his authorities did not believe that further stimulatory action would compromise the important objective of avoiding a resurgence of inflation; the risk could be reduced by adopting measures of a temporary and reversible character. Moreover, a higher rate of capacity utilization would have a dampening effect on the rise in the average unit cost of production. The need to increase capacity utilization appeared to have been confirmed by the tendency toward stagnation or decline in industrial production in the fourth quarter of 1975. At present, utilization of manufacturing capacity was below 80 per cent, and there also existed a large overall gap between potential and actual GNP.

In view of those slacks, Mr. Åsbrink continued, and the recent success of the authorities in internal and external stabilization policies, Japan was in a good position to stimulate domestic demand and thereby achieve balanced economic growth. Japan, unlike many other countries, was in the enviable position of being able to serve its own interest and, at the same time, serve the interest of the world community.

Mr. Jagannathan praised the Japanese authorities for their well-conceived measures for tackling inflation, for keeping the level of unemployment below that experienced by other industrial countries and for achieving a positive rate of growth in 1975. The difference of view between the staff and the Japanese authorities had been with respect to the adequacy of fiscal stimulation to economic recovery. While the authorities considered a cautious approach appropriate, the staff had suggested a more expansionary policy to achieve the rate of growth needed to reduce existing excess capacity. Moreover, Mr. Kawaguchi had said that his authorities would not regard the balance of payments as a major constraint in the pursuit of its policy objectives. Considering the importance of the Japanese rate of economic recovery for other countries--particularly those in Asia--he was disposed toward the staff position in favor of more rapid growth. Nonetheless, he found Mr. Kawaguchi's remarks persuasive. The authorities appeared to be following a pragmatic policy regarding the appropriate degree of stimulation, a course with which he sympathized, particularly since their attitude was based on the fear of rekindling the inflationary pressures of the previous few years.

The growth potential of the economy had been reduced from the 10 per cent to 11 per cent achieved in recent years to around 6 per cent, Mr. Jagannathan noted. Like previous speakers, he considered that achieving a rate of growth of 5.6 per cent in 1976 would be a good performance. Perhaps the price stability resulting from such a rate of growth would enable Japan to attain a higher rate of growth in coming years. He welcomed the authorities' intention to take additional measures, if necessary, to ensure the achievement of the 1976 growth target, by activating the contingency fund for public works and by concentrating the execution of public works expenditures in the earlier part of the fiscal year. Although Mr. Whitelaw had mentioned the time lag between making plans for public works and creating employment, he presumed that the authorities had taken measures to reduce the time lag. Finally, he was pleased to note that the budget provided for an increase in development assistance, and he thanked Japan for its sustained and beneficient assistance to his constituency.

Mr. Suárez said that he had been impressed by the success of the Japanese authorities in reducing inflation. However, economic indicators presently pointed to a weak recovery from recession. The major determinant of whether the recovery would accelerate was whether the stimulus given by the public sector would be able to compensate for the deficiencies of private investment and consumption. He wondered why the authorities had not reduced taxation to stimulate private demand.

He had been interested in the section in the paper on recent economic developments entitled "developments affecting capital flows," Mr. Suárez remarked, and in particular in the section relating to capital flows to developing countries and the analysis of bilateral trade and capital flows. In that connection, he noted that the decline in overall flows in 1974 had been compounded by a lack of adjustment of changes in bilateral flows to changes in bilateral trade balances. It was a pity that figures were not available for 1975. The detailed coverage of capital flows to developing countries in the staff paper should be repeated in other papers covering economies of the importance of Japan. Staff papers on industrial countries had usually concentrated on the amount of official development assistance given. For many countries other types of assistance were more important than official development assistance. In the case of

Japan, direct investments had largely compensated for the low level of official development assistance. In future, staff papers should provide information regarding access to a member's capital markets by both multilateral institutions and individual countries. While the World Bank and the Asian Development Bank had had access to Japan's capital markets, access for individual countries remained somewhat closed.

Mr. Yaméogo indicated that he had read with interest the tables in the paper on recent economic developments regarding the geographic distribution of Japan's foreign trade and the distribution of loans and other long-term credits. Table III-11 had shown loans and other long-term credits to international organizations, industrial countries, and others; he would welcome similar statistics on a geographic basis for Latin America, Asia, and Africa. Japan's direct investment in those areas was less than its favorable trade balance, and that meant that they were financing Japan's development. Nonetheless, it was encouraging to note that Japan's trade with the developing countries was increasing by about 25 per cent per year. The state of the Japanese economy was of interest to the international community in general, and to the developing countries in particular.

