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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 93/101

2:30 p.m., July 16, 1993

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
	J. M. Abbott, Temporary
	J. B. Wire, Temporary
J. de Groote	
I. Fridriksson	
H. Fukui	N. Tabata
	T. Oya, Temporary
K. P. Geethakrishnan	
	K.-T. Hetrakul
	Hon C.-W., Temporary
	W. C. Keller, Temporary
	J. C. Jaramillo
	G. Y. Glazkov, Temporary
G. Lanciotti	J. Papadakis
	P. Bonzom, Temporary
R. Marino	P. A. Merino, Temporary
	O. Kabbaj
	B. S. Dlamini
D. Peretz	J. Dorrington
G. A. Posthumus	
	Y.-M. T. Koissy
S. Schoenberg	
	Y. Y. Mohammed
D. E. Smee	
E. L. Waterman	A. M. Tetangco, Jr.
	Wei B.
	Wu H., Temporary
	A. F. Jiménez de Lucio

L. Van Houtven, Secretary and Counsellor
S. Yeager, Assistant

Also Present

Central Asia Department: H. Neiss, Director; B. B. Aghevli, Deputy Director; U. Baumgartner, M. W. Bell, E. R. D. Canetti, Y. Horiguchi, S. Y.-L. Jen, J. S. Kahkonen, S. Kim, K. Kochhar, H. L. Mendis, G. M. Meredith, K. M. Miranda, I. Otani, Y. Yokoyama. European I Department: P. R. Masson, H. Vittas. External Relations Department: E. Ray. Fiscal Affairs Department: A. T. Mourmouras. Legal Department: F. M. Zeidan. Policy Development and Review Department: J. T. Boorman, Director; T. Leddy, Deputy Director; M. Allen, N. Kirmani. Research Department: T. A. Bayoumi, S. M. Fries, F. Larsen, G. J. Schinasi. Secretary's Department: A. Leipold, A. Mountford. Western Hemisphere Department: S. T. Beza, Counsellor and Director. Office of the Managing Director: P. R. Narvekar, Special Advisor; G. R. Saunders, Personal Assistant. Advisors to Executive Directors: J. O. Aderibigbe, A. Chang Fong, J. Jonas, W. Laux, M. F. Melhem, J. R. Súarz, J. W. van der Kaaij. Assistants to Executive Directors: H. M. Al-Atrash, S. Al-Huseini, G.M. Blome, J. H. Brits, C. D. Cuong, J. C. Estrella, R. Ferrillo, L. Fontaine, H. Golriz, S. Ishida, T. Kanada, E. Kotova, A. M. Koulizade, T.-M. Kudiwu, K. J. Langdon, B. M. Lvin, G. J. Matthews, S. C. McDougall, R. K. W. Powell, N. Prasad, E. Quattrociocche, S. K. R. Regmi, P. L. Rubianes, A. Sighvatsson, A. Viirg.

1. JAPAN - 1993 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/93/100, 7/16/93) their consideration of the staff report for the 1993 Article IV consultation with Japan (SM/93/132, 6/22/93; and Sup. 1, 7/12/93). They also had before them a background paper on recent economic developments in Japan (SM/93/142, 7/6/93; and Sup. 1, 7/8/93).

Mr. Jaramillo made the following statement:

Japan's economic slowdown, although deep by Japanese standards, has been comparatively short. To a large extent this can be attributed to the Government's ability to adopt a stimulative fiscal package aimed at reviving faltering demand. This option was more clearly available to Japan than to any other industrial country during the world economic slump of the early 1990s, owing to its fiscal discipline during the 1980s. Although it is true that Japan may confront savings difficulties over the medium and long term resulting from an aging population, in the short run it has been able to stimulate demand safely because of its overall favorable fiscal position and low inflation.

Current conditions seem set for both a resumption of growth and a reduction in the surplus, thanks to a recovering economy and an increased responsiveness of imports to changes in domestic demand. However, recent yen appreciation does cast a shadow on short-term recovery prospects. A cautious stance is thus called for. In past recessions Japan seems to have stimulated its economy too much for too long, giving rise to later problems. Furthermore, on this occasion many relevant indicators show that a recovery is already under way. For these reasons, we would caution against further fiscal stimulus at this time, unless clear indications emerge that a downturn is again a clear possibility. While further fiscal stimulus could conceivably help to more rapidly reduce Japan's trade and current account surpluses, an excessive stimulus would later require restrictive actions that could hamper the recovery in the medium term. Fiscal policy effects cannot be rapidly reversed and, since additional sharp fluctuations of the yen are undesirable, there would be little scope for monetary policy to quickly compensate in case of excessive fiscal stimulus. Financial sector fragility may also limit the scope for rapid monetary retrenchment.

We incline toward the view that overall macroeconomic constraints limit the extent to which Japan's trade surplus can be rapidly curtailed. Increased deficits in Germany and other industrial nations, in the states of the former Soviet Union, and in major Latin American countries must have their counterpart somewhere. To an extent, the increase in Japan's surplus provides some of the savings needed to finance these larger deficits.

Consequently, as this chair has argued on other occasions, Japan's trade surplus is not to be seen as an entirely unwelcome development. This is not to say we would not favor more open Japanese trade and distribution practices. However, in view of the considerations I have mentioned, we believe that fiscal stimulus directed at reducing the trade surplus is not called for at this time.

Mr. Jiménez de Lucio made the following statement:

We join previous speakers in welcoming the news that Japan's economy is showing increasing signs of recovery. As stated by Mr. Fukui, a strong adjustment effort by the private sector, coupled with stimulative policy measures by the Government, seems to have succeeded in turning around the economy. We commend the authorities on their success and encourage them to persevere with their efforts, so as to ensure that the economic recovery becomes firm and sustainable over the medium term. In this regard, we are heartened by the authorities' decision to set as the main policy target for the FY 1993 budget strengthening the economic recovery, relying mainly on domestic demand.

We are in broad agreement with the staff appraisal and will therefore focus our comments on a single subject: the current account surplus.

The recent increase in Japan's current account surplus is a cause for concern for many countries--an exaggerated concern in our view, as we stated during last year's Article IV discussion on Japan (EBM/92/88 and EBM/93/89, 7/15/92). External balances are, as we all know, determined by underlying patterns of savings and investment. Japan's high savings rate generates savings in excess of investment demand, resulting in a current account surplus fairly insensitive to government policies. The surplus can be expected to continue over the medium term.

On this matter, in the recent working paper on Japan's external adjustment (WP/93/52, June 1993), the staff concludes that over the 1986-92 period, trade volumes and prices reacted as predicted by conventional determinants of trade flows. In sum, the current account surplus will remain as long as there is no change in the fundamental determinants of external balance.

We should not conclude from this that nothing can or should be done with regard to Japan's current account surplus. On the one hand, investment opportunities abroad should be actively pursued. Japan can make a major contribution to development in other countries by exporting capital, particularly in the form of direct investment. In this regard, we are pleased to note that

last year the balance of payments once again registered a net outflow of long-term capital.

On the other hand, a major effort should be undertaken to effectively increase market access, through deregulating the distribution and transportation sectors, eliminating the remaining formal restrictions on agricultural products, and increasing the transparency of administrative rules and procedures. While these measures would increase market access, they are unlikely to reverse the current account surplus. Nonetheless, they would help reduce the surplus and, perhaps more important, would show Japan's willingness to take action to address its external imbalance.

Perceptions are sometimes more important than actions, because people react based on their perceptions. We believe that to a certain extent Japan is adversely affected by a negative perception abroad of its economic policies. In particular, some countries view Japan as unwilling to take the requisite actions to lower its current account surplus. This negative perception needs to be addressed, and the most convincing action that could be taken to this end is to increase access to Japan's domestic market.

We share the authorities' and the staff's concern over managed trade arrangements. This approach to redressing trade imbalances introduces unnecessary distortions and is clearly contrary to the promotion of free trade. The most effective way to promote multilateral trade is through a successful completion of the Uruguay Round, and we encourage the Japanese authorities to play an active role aimed at reaching a global agreement before yearend.

In closing, we commend the Japanese authorities for having increased significantly their official development assistance (ODA) and for becoming the largest donor country in the world. We welcome the authorities' intention to further augment their ODA under their fifth medium-term program and encourage them to attempt to reach the UN target in the near future. We also welcome the authorities' intention to participate actively in the funding of the ESAF successor.

Mr. Waterman made the following statement:

Listening to Mr. Dawson, I wonder what the Group of Two say to one another in private.

We are not preparing the report card on someone at the bottom of the class. Standing back a little, it is important to acknowledge that Japan's performance over the long haul has been excellent--some would say second to none. Japan has benefited

from relatively open world trade and capital markets. But the Japanese economy has also made an important contribution to world growth and improved living standards.

As to the current situation and immediate outlook, I agree with the comment made earlier that, looking back, clearly the authorities should have moved earlier to moderate the asset price boom in the second half of the 1980s and, in more recent times, should have moved earlier to ease policies so as to offset the sharp weakening in economic activity. In any event, there have now been sizable shifts in both fiscal and monetary policy that should get the economy moving and underwrite continued economic recovery. The full impact of the fiscal measures, particularly the most recent ones, will not be felt for some time. It is important to ensure the full and timely implementation of the package.

The staff's analysis suggests that it would be counterproductive to do more on the capital works side. I accept that argumentation. Taking that analysis at face value, if additional measures were taken on the fiscal side, they could well be difficult to reverse. In terms of the debate today, that may not be undesirable, insofar as it led to a better savings/investment balance in Japan. But it could work against the need to lift world savings as the recovery proceeds and investment recovers. Bond yields are still high for this point in the cycle; if we encourage greater public dissaving in Japan, it underlines the importance for the rest of us, including the United States, to reduce fiscal imbalances. As to Japan, the country is, I hope, at a stage in the cycle where further fiscal measures will not be required so long as the announced measures take effect quickly and the automatic stabilizers are allowed to operate fully.

Nevertheless, it is clear that the authorities need to keep an eye on the recovery and, if it appears to languish, some further easing of policy might be required. In view of our discussion today, I would probably come down on the side of monetary policy easing rather than fiscal policy easing. In that context, Mr. Dawson's point on the need for further reform of the financial system was particularly striking.