The Deputy Director of the Asian Department commented that formulating policies on the basis of economic forecasts was difficult, especially at the present time when economic dislocations were still large. With regard to those Executive Directors who had asserted that excessive reliance had been placed on GNP gap analysis, the staff report (SM/75/303) had not used an overall gap estimate, partly because the Japanese authorities were re-examining their statistical data and partly because of the doubts about the significance of aggregate gap figures. There were, however, wide ranging data indicating the existence of unused capacity in the economy. For example, Table I-3 on page 10 of the paper on recent economic developments showed the level of capacity utilization in major industrial sectors. Even after a good recovery in the second quarter of 1975, capacity utilization in many industries had remained below 80 per cent, providing worrisome evidence regarding the depth and extent of the recession. With the projected rate of growth of 5.6 per cent for fiscal 1976, and the medium-term rate of growth of 6 per cent through the end of the decade expected by the authorities, excess capacity would remain substantially unchanged through the period. Chart 1 on page 8a of SM/75/303 provided some indication of the extent of the problem. Moreover, the excess capacity was associated with a serious squeeze on profits with unfortunate implications for price performance. While a long-term rate of growth of 6 per cent was perhaps not unreasonable, the staff believed that a better strategy would be to approach the rate after a period of faster growth to reduce the amount of unutilized capacity.

Part of the staff concern had been caused by the absence of smooth and vigorous recovery in the second half of 1975, the Deputy Director remarked. Recovery had accelerated in the second quarter of 1975, but stopped in the second half of the year as output trends remained flat. Private investment would probably increase by 2 per cent in real terms in 1976, as had been forecast. However, given the slow adjustment in inventories in the second half of 1975, the staff projection that they would rise in the first half of calendar year 1976 now appeared optimistic, and it was even doubtful how strong the increase would be in the second half. Both in 1974 and in 1975 private consumption had been disappointing, as increases in incomes were accompanied by higher savings. The staff had assumed a 10 per cent increase in wages from the 1976 "Spring round" of negotiations, and had projected a rise in consumption based on that figure and on the assumption that the upward shift of the savings function would be halted. As to the balance of payments, he agreed with those Executive Directors who said that exports would rise, but imports were expected to rise faster than exports and, therefore, the external position would deteriorate.

The estimates relating to the budget, the Deputy Director said, had been based on conversations that the staff had conducted with the authorities in November 1975, prior to the publication of the budget. The figures presented in SM/75/303 were, however, little different from the ones that Mr. Kawaguchi had used in his statement. The staff had assumed an increase in expenditures of 7 per cent in real terms, and that was very close to the actual budget. He noted that the amount available to the contingency fund for public works--¥ 150 billion--had been included in the budgeted expenditures, but it had not been singled out for emphasis because it was so small--0.6 per cent of total general account expenditures. Current receipts were forecast in the budget to rise by 10.8 per cent, which the staff regarded as a conservative estimate when GNP in nominal terms was estimated to increase by 13 per cent. As the rate of change of expenditure was higher than the targeted rate of growth of 5.6 per cent for the economy as a whole, the budget could be regarded as providing some stimulus. However, expenditure on the Fiscal and Investment Loan Program was projected to decline by 0.8 per cent between 1975/76 and 1976/77. With vigorous recovery in the private sector, such a pattern of expenditure changes would be satisfactory. If there were doubts, however, that private investment and exports would increase markedly, hope for recovery would have to be based solely on an increase in consumption, which had behaved in an erratic way recently. It was in that context that the staff had questioned whether fiscal policy was sufficiently expansionary, especially given the problem of time lags.

As to monetary policy, the Deputy Director remarked, the 14 per cent increase in money supply (M_2) in the last quarter of 1975 appeared appropriate. The staff was worried that insufficient demand from the private sector would mean that credit expansion would not be sufficiently vigorous to ensure that the level would be reached during 1976. The staff, therefore, foresaw the possibility of government borrowing beyond the amounts provided in the budget without exceeding the 14 per cent growth target for money supply.

Regarding central bank purchases of low-yielding government bonds, the Deputy Director commented, the purchases had been made in connection with the authorities' credit policy and had not been prompted by a desire to ease the profit squeeze on the banks. However, since August 1975, there had been a considerable effort to reduce the level of lending rates, and that had involved reductions on rates paid on deposits prior to the reduction of lending rates.

The staff had initially been surprised by the estimate that anti-pollution investment would rise to about 20 per cent of total investment, the Deputy Director indicated, as that seemed high compared with other industrial countries. The estimate had been worked out by the Ministry of Trade on the basis of a sample survey of industry and was regarded as accurate. It undoubtedly reflected a major effort to curb the harmful effects of highly concentrated industrial production.