While I would not argue for further fiscal measures at this stage, I do not see any urgent need to begin fiscal consolidation at a time when early withdrawal of stimulus could jeopardize the recovery.

Japan has made some important progress in reducing barriers to external competition but much more remains to be done. This is especially the case in the area of agriculture but also more generally in terms of those factors identified by staff and other

Directors, including the distribution system, product standards, and government regulations and practices.

Japan clearly has a central role to play and interest in ensuring a successful outcome to the Uruguay Round and should be encouraged to do that.

I agree with the authorities' stance that managed trade is no solution. That view is consistent with this constituency's direct interest in an open world trading system. We believe history supports the view that, at best, policies such as managed trade are a poor substitute for more general measures to encourage trade and, at worst, run the risk of undermining the multilateral system that has served us well in the postwar period.

Size and wealth bring great benefits but they also bring significant responsibilities. We would encourage the Japanese authorities to take a strong leadership role in the further liberalization of world trade and capital flows in the period ahead.

Mr. Fridriksson made the following statement:

As in many other countries, the economic downturn in Japan has proved to be deeper and more profound than initially forecast. The combination of a sharp rise in asset prices during the 1980s, rapid economic growth, and the continuation of an easy monetary policy well into the economic upswing must be considered to be the main factors in explaining the current problems. Several downward revisions have been made since the Board last considered the Japanese economy. Even if special factors, such as the delay in implementing the stimulus package last fall, can explain some revisions, the effects of asset price depreciation once again seem to have been underestimated. The Government's latest fiscal package, together with last year's package, has stimulated the economy and may have created a more optimistic sentiment among market agents in Japan. However, the sharp and sudden appreciation of the yen and the problems in the financial sector reinforce uncertainties about the strength of the recovery. I can therefore agree with the staff that the economy is now in a delicate situation, and it is difficult to determine what constitutes a sufficient stimulus.

Some encouraging signs indicate that the economy may be turning around, as Mr. Fukui has emphasized. However, there are also some indications that more adjustment may still be needed before a sufficient autonomous recovery can be expected to take hold. One area of concern is the labor market. So far, there has only been a moderate increase in unemployment. This must be due

in part to institutional rigidities in the labor market. According to the background paper, productivity in manufacturing declined by 3.8 percent last year while unit labor costs rose by 8.6 percent. This may indicate that Japanese businesses will face increasing pressure over the coming months to lay off workers owing to the economic pressures of recession and increased international competition. If substantial adjustment has to take place at this juncture, it could delay recovery as incomes are depressed and workers increase their precautionary savings in response to decreased employment security. I would welcome some comments from the staff regarding the prospects in the labor market, as this issue is not extensively discussed in the staff papers.

The experience with overstimulation of the economy, which played a part in the overheating during the previous upswing, shows that the authorities need to be cautious in their attempts to support the recovery. Following years of prudent fiscal policies, the fiscal situation--despite Mr. Fukui's characterization--is sufficiently sound to offer some room for further stimulation, should that become necessary. Even so, the authorities must strike a delicate balance between immediate and medium-term goals. A "wait-and-see" attitude seems appropriate at this moment, but if the economy remains weak, the appreciation of the yen over the most recent months may also give scope for even lower interest rates than at present.

Even though there may be room for possible further fiscal stimulus later in the year, my authorities agree that in the medium term, partly owing to the aging of the population, expenditures will increase markedly. Thus, any stimulus package must be reversed when the recovery is firmly established. Any new fiscal measures that cannot be easily reversed will have a negative effect on the medium-term objectives. A reform of the tax structure to increase reliance on indirect taxes would yield positive results and provide some opportunities in the short run for using the budget in a countercyclical way.

On the financial sector, my authorities welcome the actions taken in August 1992 but fear that further action may be needed. Japanese banks still have substantial amounts of bad loans. While lower interest rates may help in the short term, the problems can only be solved in a medium-term context. Improved supervision and transparency are of utmost importance, and I encourage the authorities to take further steps in this direction. I also fully agree with the staff on the need to eliminate the distortions caused by the competitive advantage of the postal savings system.

I can accept that for the time being, current account movements can be explained by developments in economic fundamentals.

However, in view of the tendencies toward protectionism, I agree with the staff on the importance of deregulating those markets that remain regulated. This applies particularly to agricultural imports, but also to general legislation and administrative obstacles, and to what the staff calls "a web of rules and regulations in certain sectors." Changes aimed at improving market access for domestic and foreign producers in these sectors should take place in a multilateral context, and would strengthen competition, increase efficiency, and benefit the Japanese consumer.

A speedy conclusion of the Uruguay Round should also reduce the current protectionist tendencies and greatly benefit the world economy, not the least Japan. In this respect, I welcome the progress within the Quadrilateral Group toward an agreement on better market access for goods and services. The Tokyo summit declaration welcomed this progress as a major step toward the immediate resumption of multilateral negotiations in Geneva. Against this background, I strongly urge the Japanese authorities to do their utmost to facilitate a successful conclusion of the Uruguay Round.

Japan has provided substantial assistance to many countries, and I would like to note the generous contribution made by Japan to the Baltic countries within the framework of the Group of Twenty-Four industrial countries. Despite an intended increase in transfers to other countries in the years ahead, Japan's official development assistance remains relatively low in GDP terms compared with some other OECD countries. Considering Japan's strong position in the world economy, my authorities encourage the Japanese authorities to increase their official development assistance.

Mr. Merino made the following statement:

We welcome the staff papers and Mr. Fukui's statement, which highlight the policy dilemmas facing Japan. I would like to comment briefly on four points: the prospects for growth, fiscal policy, monetary policy, and the external accounts.

The Japanese economy, as Mr. Fukui has pointed out, is showing increasing signs of recovery from the cyclical downturn that began in mid-1991. However, uncertainty still remains regarding two issues: the robustness of the recovery in the short term and the potential growth rate of the Japanese economy over the medium term.

On the first issue, it seems that economic activity has lost momentum since the start of the fiscal year, based on the performance of a number of indicators, such as industrial production, machinery orders, and auto sales. However, increased public

spending and declining excess inventories should counterbalance this trend. The staff's introductory comments at the previous meeting regarding industrial production, the current account, and inflation give rise to a greater degree of optimism.

As to the second issue, the medium-term outlook, the staff considers that in spite of the slowdown in the potential growth rate from about 4 percent in the 1980s to 3 1/4 percent in the 1990s owing to population aging and lower private investment, the Japanese economy will grow above potential from 1995 onwards, recovering the so-called output gap. We wonder whether this projection is overly optimistic, especially in view of the nominal and real appreciation of the yen, or whether, in fact, potential GDP growth in Japan has declined. We certainly hope that this scenario--of Japan growing at above potential with low inflation while addressing the medium-term structural problems--materializes, as it would provide a strong impulse to the world economy. However, we have already heard the less optimistic divinations of others who are in the competition for the "golden guru award."

We share the staff's concerns about the excessive use of fiscal policy as a countercyclical instrument. There are medium-term concerns that have to be addressed, and the tendency has been to act "too much, too late" in reacting to previous cyclical weaknesses. As we have seen, there is a considerable lag between the approval of fiscal stimulus and the implementation of measures. There therefore seems to be little room for further fiscal stimulus in the event that the pace of recovery is not as robust as desired. This is particularly true if the authorities' forecast for tax revenues for FY 1993 proves to be optimistic.

The envisaged increase in tax revenue is based on assumptions of a high nominal GDP growth rate--around 4.9 percent--and a relatively high income elasticity of tax revenue of 1.3 percent. Even the staff's revised projections seem to be on the optimistic side, in light of the possible downward revision in the base for the FY 1992 estimate and the fact that the revised figures for nominal GDP growth and increase in tax revenues would yield an implicit income elasticity of tax revenue of around 2.6 percent. I would appreciate staff comment on its current views regarding tax revenues for FY 1993 and the forces underlying its projections.

As to monetary and exchange rate policy, even though the official discount rate is already at historically low levels and the growth rate of money supply seems to have turned positive since April 1993, the absence of inflationary pressures, coupled with the strong yen and its possible contractionary effects on the economy, could provide some room for a further easing of monetary

policy. Moreover, an easing of monetary policy would help the financial sector to "earn" its way out of its present difficulties.

We share the staff's views that the factors behind the recent surge in Japan's current account surplus are the conventional ones: relative prices and demand conditions in Japan and partner countries. However, Japan has to increase the transparency of its rules and regulations in many sectors--the so-called gray areas--in order to avoid external pressure about the need for a stronger reduction of its current account surplus. However, we agree with the staff that the present current account surplus is mainly the result of cyclical divergences and structural differences in savings and investment trends in major industrial countries. Moreover, we fully agree that managed bilateral trade is not the solution to the trade imbalances. We therefore welcome Mr. Dawson's clarification of his authorities' views in this regard.

We would like to commend the Japanese authorities for the generous official development assistance provided to many countries. We hope that the new five-year foreign assistance plan and the plan to increase financial cooperation to developing countries will provide a substantial contribution to the much-needed development assistance in developing countries and will lead the way to Japan's reaching the UN's ODA target.

Mr. Dlamini made the following statement:

As in many other industrial countries, the recession in Japan is deeper than expected. This is not good for the global economy. Therefore, the joint commitment of the major industrial countries to focus attention on the question of economic growth recently announced at their summit in Japan is welcome news. The Japanese Government has already made significant efforts in this direction, providing support to flagging domestic demand through two stimulus packages. On balance, it appears that the recession is bottoming out, although private demand remains fragile and there is concern about the appreciation of the yen. The authorities were better placed to implement countercyclical fiscal policies because of their commitment to fiscal consolidation in the 1980s. Other major countries should learn from the Japanese experience.

Despite the recession, the economy remains fundamentally strong: inflation is low, the level of unemployment is modest in absolute terms and in relation to the labor force, and public finances continue to be sound despite recent pressures. Mr. Fukui has given assurances that the process of medium-term fiscal consolidation will continue, aimed at containing government debt.

Japan's role in promoting a freer multilateral trading system is crucial. In this regard, the ongoing efforts aimed at lowering informal barriers to the Japanese market are welcome. In this respect, bilateral arrangements to improve market access should be discouraged. The multilateral system being pursued in the context of the Uruguay Round is the best way of dealing with trade issues. All major countries should act in a timely fashion to bring this Round to a successful conclusion.

Japan's financial assistance to developing countries is commendable. I note, in particular, the role of such assistance in many African countries. I am particularly pleased that Japan will participate in the funding of the ESAF successor. Its leadership in helping the Fund to respond more effectively to the needs of low-income countries should inspire other donor countries to act in a timely manner with regard to the establishment of the ESAF successor.

Mr. Koissy made the following statement:

We are in broad agreement with the staff's analysis and can endorse its policy recommendations.

Like other speakers, we are encouraged to note that the economic situation in Japan is showing some signs of recovery from the significant cyclical downturn experienced in 1992. This improvement appears to be a reflection of the completion of corporate inventory reduction following a cycle of balance sheet adjustments, the picking up of public investment, and the rising trend in equity prices. We also note that the economic measures and the fiscal stimulus packages adopted by the authorities are expected to contribute to a gradual economic recovery in the course of 1993 and more significantly in 1994, when the rate of economic growth is projected at 3 percent. While we support the strong expenditure increase that has been planned under the fiscal stimulus packages, we share the authorities' view that the process of fiscal consolidation should resume once the recovery is firmly established.

In view of the risks mentioned by the staff, we agree with the authorities' objective of monitoring a broad range of indicators for the conduct of monetary policy. We also find appropriate their intention to restructure the financial system by addressing, without cost to taxpayers, the question of nonperforming loans, as well as enforcing more market discipline on financial institutions. In this regard, we welcome Mr. Fukui's statement that so far, developments indicate that the problem of nonperforming assets will not undermine the stability of the banks' management or the financial system as a whole.

On external economic cooperation, Mr. Fukui has given detailed information on the assistance that Japan is providing to other countries, especially to developing countries, and also on the projected increase in ODA under the fifth medium-term plan. This chair cannot but express its appreciation to the Japanese authorities for their efforts to assist the developing countries, particularly when acknowledging that this assistance is not necessarily tied. We are also very much encouraged by the statement that Japan will participate actively in the funding of the ESAF successor.

Mr. Kabbaj made the following statement:

In view of the wide-ranging discussion that has already taken place, I will be brief.

On the overall stance of macroeconomic policies, we agree that the principal policy issue facing Japan at this juncture is how to provide support for economic recovery led by domestic demand and facilitate a return to the path of sustainable non-inflationary growth. While economic developments in early 1993 showed some improvement, indicating that the recession has probably bottomed out, considerable uncertainty remains on the timing and strength of the recovery. The weakness in macroeconomic indicators in April-May 1993 underscores this point. The authorities deserve to be commended for the strong fiscal policy actions taken in 1992-93, which should provide substantial stimulus through the remainder of the fiscal year. However, the situation calls for careful monitoring. Should the recovery falter, we hope that the authorities will give careful consideration to the need to provide additional fiscal support in the context of the supplementary budget.

On monetary policy, we can support the staff and those Directors who have argued that the sharp appreciation of the yen, combined with weak inflationary pressures, offers the authorities some scope for additional monetary easing. It would also alleviate the contractionary impact now being felt on the economy and help place the incipient recovery on a more firm footing. At the same time, like Mr. de Groote and others, we believe that the health of the financial sector should not be overlooked.

With regard to the external surplus, the staff is right in saying that macroeconomic policies should not be altered specifically with a view to reducing the surplus. However, a surplus which is augmented by cyclical factors does invite protectionist pressures. In any event, we welcome the fact that Japan's long-term capital account has reverted to a traditional deficit position and thereby continues to provide valuable savings to the world economy. We were nevertheless concerned by the fact,

reported in the background paper, that within the long-term capital account, net investment by Japanese firms dropped by one half in 1992.

On external economic cooperation, we welcome the increase in ODA in the fifth medium-term plan. However, while the absolute amount of Japan's ODA makes it the largest donor country in the world--and this is certainly commendable--Japan's position in the global economy warrants a special effort to lead the way by raising its ODA toward the UN target. We would also urge a better geographical distribution of its ODA flows.

We join the staff and other Directors in urging Japan to continue to play a leading role in helping to bring the Uruguay Round to a successful conclusion and hope that the progress made in the discussions on the Round during the recent Economic Summit will give new impetus to an agreement.

We commend the authorities for their various contributions to the Fund in the past and for their active participation in the funding of the ESAF successor.

Mr. Mohammed made the following statement:

Economic growth performance in Japan during the first quarter of 1993 was stronger than expected. However, as noted by the staff, the subsequent weakening in macroeconomic indicators underscores the continued downside risks present at this stage in the business cycle. I therefore agree that the main issue for macroeconomic management at this juncture is to give support to economic recovery so as to ensure that it gains sufficient momentum and a firm foothold.

There cannot be much disagreement that the depth of the recent recession in Japan was, at least initially, substantially underestimated. To a considerable extent, this may have reflected an underestimation of the wealth and other effects of the sharp asset price decline. In addition, it would appear that not enough weight was given to asset price movements in the formulation of monetary policy. This, in turn, may have compounded the inadequacy of traditional indicators of the tightness of the monetary policy stance. There is therefore in our view a clear need for developing more reliable indicators of monetary conditions. Until such indicators are developed, it will be important to continue to exercise due flexibility in formulating monetary policy, and to do so in a manner that gives more attention or weight than in the past to movements in asset prices.

The pressure that banks in Japan came under in recent years has had a large real estate component, as was the case in banking

systems in other industrial countries. It is hoped that as the recovery takes hold, the banking sector's strains will ease. Nevertheless, we share the staff's emphasis on the need to resolve asset quality problems as quickly as possible, and on the need to have asset quality disclosed more fully.

We endorse the staff's views on trade and structural policy issues. On trade, I would, in particular, wish to join the staff in calling on Japan to do everything in its power to help bring the Uruguay Round to a successful conclusion.

I would like to join previous speakers in commending the Japanese authorities for their ODA contributions and in urging them to make every effort to move more quickly toward achieving the UN target of 0.7 percent of GDP.

Mr. de Groote said that in view of the divergence of views that had arisen in the course of the discussion regarding Japan's current account surplus, and to clarify further his own position in that regard, he wished to distinguish two questions that he had addressed in his statement without, perhaps, separating them sufficiently. The first was: was Japan's current account position optimal from the viewpoint of international adjustment? The other was: could or should Japan's current account position be influenced by short-term expansionary demand management measures at the current time? Most Directors would say "no" to the first question, although Mr. Peretz had convincingly explained the many sides to the problem and most speakers had, in the framework of the current world shortage of savings, congratulated the Japanese authorities for recycling their large surplus to some extent.

On the second question, he had attempted in his statement to defend the view that in current circumstances, not much additional fine-tuning could, or should, be done, Mr. de Groote continued. The package of measures that Japan was implementing seemed to be substantial, and there were serious indications that a recovery would soon take hold and that the recovery would be strong because the rehabilitation of the financial position of enterprises and financial intermediaries was almost complete. Moreover, experience indicated that Japan had almost always, at the general prodding of the rest of the world, implemented excessively expansionary measures at certain phases of the business cycle when that was no longer needed.

Some Directors had pointed out that part of the asset bubble at the end of the 1980s and the beginning of the 1990s was due to the fact that monetary policy had become too expansionary and the appropriate mix between fiscal and monetary policy had not maintained, Mr. de Groote recalled. One should not forget that during that period, the Executive Board had continued to urge Japan to be expansionary and even to reinforce its expansionary fine-tuning. In current circumstance, he considered that the Board should recommend to the Japanese authorities that they continue to look at the situation, and, in the spirit of pragmatism and flexibility, adopt

additional expansionary measures before the end of the year, if the recovery did not materialize, and to move quickly to consolidation in the event that the recovery blossomed.

Looking at the current account position, the imbalance between Japan and the other industrial countries seemed to be mainly the result of J-curve effects of exchange rate movements and diverging macroeconomic policies, Mr. de Groote continued. It was therefore not obvious to him that subtle changes in the composition of the demand management package and fine-tuning in the direction of expansionary policies would have much impact on the current account position. In the circumstances, he believed that it would be wise to recommend to the authorities that they stand ready to react quickly to developments in the second half of the year. In fact, the current account could only be influenced by measures that acted on the structure of the economy, on the grey zone, and on the general conditions of competitive-ness between Japan and the rest of the world.

Unlike many other Directors, he had, at the previous consultation discussion, stressed deep concern about the emerging situation in Japan's banking sector, and he was therefore particularly pleased to see that a great deal had been done in the past year to strengthen the position of that sector, Mr. de Groote stated. Viewed in terms of the BIS's capital adequacy ratio, however, the situation of a number of Japanese banks remained precarious. He was not sure that the precariousness of their situation reflected their capital adequacy ratio or the problem of bad loans. That issue had not been discussed sufficiently, and he wondered whether Mr. Fukui considered that enough progress had been made in that area.

Mr. Al-Jasser said that the contribution of Japan to the world economy through the recycling of domestic savings was an interesting issue that should be addressed in the next Article IV consultation with Japan. Such recycling not only enhanced future Japanese welfare through the reflows of income arising from those investments, but also had a significant impact on other economies.

The Deputy Director of the Central Asia Department said that the staff would be undertaking a study of the impact of Japanese investment for issuance to Directors prior to the next consultation discussion on Japan.

The staff had reflected on Directors' comments with a view to finding a common thread in the proposed policy recommendations, the Deputy Director remarked. The situation in the short term was clear: the recovery was not as robust as had been hoped, notwithstanding the substantial easing of fiscal and monetary policies. The issue was then whether additional policies were needed at the present time or later.

Directors' views on the need for further policy measures had differed somewhat depending on their assessment of the upcoming recovery, the Deputy Director continued. For its part, the staff did not see a clear need for additional fiscal stimulus as yet, although it did see room for further

monetary easing. It was not, however, dogmatic in its views, given the substantial uncertainty regarding the strength of the recovery. Therefore, the staff would support a strategy of monitoring the situation carefully and introducing additional fiscal measures in the context of a supplementary budget in September, if that became necessary.