The relationship between the staff forecast of the rise in the consumer price index and the sharp adjustment of prices of public utilities was consistent, the Deputy Director remarked. The 8 per cent to 10 per cent increase in wages expected in the spring of 1976 should be substantially offset by increased productivity, provided that the rate of growth was in the range of 5 per cent to 6 per cent. There were, however, accumulated pressures on profit margins and predictions of the extent of the rise in consumer prices were consequently subject to a considerable range of error. The staff assumption of near stability of dollar prices for imports and export prices had been drawn from the analysis in the World Economic Outlook papers. Finally, on fiscal policy, the staff had favored expenditure increases rather than tax cuts because, in the light of the recent behavior of the consumption function, tax cuts might have little, or only a delayed, effect on consumption expenditures.

Mr. Sacerdoti said that his authorities regarded GNP gap analysis as useful. The staff should continue to employ the concept and try to make improvements. For instance, the analysis should take account of all kinds of shifts both in the composition of labor and in supply and demand. To abandon the concept because of criticism would make it easier for members to justify policies that would not reduce unemployment or capacity underutilization. Of course, he would be pleased if a better concept than gap analysis could be found; the staff should conduct different analyses, if possible.

Mr. Drabble observed that on page 8 of SM/75/303, Supplement 1, the staff had reported that the operating ratio of manufacturing industries, which had been 83.5 in November 1975, was projected to reach 94 by March 1977. The figures appeared to suggest a rapid taking up of the slack in the manufacturing industries, and ran counter to some comments by the staff in its papers regarding the problem of the gap between actual and potential output.

The Deputy Director of the Asian Department commented that the staff believed that the official estimates seemed to have overlooked the expansion of capacity that would inevitably occur if investment achieved the levels projected for the period.

Mr. Kawaguchi observed that a fundamental question was whether or not the Government's policy was sufficiently expansionary; on that matter, the views of the Executive Directors differed. He was encouraged by the general support given to his authorities' steady and realistic policy stance; but, at the same time, he would pay due regard to those who had voiced anxieties about the strength of the recovery. His authorities attached political importance to the achievement of a real rate of growth of 5.6 per cent in fiscal year 1976, and they would be prepared to take additional measures, if necessary, in order to reach their goal. The budget for fiscal year 1976 represented the maximum efforts of his authorities to ensure a smooth upswing within such constraints as the balance between the expansionary effect of policies and confidence in government finance, the fear of "crowding out" from capital markets and the anxiety about reviving inflation. In that connection, he had some difficulty in understanding the staff attitude in singling out Japan, especially in the World Economic Outlook paper, on the grounds that its fiscal policy was not sufficiently expansionary. From listening to the present discussion, it appeared that his authorities' policies had been broadly endorsed by the Executive Directors.

As to the size of the Government's deficit in terms of GNP and the portion of total government expenditures to be financed by bond issues, Mr. Kawaguchi remarked, an international comparison between major industrial countries of the latter ratio showed Japan's to be the highest in both 1975 and 1976. In fiscal 1976, for instance, the portion of total government expenditures to be financed by bond issues would reach 30 per cent in Japan compared with 23 per cent in Germany, 11 per cent in the United States and zero in France. Moreover, the figures in those three countries would be lower than in 1975, while that of Japan would increase from 26 per cent to 30 per cent. More important than the international comparison was the authorities' belief that the new budget would be sufficiently stimulatory to ensure the achievement of 5.6 per cent real growth in fiscal year 1976.

The staff's rejoinder, Mr. Kawaguchi continued, was that Japan's policy was not sufficiently expansionary in view of the country's high growth potential and the existence of large economic slacks. Gap analysis was a popular concept in Japan and should be further developed; in fact, estimates were made by both official and private institutions using various functions. While it was a useful tool, special care had to be taken when relating it to policy applications. According to the index compiled by the Ministry of International Trade and Industry, capacity utilization of manufacturing industry stood at 84 in October 1975--1970 being 100--compared with 77 at the bottom of the recession in March 1975. The indices for individual sectors showed a considerable divergence; for example, petroleum 74; chemicals 75; metal products 73; and pulp and paper 76 indicated a large amount of unused capacity. On the other hand, the indices for automobiles 97; textiles 92; and electrical machinery and equipment 89 showed a high or virtually full utilization of capacity. Such a divergence highlighted the danger that too rapid an expansion would lead to an acceleration of price increases, even though the aggregate rate of utilization showed the existence of slacks. In passing, he noted that the official forecast was that the index of capacity utilization of manufacturing industry at the end of the next fiscal year in March 1977 would be around 94.