In a sense, the situation was similar to that in 1992, the Deputy Director commented. By the time the staff had issued its supplementary report in June 1992, it had become clear that Japan's economy was considerably weaker than it had been at the time of the staff mission in April. At that time the staff supported the authorities' preparedness to introduce, if needed, a fiscal package in September 1992, and urged them to determine its size and composition as soon as a clear view could be formed of developments. In the event, the authorities had pursued that course, but unfortunately political developments had delayed implementation of the fiscal measures until later in the year. Clearly, if the staff had anticipated the depth of the ensuing recession, it would have recommended more aggressive fiscal action.

In the current instance, with the stock adjustment having gone considerably further, the staff believed that the likelihood of an imminent recovery was reasonably good, although the past year's experience highlighted that the staff could not be certain of its forecast, the Deputy Director continued. That was the context for the staff's earlier statement that, in retrospect, it would have proposed the same policy: it would still advocate monitoring the situation carefully, and, if events turned out worse than was expected, it would support a further fiscal stimulus.

As to the rationale underlying the recommendation to shift from an income tax to a consumption tax, he wished first to clarify that the staff was not advocating the introduction of a consumption tax to raise savings, the Deputy Director of the Central Asia Department explained. In fact, the staff had suggested that, in the short term, such a shift could be staggered, so that the decline in income tax would precede an increase in the consumption tax and allow for some fiscal stimulus. Compared with the tax structure of other industrial countries, Japan's taxes were tilted toward the income tax, and the staff therefore supported a shift from direct to indirect taxes over the medium term so as to reduce the distortions and inefficiencies associated with excessive reliance on income and corporate taxes. The issue was more one of improving the tax structure than adjusting tax policy to influence savings and consumption.

In responding to a question by Mr. Al-Jasser regarding the distortion to be corrected, the Deputy Director of the Central Asia Department remarked that in the staff's view, there was a balance to be struck between direct and indirect taxes. Corporate taxes in particular introduced certain inefficiencies, for example, in production and investment behavior. To that extent, the objective was to maintain a balance. In the Japanese tax structure, the contribution of the consumption tax was small.

Mr. Al-Jasser said that, in his view, if there was any distortion, it was toward saving rather than consumption. In any event, when the staff explicitly suggested that a correction needed to be made, the staff report should explain exactly what distortion needed to be corrected. Without ruling out the need for lower consumption and higher saving in the future, he remained unconvinced that in the long run, there was a need for higher saving in Japan.

Mr. Abbott remarked that he supported Mr. Al-Jasser on that particular point. Another aspect of tax reform was tax elasticity: he would be interested to hear how a switchover would affect fiscal behavior.

The Deputy Director of the Central Asia Department reiterated that the staff was not advocating raising the consumption tax in the short term. In fact, the proposed shift would be revenue neutral in the initial stage: there would be a delay in increasing the consumption tax, and in the interim, there would be some reduction in income taxes. As changes in the tax structure could take place only when the economy had recovered to full potential growth and there was no longer a need to stimulate consumption, the matter was a medium-term, rather than a short-term, issue. In the event, there would be some decline in the progressivity of the tax structure owing to the shift away from the income tax, which was generally more progressive, and the change would take place in a period of declining savings.

As to Japan's current account surplus and savings over the medium term, the staff was aware that large and sustained current account surpluses would create problems if for no other reason they contributed to intensifying protectionist pressures, the Deputy Director of the Central Asia Department stated. The staff expected, however, that over the medium term, there would be a gradual decline in savings and a declining trend in the surplus. Thus, it did not anticipate that the surpluses would create economic problems. Nevertheless, in the staff's view, the fact that Japan would continue to register surpluses placed two responsibilities on Japan. The first was that, to the extent possible, macroeconomic policy should at least try to reduce, if not eliminate, cyclical departures from capacity growth, which would add to the underlying surplus, up to the point that it would not jeopardize noninflationary growth. The second was the critical need to do everything possible on the structural side to deal with the problem of grey areas. That problem should be addressed aggressively and directly even if there was a sharp reduction in the current account surpluses so as to remove concerns about access to Japanese markets.

The staff representative from the Central Asia Department observed that a recurrent theme of all recent staff papers on Japan had been that market-opening measures needed to be strong and forceful and that Japan needed to have demonstrably open markets. There were a number of issues to be addressed. While grey areas and their effect, for example, had been studied a great deal, the large body of literature did not show a clear picture. A number of studies using factor endowment models maintained that there was

nothing wrong with the level of Japanese imports, although the level of manufactured imports was, indeed, much lower than elsewhere. A second group of studies used more ad hoc frameworks--for example, population, natural resources, and the level of income--that provided split evidence on the matter: some indicated that imports were lower than the ad hoc models suggested. A third group of studies was mainly concerned with intraindustry trade. They generally concluded that the extent of such trade in Japan was less than elsewhere and, therefore, the level of imports was also lower. It was important to emphasize, however, that if Japan imported less than it should, it also exported less than it should, because the balance between the two was determined by broad macroeconomic factors--the saving/investment balance.

The staff had also studied market openness, the staff representative commented. The conclusions of its earlier study on barriers to agricultural imports still remained valid. According to that study, the welfare loss to Japan owing to barriers to agricultural imports was significant--in the range of 1 percent to 2 percent of GNP. A more recent study on keiretsu (PPAA/92/2, August 1992)--Japan's close intracorporate relationships--was also still very much valid. That study showed that keiretsu were perhaps less well defined in terms of their structure than many observers had indicated. The staff's data did not show a clear intragroup bias in the behavior of keiretsu firms. Nonetheless, and given the fact that the evidence was not clear, there were strong structural impediments to market access that ought to be removed, including those with respect to the distribution system, the various measures and regulations that resulted in a low share of foreign direct investment in Japan, and the public procurement system. To some extent, actions had been taken in all those areas, but there was room to do much more, including strengthening antitrust regulations and improving their enforcement, removing the remaining price controls, improving patent protection, and further the opening of large-scale stores.

The staff did not have data on nonperforming loans or any other troublesome aspects of the financial system that were not in the public domain, the staff representative remarked. The staff had made various estimates based on the available information and, on that basis, had concluded that the banking system, as a whole, would be able to earn its way out of the current problems, even if it took few years, and that the system as a whole could absorb the losses that were likely to be incurred. As Mr. de Groote and others had pointed out, there were probably individual institutions that would encounter significant difficulties. It would seem, however, that the mechanisms that had been put in place would be able to deal with those problems as they arose. However, there were still risks, including that the needed financial sector reform might be delayed in order to preserve calm in the financial system. That should be avoided. Financial sector reform needed to be pursued vigorously to strengthen competitiveness by opening the sector to both domestic and foreign competitors.

Several Directors had mentioned the reform of the postal savings system, the staff representative recalled. The staff fully agreed with Mr. Dawson that the postal savings system was not yet on an equal footing with the rest of the financial system, that it enjoyed a competitive advantage, and that more drastic reform measures were required in that area.

It was remarkable, given the depth of the recession, that unemployment had increased so little, the staff representative stated. That was due to the large scope for reducing overtime. There was, however, a risk that if a recovery of sufficient strength did not emerge soon, there would be a larger labor market adjustment. That remained, to some extent, a concern, although more recently, the decline in overtime seemed to have abated.

There were differences of view between the staff and the authorities on what concepts or fiscal aggregates should be used, as Mr. Fukui had indicated, the staff representative from the Central Asia Department remarked. The authorities preferred to look at the general account of the Central Government and the Fiscal Investment and Loan Program (FILP), while the staff favored broader concepts on a national income accounts basis. The different concepts were set out in the annex to the background paper.

Mr. Posthumus, recalling the staff's comment on the possibility of a supplementary budget in September and that that would be the time to judge whether another stimulus package was needed, observed that effects of the last stimulus package were unlikely to be fully visible within the coming month and a half, especially as it involved large-scale investments that would take perhaps a year to have an effect on economic developments. In the circumstances, he did not see how a decision on further stimulus could be taken in September. In his view, that was a clear example of excessive fine-tuning.

The Chairman said that he had understood the staff's comment in a slightly different way. He had the impression that September was viewed as the first occasion when, if needed, the Japanese authorities could add more stimulus, but the staff was not suggesting at the present time that that should necessarily be done on that occasion.

Mr. Peretz remarked that he had been fascinated by the account of the various studies that seemed to have produced uncertain results about whether there were structural impediments to importing to and investing in Japan. In his view, there was something wrong with those studies if they produced uncertain results. Any exporter anywhere in the world could recount the difficulties of exporting to Japan, and any financial institution anywhere in the world could recount the difficulties of doing business in Japan. The almost complete absence of inward foreign investment in Japan spoke for itself. He did agree that action to remove all impediments was needed and would have a clear welfare gain to Japan and to the rest of the world. He was also content with the conclusion that the removal of structural impediments would not necessarily change the current account balance. In his view, the current account balance was in the end determined by the

balance between savings and consumption in Japan and in the rest of the world.

The United Kingdom's openness to Japanese investment, which it had welcomed, had produced a clear welfare gain, both to the United Kingdom and to Japan, and he offered that as a prescription for other countries, Mr. Peretz commented.

The change in demographics could bring about a fall in Japanese savings, Mr. Peretz observed. In reflecting on the Board discussion, he found it striking that no one had mentioned the prospect of fairly rapid social change in Japan, instanced perhaps by the current unprecedented political situation in Japan and certainly by accounts of the changing role of women in Japanese society. There were a number of social forces at work that caused him to be uncertain about the future because they could well affect the balance between consumption and saving and could have a much more dramatic effect than any change in the tax system. Because the Fund did not know what was going to happen in Japan, he considered that it ought to be somewhat modest in its policy prescriptions.

Mr. Fukui said that he appreciated Directors' interest in developments in Japan's economy and would convey to his authorities all the points that had been raised. His authorities viewed the Article IV consultation discussion as an important occasion because it afforded them a good opportunity to hear from all member countries, industrial and developing countries alike. In that sense, the discussions provided a perspective that differed from that gained through bilateral talks.

At the previous Article IV consultation discussion, his authorities had regarded the need for a stimulus package with caution in view of Japan's stratospheric growth rate over the previous four years, Mr. Fukui recalled. At the time, his authorities viewed the slowing of the economy as a good opportunity for some adjustment following a period of high growth. They had therefore chosen to take some time to size up the seriousness of the problems and the available options. Thus, any "delay" was both reasonable and understandable. In the event, when the slowdown turned out to be more serious than expected, the authorities introduced two stimulus packages within a relatively short period of time. They had acted in a timely fashion. In fact, 1993 marked the first time in 34 years that the fiscal budget had been implemented at the outset of the fiscal year.

As to the current situation of the Japan economy, he would only stress that private consumption was an important factor, Mr. Fukui continued. The authorities considered that disposable household income would remain relatively comfortable in view of the fact that the recently negotiated wage increase for 1993 was about 3.9 percent while inflation stood at about 1 percent. In addition, some statistics showed that overtime was increasing. Overtime was a peculiar phenomenon in the Japanese economy in that it responded quickly to changes in the economic situation. When the economy slowed, overtime was cut back; but once a recovery was under way,

overtime increased. The recent increase in overtime was, of course, good for households. Against that background, the authorities expected private consumption would continue at a relatively good level.

Moreover, the impact of the economic stimulus package was currently being felt fully throughout the economy, Mr. Fukui remarked. Public works were increasing at double-digit figures, particularly at the local government level, where discussions on follow-up budgetary measures in the light of the new economic package had been completed in April and May. The new economic package also contained some elements of quick delivery. For example, the package provided for some new investment in computers and educational apparatus for various national universities and research institutions, starting around July. Thus, the recovery was under way. According to a Japanese saying, "when winter changes to spring, there will be three cold days, but they will be followed by four warm days." Although there might still be some cold days for the economy, its spring was coming.

He remained unconvinced by the argument that Japan's current account surplus was a drag on the growth of the world economy, Mr. Fukui stated. After all, the United Kingdom had had a current account surplus amounting to about 2-4 percent of GDP for about 100 years. His authorities had great difficulty understanding such arguments. Indeed, there had been a minimal increase in export volumes, which meant that in current circumstances, the increase in the trade surplus was almost entirely attributable to higher value added--a situation that contrasted sharply with that pertaining seven or eight years earlier when the "Miyakawa Report" was issued. At that time, export volumes were expanding by more than 10 percent. Moreover, the contribution of external demand to the growth in Japanese GNP in the first quarter of 1993 had been zero or slightly negative. In that sense, as the increase in the surplus was not export driven, it could not be said to have a detrimental effect on the world economy.

Some explanation on the components of Japan's exports might provide some insight into the current situation with respect to the current account surplus, Mr. Fukui continued. There was nothing mysterious about Japan's current account position: the country had a strong comparative advantage in a particularly limited area of trade. Broadly speaking, Japan's trade could be divided into three broad categories. The first was food, mining, and raw materials; Japan had little advantage in those areas. The second category was machinery and parts, including cars--a middle-high technology area. In that area, Japan had a strong vertical trade relationship with other countries, whereas the horizontal ratio--with 100 percent representing an equal amount of exports and imports--in that area was low. For example, for cars, the horizontal ratio was about 6 percent, and for video camcorders, the ratio was about 1 percent. The third category was super-high technical or research-and-development-intensive commodities. In that category, Japan had a lower competitive advantage and relatively good horizontal ratios compared with other countries. For example, the ratio for process controlling systems was 98 percent; for organic chemicals, 87 percent; for special optical machinery, 58 percent; and for semiconductors, about 74 percent.

Thus, the current account surplus could be easily explained by the particular commodity or limited sector in which Japan had a relatively strong competitive advantage.

While Japan had to address the issue of market opening, any recommendation that it should buy some less competitive commodity would not contribute to optimizing economic welfare, Mr. Fukui observed. At the same time, his authorities did not see efforts to manage trade imbalances on a bilateral basis as meaningful from an economic standpoint. It was clear from the current discussion that most Directors shared his authorities' view in that regard. After hearing Mr. Dawson's comments and in light of the recent summit discussions, he wondered what the United States meant by "managed trade." If it meant some sort of quantitative or numerical target approach, managed trade was not, in his authorities' view, the solution to the problem. Rather, it was important to better understand the problem. While he could assist in identifying its components, he could not give any clear answer on how to address it. In any event, he wished to emphasize that Japan was committed to the expansion of free trade, and for that purpose, it would take measures as necessary to expand its imports, as mentioned in the Tokyo Summit declaration.

He was pleased to hear Directors' comments on Japan's contribution to the global economy through its foreign investment, and he agreed that more attention needed to be given to that issue, Mr. Fukui remarked. He would only add that Japanese private foreign investment was creating jobs in recipient countries. For example, Japanese studies showed that in the United States, from 1987 to 1989, about one third of all new jobs in the manufacturing sector--about 130,000 of a total of 420,000--had been created by Japanese investment. The same was true in many other countries, including some EC countries. He was therefore pleased to hear calls to give more attention to the role of Japan's foreign investment, particularly in the context of serious unemployment in some countries.

As to whether there was room for easing monetary policy, he would only note that interest rates were at historically low levels in Japan, Mr. Fukui commented. Moreover, in previous periods of economic recovery, interest rates had been somewhat higher. In that light, his authorities considered that interests rates were sufficiently low. According to a recent survey by the Bank of Japan, their view was shared by some manufacturers, who found that it was currently easier to obtain financing.

As to the situation of the financial system, he could add little to the official figures on nonperforming loans, Mr. Fukui remarked. Such loans represented about 2.1 percent of the total assets of major Japanese banks and about 3.2 percent of total lending. While it was difficult to make comparisons with banks in other countries, he would note that in the United States, the nonperforming loans of the major commercial banks amounted to 4 percent of total lending and that in Europe, the figure was reported to be even higher. He hoped that such international comparisons might help put the magnitude of the problem in Japan in perspective.

It was customary in Japan to hold discussions on a supplementary budget in September, Mr. Fukui explained. Traditionally, at that time, the Government reviewed any damages owing to recent natural disasters--for example, typhoons. The review of the salary of the civil government was also conducted at that time. Thus, the forthcoming supplementary budget discussions that the staff had mentioned were not unusual and would offer yet another occasion to review the economic situation.

The issue of shifting from direct taxes to a consumption tax was not dependent, in Japan's thinking, on some sort of consumption or saving ratio, Mr. Fukui observed. The objective was to achieve a good balance between indirect and direct taxes while attaining higher household income levels. From that viewpoint, introducing a consumption tax could adversely affect some less fortunate segments of society.

He wished to reiterate that he welcomed a further study of Japanese market practices, Mr. Fukui stated. At the same time, he wished to stress that there were no clear-cut answers to the issues that Directors had raised. Market access, for example, could be limited because of the limited ability of foreign businessmen to speak Japanese. In any event, the question of market openness was a difficult one and was deserving of some study.

The Chairman made the following summing up:

> In discussing the staff report on the 1993 Article IV consultation with Japan, Directors noted that over the past two years, the Japanese economy has experienced its sharpest downswing since the mid-1970s. The recession was mainly due to the cyclical downturn and the inevitable correction of the factors that characterized the preceding boom and contributed to its unsustainable pace. These factors included a sharp run-up in asset prices; a large increase in the stock of capital and consumer durables, reflecting easy financial conditions; and excessive lending by the financial system to the real estate sector. Directors' views on whether the recession has bottomed out differed; while a number of Directors noted increasing signs of recovery, most speakers felt that, despite such signs, the economy had yet to turn the corner fully, and downside risks persist at this stage of the cycle. Several Directors also expressed doubts whether the projected strong increase in domestic demand from 1993 to 1994 would materialize. The main policy issue now is to solidify the momentum of the recovery, while maintaining Japan's excellent price performance and pursuing structural reform. Doing so would benefit Japan and the world economy and would constitute an important contribution to the global cooperative effort to bolster confidence and strengthen prospects for a durable noninflationary world expansion.

Directors welcomed the authorities' response to the cyclical downswing, on both the monetary and fiscal fronts, although some Directors believed that earlier and more forceful action would have been warranted. With respect to monetary policy, Directors observed that conditions had eased significantly since mid-1991, with the official discount rate having being lowered six times to its historic low of 2 1/2 percent. While a number of Directors considered that with the recent strengthening of the yen and the absence of inflationary pressures, a further easing of monetary policy was warranted, a number of other Directors believed that caution would need to be exercised in guiding interest rates down further.

With respect to fiscal policy, Directors commended the authorities for implementing large economic stimulus packages in both late 1992 and early 1993. They viewed the support to domestic demand provided by these packages--even if delays in implementing the first package were regretted--as critical to economic recovery, and they commended the authorities' decade-old fiscal consolidation effort, which had provided the room for maneuver during the current downturn.

A number of Directors felt that Japan's fiscal position allowed room for providing additional stimulus, at least in the short run, should economic weakness persist; the supplementary budget exercise later this year would provide an opportunity to consider the matter. In that context, it was also observed by several speakers that the automatic stabilizers should in any case be allowed to work fully. Other Directors were concerned that an additional fiscal stimulus could prove procyclical and might be difficult to reverse. Some Directors thought that it would be better for further easing, if needed, to be on the monetary side rather than on the fiscal side. Most Directors believed that once the recovery was firmly established, medium-term fiscal consolidation efforts should resume, and in that context, the prospective large pressure on public expenditure arising from the aging of the population was mentioned by a number of speakers. A few other Directors, however, placed less emphasis on the medium-term demographic outlook and advocated instead continued fiscal expansion in the form of greater public investment and/or a reduction in income tax to raise living standards and stimulate consumption.

As regards external developments, Directors observed that the current account surplus had widened significantly since 1990. Most Directors took the view that, as the Japanese economy recovers and trade volumes respond to the stronger yen, the current account surplus would again decline. This confirmed their view that policies should focus on sustainable, strong, job-creating growth with low inflation and contribute indirectly to a

reduction of the external current surpluses. A falling propensity to save resulting from a rise in the share of the elderly in the population would also contribute to lowering the surplus over time. A number of Directors noted Japan's important contribution to the world pool of savings.

With respect to recent exchange rate developments, many Directors observed that an appreciation of the yen over the medium term would be consistent with a cyclical upswing in Japan. However, a number of Directors cautioned that a too rapid further appreciation of the yen could weaken or delay the emerging recovery.