There were technical problems with the production function that was used to estimate the gap, Mr. Kawaguchi said. First, the function was based disproportionately on the manufacturing sector and failed to take account of the rising importance of the service sector; and second, capital stocks failed to exclude antipollution investment that did not contribute to productive capacity.

His authorities believed that a downward shift in productive capacity had occurred in the course of the so-called "oil crisis," Mr. Kawaguchi indicated. The aluminum industry, for instance, had been forced to terminate its domestic refinery operations, because electricity had become too expensive and, as a result, the industry had lost its international competitiveness. Further, the shipbuilding industry had a large productive capacity, but due to a marked structural decline in demand for tankers after the oil crisis, it was doubtful whether the authorities should regard the capacity as idle to be absorbed by expansionary policies, or whether they should count it as a cushion to prevent inflationary pressures from emerging once the upswing became vigorous. The intensification of antipollution controls in the past several years had also reduced productive capacity. Many industries had been forced to write off old capacities or had been compelled to operate at a lower rate of output as a means of reducing pollutants or noise.

The difference of opinion between the Japanese authorities and the staff, and among the Executive Directors, Mr. Kawaguchi considered, had centered on whether or not a 5.6 per cent real rate of growth could be achieved given the authorities' present policies. Recent indications were that housing construction had increased, that exports would rise, that industrial production would rally, and that corporate profits would improve. Moreover, increased price stability should contribute to a rise in private consumption and the budget should help restore business confidence. There had been a steady increase in domestic demand for iron and steel, which, supported by good orders from abroad, had reduced dealers' inventories; in previous recoveries, expansion in the iron and steel industries had been the harbinger of overall recovery.

Several Executive Directors had recommended a tax reduction to stimulate the economy, Mr. Kawaguchi recalled. Reducing income and corporate taxes had been a controversial issue and had been urged by many in the business community. However, his authorities believed that recovery was under way and that present policies were sufficiently stimulatory to ensure a smooth upswing. Moreover, no tax reduction had been envisaged because the fiscal deficit, which had to be financed by bond issues, was considered high enough and it had been thought unwise to increase it. In addition, government expenditures--especially public works expenditures--appeared to be more effective in stimulating the economy than an equal amount of tax reductions, particularly in view of the present high savings ratio that was unlikely to be speedily reduced.

Finally, the figure of 9 per cent for the ratio of central government deficit to GNP in fiscal year 1976 had been taken from the staff paper, Mr. Kawaguchi commented; his authorities did not have an official estimate of their own. While the staff predicted that in 1976 the ratio would not change substantially, he believed that it would increase to some extent, and that again showed the expansionary character of the 1976/77 budget.

The Executive Directors concluded their discussion of the report for the 1975 Article VIII consultation with Japan.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Directors without meeting in the period between EBM/76/14 (2/4/76) and EBM/76/15 (2/9/76).

4. KOREA - TECHNICAL ASSISTANCE

In response to a request from Korea for technical assistance, the Executive Board approves the proposal set forth in EBD/76/18 (1/30/76).

Adopted February 4, 1976

5. KUWAIT - TECHNICAL ASSISTANCE

In response to a request from the Central Bank of Kuwait for technical assistance, the Executive Board approves the proposal set forth in EBD/76/19 (1/30/76).

Adopted February 4, 1976

6. UNITED NATIONS - AD HOC COMMITTEE ON RESTRUCTURING - FUND REPRESENTATION

The Executive Board approves Fund representation at the second session of the Ad Hoc Committee on the Restructuring of the Economic and Social Sectors of the United Nations System to be held at the United Nations Headquarters, as set forth in EBD/76/20 (2/2/76).

Adopted February 5, 1976

7. SURINAM - REQUEST TO PUBLISH REPORT ON RECENT ECONOMIC DEVELOPMENTS, 1975

The Executive Board approves the recommendation set forth in EBD/76/22 (2/2/76).

Adopted February 6, 1976

8. INFORMAL BOARD RECESS

The Executive Board approves the proposal set forth in EBAP/76/16 (2/3/76).

Adopted February 6, 1976

9. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/76/17 (2/5/76) is approved.

APPROVED BY THE EXECUTIVE BOARD:
Meeting 76/83, June 11, 1976

H. JOHANNES WITTEVEEN
Chairman

ROGER V. ANDERSON
Acting Secretary