Directors urged Japan to continue its efforts to open up markets. A priority in this regard was the reform of agricultural trade. Directors also stressed, inter alia, the need for further strong measures to reform the distribution system, strengthen competition policy, reduce regulations and make them more transparent, and promote foreign direct investment. Demonstrably open markets would be an important antidote to protectionist pressures. Most Directors expressed concerns about managed trade arrangements and stressed the paramount need for market opening and deregulation in a multilateral framework. A few Directors noted that some recent bilateral initiatives could nevertheless promote market opening. Directors also urged the authorities to help bring the Uruguay Round negotiations to a successful conclusion, and they welcomed Japan's recent proposal of tariff reduction.

Many Directors noted the risks posed by the recent problems in the financial system. They believed that more transparency, quicker action to deal with the problem of nonperforming loans, and greater disclosure of asset quality were needed. Directors also noted continued interest rate liberalization under the recent enactment of the Financial System Reform Act, and they encouraged the authorities to continue with financial sector reform. A few speakers particularly stressed the need to reform the postal saving system and ease market access by foreign financial institutions.

Directors noted the high absolute amount of Japan's official development assistance, particularly in close collaboration with the Fund, and they welcomed the authorities' new five-year foreign assistance plan. Several Directors expressed the hope that Japan would make every effort to raise its level of official development assistance further and, in particular, to achieve the UN target at an early date.

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

2. MYANMAR - 1993 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1993 Article IV consultation with Myanmar (SM/93/130, 6/21/93). They also had before them a background paper on recent economic developments in Myanmar (SM/93/134, 6/28/93).

Mr. Hon made the following statement:

Following a two-year economic recovery, real GDP declined by 1 percent in 1991/92, reflecting mainly a 3.9 percent reduction in agricultural output owing to adverse weather conditions. During 1992/93, which was designated as the Economic Year, top priority was given to the revival of agricultural production. In response to various government support measures, and aided by favorable weather conditions, agricultural output rebounded strongly by 15.2 percent in 1992/93 and contributed to a preliminary estimated GDP growth rate of more than 8 percent. This supply response, together with a slowdown in monetary expansion, led to a moderation in inflation from 29 percent in 1991/92 to 20 percent in 1992/93, as measured by the Yangon Consumer Price Index.

The public sector budget deficit was successively reduced from 8 percent of GDP in 1990/91 to 7 percent in 1991/92 and to 6 percent in 1992/93. This improvement was achieved through expenditure control and several revenue measures. Restructuring of state economic enterprises has been continuously pursued in an orderly fashion, including through the streamlining of their activities and forming joint ventures with both domestic and foreign investors.

On monetary developments, money supply growth was reduced to 31 percent in 1992/93. At the same time, savings deposits continued to grow at a high rate of 22 percent owing to the various savings promotion measures that have been implemented in recent years, including the enactment of the new Savings Bank Law in June 1992. Six domestic private banks have been licensed and opened, and all of them recorded profits at the end of 1992.

My authorities have taken due note of the advice of the Executive Board in the context of Article IV consultations with Myanmar. Policy measures will continue to be formulated and implemented with due regard to the political, economic, and social conditions of the country so as to achieve the ultimate aim of establishing a market-oriented economy. In this connection, my authorities would like to highlight their policy stance for 1993/94.

A targeted reduction in the public sector budget deficit to 4 percent of GDP has been the core of the strategy to correct internal and external imbalances. Revenue measures include strengthening tax enforcement, improving tax administration, and harmonizing customs tariffs. A proper prioritization of productive expenditure and a substantial reduction of unproductive expenditure will be effected. Expenditure control and monitoring will be strengthened to ensure the achievement of the fiscal target. The restructuring of state economic enterprises will be enhanced through increased managerial autonomy and a progressively hardened budget constraint.

A significant reduction in the financing of the public sector deficit would enable the central bank to pursue a more effective monetary policy so as to restrain monetary growth to 25 percent in 1993/94. Government treasury bonds will be issued shortly to enhance savings and monetary control. In the meantime, preparations for the opening of a stock market are under way.

My authorities aim to achieve a GDP growth rate of 5 percent a year in the medium term. For 1993/94, the targeted real GDP growth rate of 5.8 percent is to be attained through improved utilization of productive capacity and a greater involvement of the private sector in the economy. This, together with tightened fiscal and monetary policies, should help contain the rate of inflation to levels below 20 percent in 1993/94.

An innovative step in exchange market reform has been taken with the introduction of Foreign Exchange Certificates in February 1993. It is expected that the eventual widespread use of the certificates will pave the way to narrowing the spread between the official exchange rate and the parallel market rate. An in-depth study would be required for the adjustment of the official exchange rate, in view of the need for a social safety net to protect the poor against any adverse effects of exchange rate adjustment and for an adequate cushion of foreign exchange reserves.

My authorities would like to reiterate that the slow implementation of adjustment measures has more to do with constraints in administrative capacity, the institutional setting of the country, and the availability of external financing than with a lack of commitment. It should be noted that a number of liberalization and reform measures have already been implemented within a relatively short period. My authorities recognize that much remains to be done in the transition to a market-oriented economy. In this connection, they are appreciative of the technical assistance that has been rendered by the Fund and acknowledge the need for a continued dialogue with the institution. My authorities would also like to thank the Fund mission for its cogent and

comprehensive discussion on policy issues of the Myanmar economy, as well as its candid observations and forthright recommendations.

Mr. Oya made the following statement:

Myanmar is one of the countries in transition that will have to implement economic adjustment policies on the basis of a firm program designed in consultation with the Fund.

In Myanmar's current situation, the immediate policy steps for economic reform are clear. As the staff rightly points out, these include devaluing the kyat to a rate close to the parallel market rate; ensuring that the public sector deficit does not exceed the targeted 4 percent of GDP in 1993/94; and tightening monetary policy beyond the current targets and raising real interest rates to positive levels.

In addition, these measures should be supported by structural reforms such as liberalization of the trade and exchange system, a reduction in defense expenditure, and a further reduction in restrictions on private sector activities.

Although the authorities seem to recognize the importance of these measures, their implementation has been slow. It seems that the authorities intend to defer the necessary reforms pending uncertain events, such as the advent of major oil and gas earnings or the full resumption of external aid.

I am concerned that such a policy stance could delay the process of economic reform and even undermine the achievements so far. There are many countries in transition that are making every effort to accelerate their economic reforms. With much pain, and despite political and social pressures, they are implementing adjustment policies aimed at containing inflation and reducing external imbalances. It is urgent that the Myanma authorities follow the example of these countries and implement decisively the necessary measures for economic reform in cooperation with the Fund.

Specifically, measures are needed to curtail defense spending. This is one step that should be taken immediately to reduce the public sector deficit. In spite of the need for fiscal consolidation, defense spending is the only category of current expenditure that has not declined relative to GDP in the period since 1988/89. It is clear that the heavy burden of defense spending is depressing essential outlays for social services and the improvement of infrastructure. I believe that it is essential to give due consideration to reducing unproductive outlays.

A further reduction in restrictions on private sector activity is also important. In transition economies, reducing restrictions on the private sector should be a central element of structural reform, as it will give an impetus to growth. I hope that the authorities will tackle the political and social resistance with determination and manage to implement the necessary measures.

The rapid accumulation of arrears in recent years is a clear reflection of the serious situation of the Myanma economy. These accumulated arrears have impeded the smooth flow of external assistance, which is necessary for the future development of the economy. In view of the amount of accumulated arrears, the authorities have no time to waste. They must take urgent and decisive measures to reduce the internal and external imbalances in the spirit of self-help. Prior actions are needed to show the authorities' commitment. Without them, there is little likelihood of a resumption in the flow of donor support and its effective use for economic development.

I hope that the authorities build up their credibility with respect to implementing adjustment policies. With these remarks, we support the proposed decision.

Mr. Wire made the following statement:

We are in full agreement with the statement made by our Japanese colleague.

We are increasingly disturbed by the lack of adjustment and reform in Myanmar. It appears that the authorities have made minimal progress in the 15 months since the Board's last review of the Myanma economy, and there is little in this report to suggest that they intend to implement any substantial corrective measures over the medium term. The few reforms that have been implemented have a patchwork, ad hoc character and lack coherence. We acknowledge that growth did jump sharply in 1992/93 and that inflation has slowed, but we also note that both figures are subject to considerable uncertainty and should be viewed with caution.

As to the report, we would like to thank the staff for its efforts, particularly in view of the apparent lack of reliable data for its work. There is little that is encouraging in the staff's economic projections for the remainder of this decade. Without a radical change in policies, growth will decline each year, the current account deficit will continue to increase, and inflation will rise somewhat. By 1995, substantial financing gaps will appear that may only be closed through the suspension of external obligations.

We agree completely with the staff's assessment of the situation and its brief recommendations. The official exchange rate must be devalued and unified at a market-determined level; and the exchange rate system needs to be fundamentally reoriented and accompanied by price liberalization and trade reforms. Significant fiscal consolidation is needed, with particular emphasis on the reform of public enterprises. Monetary policy must be tighter and should be accompanied by real positive interest rates, institutional improvements, and further financial sector reform. Throughout the economy, the role of the private sector must be substantially strengthened.

In view of the obvious desirability of an economic policy framework to address the collective impact of the adverse economic scenario in the staff report, we find it hard to take seriously the authorities' statement, as reported by Mr. Hon, "that the slow implementation of adjustment measures has more to do with the constraints in administrative capacity, the institutional setting of the country, and the availability of external financing than with a lack of commitment." With particular regard to the first two factors, we are all aware that a number of other members--Albania is perhaps among the most recent--have been able to successfully implement strong stabilization and adjustment programs under equally or more trying conditions.

The absence of reform in Myanmar has a human cost that should not be overlooked. The table of social indicators shows that GDP per capita is only $55 when valued at the market-related exchange rate, rather than $910 at the official rate. Even if statistical uncertainties raised the figure to twice or three times this level, per capita income would be exceedingly low. Furthermore, with population growth of 2.1 percent per year, the projected slow and declining growth in real GDP will do little to raise per capita incomes, especially among the most vulnerable segments of the population.

The only real glimmer of hope we see in this situation comes from reports that the aggregate effect of the limited reforms over the past several years may have modestly increased the small scope that exists for private sector activities. As support for market principles develops at the grassroots or microenterprise level, perhaps it will come to have some modest effect on the authorities. We would be interested in any comments the staff may have in this regard.

We would conclude with three points regarding the Fund's relationship with the authorities. First, in view of the great demands for technical assistance this institution faces, and the evident and longstanding disregard the Myanma authorities have for

the advice of the staff, we welcome the termination of the Fund-supported technical assistance program.

Second, at the last Article IV consultation with Myanmar, we noted that the authorities might be well on their way to becoming candidates for procedures under Article XXVI, which prescribes the penalty for failure of a member to fulfill its obligations under the Articles of Agreement. We based that judgment on the absence of efforts to foster orderly economic growth and stable financial conditions, avoid manipulation of exchange rates to avoid effective balance of payments adjustment, and provide adequate statistical information to allow the Fund to perform its duties. Regrettably, there have been no developments that induce us to change this assessment. If anything, Myanmar has slipped a bit further in an unwelcome direction, as the staff projects that without a radical change in policies, external arrears to the Fund and the other international financial institutions should be expected within the next two to three years.

Third, and with respect to the two points I have just made, we would very much like to see steps by the authorities that could begin to restore a fuller level of cooperation with the Fund that could lead to Fund support. The present situation is not in the interests of Myanmar and its long-suffering people.

Mr. Fridriksson made the following statement:

In March of last year, I requested a Board discussion on the staff report on the 1991 Interim Article IV consultation on Myanmar. The reason for my request then was the serious picture that the report painted of the economic situation and the highly inappropriate economic policies pursued by the authorities. Unfortunately, this year's report reveals only very limited progress in correcting economic policies and in moving Myanmar in the direction of a market-oriented economy.

I agree with the staff's assessment and policy recommendations, and I am tempted to deliver the same statement as last year. The points I made then are equally valid today. Rather than doing so, I shall limit my remarks to emphasizing a few points.

The central system of planning still dominates the economy. While I note that some liberalization and reform measures have been implemented, I believe that the slow progress results from a lack of commitment by the authorities, and perhaps even reluctance, to reform the economy. To the extent that constraints on administrative capacity hinder progress, they are a result of the policies which the authorities have pursued. We can cite several examples of countries where similar administrative constraints

have been overcome quickly, and the Myanma authorities should not use them as an excuse to move at a snail's pace.

It is disappointing, yet understandable, that the technical assistance so urgently needed in Myanmar has been scaled back by the UNDP because of the absence of a policy environment conducive to reform. It is also understandable that the Fund wishes to direct its limited technical assistance resources at countries showing clear evidence of a commitment to financial and economic reform. This should provide ample warning to the authorities of Myanmar that more determined action is essential.

As before, exchange rate policy in particular continues to be blatantly out of line. I fully agree with the staff on the need to unify the exchange rate at a realistic level and that perceived harmful effects on the poor should not hold back action, as a correction of exchange rate policy would eventually--and perhaps even immediately--benefit the poor. The possible initial negative effects of corrective actions could easily be mitigated through carefully targeted measures. Accompanying a change in exchange rate policy, the authorities need to greatly simplify the exchange and trade system.

On the fiscal side and the operation of state enterprises, I fully agree with the recommendations of the staff and will only repeat the concerns I expressed last year on the high level of defense expenditure, which has actually risen as a share of GDP since last year, according to the authorities' own figures.

In the area of monetary policy, the staff report has little new to report. Again, I wish to emphasize the need to permit the financial institutions law to become fully enacted. Clearly, monetary policy will not contribute to improved performance of the Myanma economy unless market conditions are permitted to prevail and interest rate subsides, directed credits, and other distortions are eliminated. In this area, I also endorse the recommendations of the staff.

On the external side, the rate of accumulation of arrears has accelerated sharply from 1989/90, but I note that Myanmar has so far met all its multilateral debt service obligations, while arrears have been accumulating vis-à-vis bilateral official and private creditors.

The medium-term prospects for the Myanma economy bring together in a nutshell the grave consequences of continued adherence to existing policies--Myanmar is heading for a catastrophic situation. Myanmar has one of the lowest per capita incomes in the entire membership, but, given its resource endowment, it should be able to grow rapidly to the benefit of all

of its people. External assistance will be meager unless the authorities break firmly with the policies they have pursued. In that respect, Myanmar needs more than a little crescendo in the move toward a market economy--it needs a dramatic leap forward. Such a course would also be the surest way for Myanmar to secure external financing and mobilize the much-needed technical assistance. It is therefore in the authorities' own best interest to engage in an active dialogue with the Fund and to take seriously the advice of the staff, which is rooted in a long experience in many countries.

Mr. Wu made the following statement:

The authorities are to be commended for the output gains, reduction in inflation, and improvement in public sector imbalances in 1992/93. However, despite these positive developments, the underlying difficulties of the economy remain. As I am in broad agreement with the staff appraisal, I will make only some brief remarks.

On monetary policy, a tight stance is needed. Although inflation started to moderate in 1992, it picked up during the first quarter of 1993, as food prices rose sharply owing to the heavy procurement of agricultural products for export.

As is stated in the staff report, one third of credit expansion in 1992/93 reflects increased demand from nonstate sector owing to its burgeoning development. Less credit to this sector will inevitably undermine the growth of economic activity there. Hence, there is little leeway for reducing credit to the nonstate sector. The underlying solution is to reduce central bank financing of the budget deficit. Its success, nevertheless, will depend on the authorities' resolve to cut the public sector deficit. In this regard, it is welcome that the authorities have envisaged a significant reduction in the financing of the public sector deficit.

On the fiscal front, notwithstanding the moderate improvement in public sector imbalances, the authorities will continue to face the formidable task of significantly reducing the fiscal deficit and improving the financial position of state economic enterprises.

As the tax revenue is inelastic, it is necessary to overhaul the tax system and broaden the tax base. In the short run, immediate steps should be taken to reduce unproductive expenditures. Reform of the pricing system will be critical for improving the financial position of state economic enterprises. In this respect, well-coordinated external and financial policies are needed to ensure that the reform does not fuel the inflation.

On exchange policy there is no denying that the overvalued official exchange rate needs to be corrected. Given the prevailing inflation and monetary conditions, however, a sharp devaluation might aggravate the inflationary situation, as the majority of imports at the official rate are essential intermediate inputs. Therefore, only when inflation is low and the public sector deficit has been reduced to a comfortable level, will it be appropriate to expeditiously narrow the gap between the official and parallel market exchange rates. With this in mind, I encourage the authorities to correct the overvaluation in a step-by-step manner, without compounding the inflationary pressures. To this end, it must be supported by a more prudent financial policy.

The agricultural sector is key to the entire Myanma economy. But the heavy dependence of economic activity on agricultural performance leaves the economy vulnerable to exogenous developments, particularly weather conditions. Fluctuations in agricultural production and the amount of procurement for export have significant effects on growth, inflation, and export performance. As agricultural output registered a remarkable rate of growth--15.2 percent--in 1992/93, it will be difficult to continue to grow at such high rates over a few consecutive years. In the event, economic growth in 1993/94 is likely to be lower. To mitigate the recurrent fluctuations in economic activity, it is necessary to encourage more technological inputs into the agricultural sector and the development of agro-based manufacturing so as to produce higher value-added products for export and facilitate a reduction in inflation.

Having said this, I have no difficulty in endorsing the proposed decision.

Mr. Tetangco made the following statement:

The Myanma economy posted some positive developments in 1992/93, with GDP increasing by 8 percent, inflation decelerating to 20 percent, and the external current account showing a smaller deficit. While welcoming this progress, I note that the gains were achieved in the midst of what the staff has characterized as only tentative steps taken by the Government toward structural reform and macroeconomic stabilization, which puts the sustainability of this progress in question. Indeed, economic performance in Myanmar has seen hills and valleys over the years. There is no doubt about the need for fundamental changes in economic policies.

I agree with the staff that the policy recommendations of past consultations still apply. What is required, as emphasized by previous speakers, is more determined effort toward their implementation. On the specific recommendations of the staff,

like Mr. Wu, I would only emphasize that an exchange rate adjustment will need to be accompanied by policies to tightly control the public sector deficit and greatly restrain domestic credit and liquidity growth. This will minimize the exchange rate action's potential inflationary effects and avoid a possible loss of newly improved competitiveness.

Together with these immediate policy steps, structural reforms are clearly required to reduce the distortions created by elaborate controls in the economy, strengthen fiscal performance, and improve financial intermediation through changes in the banking system. I endorse the proposals put forward by staff in this regard. I also join other speakers in urging the authorities to lift exchange restrictions and multiple currency practices as soon as possible.

The hesitancy toward adjusting the exchange rate is said to be due in part to what the authorities see as a need to first have a sufficient foreign exchange buffer. This is not an uncommon concern among countries that are about to let market forces play a greater role. However, we also know that a lower exchange rate serves to moderate the risk of a sudden rise in foreign exchange demand while improving the competitiveness of exports. Moreover, and in a broader context, a credible stabilization and reform program is bound to enhance confidence, which should encourage the inflow of foreign capital into the economy as we have seen in a number of cases.

Tentative steps toward reform will not sufficiently address the problems facing Myanmar. The need for urgent, decisive action is nowhere more clearly evident than in the balance of payments situation. While gross international reserves are at about 3.8 months of imports, this liquidity is, in a sense, not real in view of the large outstanding stock of arrears. Financing through arrears has allowed the economy to stay afloat over the last six years. But the annual debt service seems to have peaked in 1992/93, and thus the scope for relying on this source of financing will increasingly diminish in the future. I agree with the staff that when that point where maturing obligations fall short of the financing gap is reached, the adjustment will necessarily become more disorderly--a situation that should obviously be avoided.

Mr. Dorrington made the following statement:

Reading the staff report on Myanmar reminded me of watching someone who had been standing still on the down escalator now taking a few tentative steps up it. This is an improvement, but a far wiser course would be to get off the down escalator and onto the up one, or if this is not possible owing to insurmountable

barriers owing to implementation capacity, they should at least switch to the stairs.

It is appears to me that the authorities present two types of arguments as to why they have only moved in a very limited way toward a market economy: implementation capacity and implications for the poor.

With regard to implementation capacity, I certainly accept that this is a significant constraint, but like Mr. Wire and Mr. Fridriksson, I find it difficult to believe the authorities' assertion that the slow implementation of adjustment measures had more to do with such constraints than with a lack of commitment to reform. If that were the case, I would be the first to encourage the staff to set about offering technical assistance as required. I would note there have been a number of technical assistance missions in the past from the Fund and elsewhere, and I would welcome staff comment on how these earlier Fund missions were received and to what extent their recommendations were implemented. Furthermore, the staff lists a number of measures that could and should be taken straightaway, and I find it impossible to believe that the authorities could not take any of these measures now, despite the limitations. Indeed, the current period of growth provides an ideal opportunity to move to an integrated foreign exchange market and to tightening monetary and fiscal policy.

As to implications for the poor, to give this as a reason for delaying reforms is at best shortsighted. As Mr. Wire has pointed out, the policies of the past have been particularly unhelpful to the poor. Of course, with any reform there may be some losers in the short run, but without reform and the growth that will follow, all but a highly protected elite will always be losers in the long run. In particular, I note that it is essentially only public sector employees that have access to foreign exchange and goods at official prices. Thus, it is difficult to see how the poor and the rest of the economy could lose, even in the short run, from unifying the exchange rate or from elimining subsidies on official prices.

Meanwhile, the down escalator continues to move downwards. For other reasons, donors are withdrawing. But even if these other concerns were to be removed, as some earlier speakers have said, donors would still be reluctant to disburse into an economy where the effective use of their resources would be far from assured. We cannot be sure exactly where we are because the statistics are so weak. And in the longer run, truly sound policies cannot be built on such a weak statistical base. Nevertheless, we are warned that at the current pace of descent, in about two years Myanmar will reach the level where there would be

a risk of its no longer being able to service its obligations to the Fund. This possibility has been mentioned explicitly by Mr. Wire and must be a matter of great concern to all of us.

I know that the staff, you, Mr. Chairman, and Mr. Hon will do all you can to try and get the Myanma authorities to see the wisdom and urgency of the recommendations in the staff appraisal, as endorsed by all the earlier speakers, and the benefits they would bring to Myanmar. I sincerely hope you are successful. But I must say that I have little grounds for optimism.

The staff representative from the Central Asia Department, commenting on implementation capacity and the utilization of Fund technical assistance, said that technical assistance had been provided in a number of areas during the past few years under a joint IMF-UNDP program. A review of the results had been conducted during the recent consultation discussions and had yielded a mixed appraisal of actual improvements in administrative capacity. There was a generally favorable impression of results in the fiscal area, particularly of the improvements in customs administration. In the monetary and exchange areas, however, the recommendations of the technical assistance experts had not yet been acted upon.

One of the dilemmas in delivering technical assistance was that while it might improve administrative capacity, it was being provided in a policy context that was clearly distortionary, the staff representative observed. For example, the customs department used the official exchange rate as the basis of valuation; that, in itself, was a major source of distortion. Until such policy distortions were corrected, the overall effectiveness of technical assistance would be limited.

As to the progress achieved so far under the authorities' limited reform effort, it should first be noted that the authorities themselves believed that they had taken some significant steps in the past few years, the staff representative remarked. They pointed, for instance, to the opening of private banks and the level of private sector activity in the agricultural sector in the past year. At the same time, they realized that the steps they had taken--or initially had intended to take--were not compatible with the limited progress that had been made in other areas and, consequently, they had had to retract some earlier reforms. For example, the opening up of the agricultural sector to nonstate procurement, which had been initiated at the start of the reform process in 1988/89, had had to be reversed. On the central issue of the exchange rate, the authorities remained unmoved. In that connection, and in line with the point raised by Mr. Dorrington on limited implementation capacity, it was striking that the authorities had been able to devote a considerable amount of administrative capacity to developing tools and techniques for circumventing the barriers that had been erected by the central dilemma of an overvalued exchange rate.

Among the positive developments in Myanmar were the grassroot initiatives to develop a foreign exchange market, the staff representative

commented. That was best illustrated by the activity in the parallel market, where trading extended from "retail level" transactions--namely, at the black market street rate--to transactions at the interenterprise level, which were partially sanctioned by the authorities. As explained in the background paper, while the authorities allowed foreign exchange transfers between enterprises, they did not monitor or acknowledge the countervailing domestic currency transaction. Therefore, the precise exchange rate at which such transactions were taking place in the parallel market was not known. Nonetheless, the foundations for a foreign currency market were clearly being laid.

That parallel markets were developing and waiting to be legitimized could be seen in many other areas, the staff representative continued. Many goods in agricultural and urban retail markets were being exchanged in the parallel market. At the purely anecdotal level, foreign visitors had noted that Myanmar's markets were full, which had not been the case three or four years earlier.

Some Directors had commented on the need for a somewhat more gradual timetable for exchange rate adjustment and supporting financial policies, the staff representative recalled. As to the latter, the staff had strongly recommended such supporting policies to the authorities. At the same time, in view of the considerable gap between the official and the parallel rates, and the Government's record of financial policy implementation, the staff considered that a gradual approach to exchange rate adjustment was unlikely to be credible unless there was a substantial adjustment at the outset.

His responses to Directors' questions underlined the fact that the central dilemma facing the authorities was the exchange system, the staff representative from the Central Asia Department observed. If there was any difference between the current staff report and the previous one, it was that the staff placed even more emphasis on the exchange system on the present occasion.

Mr. Hon said that he wished to thank Directors for their comments. He would convey the tone, as well as the substance, of the discussion to his authorities. He wished, however, to state that, in all fairness to his Myanma authorities, and not negating the progress that had been made in recent years compared with that of countries with similar income levels and social conditions and at the same stage of economic development, he could not agree with the view that his Myanma authorities were not fully cooperating with the Fund.

The Chairman said that he agreed with Mr. Hon that in judging cooperation with the Fund, all elements of the situation had to be taken into consideration. He had, nevertheless, to say that in the case of Myanmar, the staff and management felt a certain degree of frustration when they saw how few of the Fund's recommendations had been taken under active consideration by the authorities and the disappointing results of the Fund's generous technical assistance to Myanmar compared with the positive impact

of similar levels of assistance on administrative and macroeconomic policy reform in other countries. For that reason, the staff and management believed that Myanmar was currently on a very slippery path, and they did not see how the Fund could help Myanmar and its people avoid the terrible consequences if the authorities were not willing to enter into a genuine dialogue with the Fund and do more to demonstrate their commitment to reform.

He looked forward to working with Mr. Hon to see what steps the Fund could take to help Myanmar reverse the course of its economic policy management, the Chairman stated. He recognized that current circumstances were unfavorable, but it was the Fund's job to try everything possible to help Myanmar and its people follow the good example of many of their neighbors. For that reason, he and his colleagues had felt compelled to speak bluntly about Myanmar's lack of cooperation with the Fund.

Mr. Hon remarked that on behalf of his Myanma authorities, he was grateful for the Chairman's remarks and observations.

The Chairman made the following summing up:

> Executive Directors fully supported the staff appraisal and, as in previous consultations, expressed serious concern about prospects for Myanmar's economy in light of the severe structural distortions and macroeconomic imbalances that persist. Despite some moves toward greater market orientation, Directors observed, Myanmar's exchange, trade, and price systems remain highly distorted; the public and private enterprises are tightly constrained by state intervention; and the overall stance of macroeconomic policies remains lax. As a result, inflation and large external imbalances have continued, and external payment arrears have continued to accumulate.
>
> Directors stressed once again that comprehensive stabilization policies and market-based structural reforms are necessary to address the difficult domestic and external situation and lay the foundation for growth over the medium term. The unexpected output gains and the modest reduction in public sector imbalances that appear to have been achieved in 1992/93 provide an opportunity for the authorities to press ahead with formulating such policies, as any gains could be quickly reversed without them.
>
> Directors emphasized that comprehensive exchange and trade reforms were an essential element in eliminating distortions in prices and resource allocation. In their view, immediate steps in this regard would be to bring the official exchange rate of the kyat close to the parallel market rate and to create an integrated foreign exchange market. They also underscored that, to be effective, these measures should be accompanied by substantial progress in liberalizing external trade and domestic prices.

Directors stressed that a significant tightening of financial policies was an essential complement to these reforms. Monetary and credit expansion should be kept below current targets for 1993/94, and real interest rates should be raised to positive levels. On the fiscal side, strong measures--including expenditure control and revenue enhancement--are necessary in 1993/94 to achieve the significant reduction in the overall deficit that is budgeted.

Directors reiterated the need for structural reforms on a broad front over the medium term. Such reforms include raising the revenue/GDP ratio through tax reform; improved budgeting procedures; overhauling the public enterprises through price reform, tightened budget constraints, and increased financial autonomy and accountability; accelerating financial sector reform; and further reducing constraints on private sector activities. Expenditure priorities should be redefined to maintain essential investment in infrastructure, and to reduce subsidies, military, and other unproductive spending while protecting essential services that are an integral part of the social safety net. Directors also underscored the adverse consequences of deferring these reforms for the restoration of inflows of external assistance.

Directors invited Myanmar to improve its collaboration with the Fund so that technical assistance and policy advice can be resumed and an active dialogue ensue with the objective of elaborating policies for the benefit and welfare of Myanmar's people.

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

The Executive Board took the following decision:

1. The Fund takes this decision relating to Myanmar's exchange measures subject to Article VIII, Sections 2 and 3, in concluding the 1993 Article XIV consultation with Myanmar, in the light of the 1993 Article IV consultation with Myanmar conducted under Decision No. 5392-(77/63), adopted April 29, 1977 as amended (Surveillance over Exchange Rate Policies).

2. As described in SM/93/130, Myanmar maintains restrictions on payments and transfers for current international transactions arising from a foreign exchange budget in accordance with Article XIV, Section 2. In addition, Myanmar retains exchange restrictions as evidenced by limitations on certain invisible payments, as well as multiple currency practices arising from the export retention scheme and the issuance of foreign exchange certificates that are subject to Fund approval under Article VIII,

Sections 2 and 3. The Fund urges Myanmar to eliminate these restrictions and multiple currency practices as soon as possible.

Decision No. 10423-(93/101), adopted
July 16, 1993

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/93/100 (7/16/93) and EBM/93/101 (7/16/93).

3. EXECUTIVE BOARD TRAVEL

Travel by an Assistant to Executive Director as set forth in EBAM/93/130 (7/14/93) is approved.

APPROVED: January 12, 1994

LEO VAN HOUTVEN
Secretary