May 5, 1998
Approval: 5/12/98

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 97/77

9:30 a.m., July 25, 1997

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

S. Fischer, Acting Chairman

Executive Directors	Alternate Executive Directors
A.A. Al-Tuwaijri	
M.-A. Autheman	A. Fayolle
T.A. Bernes	
B. Esdar	R.J. Heinbuecher, Temporary
E.R. Grilli	N. Coumbis
	F. Mercusa, Temporary
	J.P. de Morais
D. Kaeser	W.K. Gruber, Temporary
A. Kafka	H. Mori, Temporary
W. Kiekens	J. Prader
K. Lissakers	B.S. Newman
	D.G. Loevinger, Temporary
	M. Daïri
	S. Rouai, Temporary
	L.V. Palei, Temporary
G. O'Donnell	
A.S. Shaalan	Y.Y. Mohammed
M.R. Sivaraman	H.B. Disanayaka
	B. Andersen
	K.M. Heinonen, Temporary
G.F. Taylor	O. Kwon
J.J. Toribio	A. Lucenti, Temporary
J. de Beaufort Wijnholds	Y.G. Yakusha
	A. Barro Chambrier
Y. Yoshimura	H. Ono
	H. Ogushi, Temporary
	D. Fujii, Temporary
	S. Joyosumarto
Zhang Z.	Han M.
A.G. Zoccali	N. Eyzaguirre

R.H. Munzberg, Secretary
S.W. Tenney, Assistant

Also Present

IBRD: G. Corrochano, Europe and Central Asia Regional Office; M. Harrold, Africa Regional Office. African Department: A. Basu, Deputy Director; G.E. Gondwe, Deputy Director; K. Driessen, M.W. Plant, R. Randriamaholy, E. Sacerdoti, J. Wieczorek. Asia and Pacific Department: A.A. Aghevli, Deputy Director; T.A. Bayoumi, R. Dekle, D.J. Goldsbrough, G.M. Meredith, I. Oishi, I. Otani, C.Thimann, C.M. Towe. European I Department: M.C. Deppler, Director; J.R. Artus, Deputy Director; Y. Horiguchi, Deputy Director; E.V. Clifton, R.J. Corker, R.A. Feldman, H. M. Flickenschild, V. Haksar, H.J. Temprano-Arroyo. External Relations Department: R.W. Russell. Fiscal Affairs Department: N.A. Chalk. Legal Department: W.E. Holder, Deputy General Counsel; H. Cisse, S. Hagan, J.M. Ogoola. Monetary and Exchange Affairs Department: M.I. Blejer, W. Coats, A. Lonneberg. Policy Development and Review Department: J.T. Boorman, Director; J. Ferrán, Deputy Director; D. Burton, R.B. Kahn, T.Kanai, G.G. Moser, C.B. Mulder, S.M. Nsouli. Research Department: T. Kruger, F. Larsen, G.J. Schinasi, A.J. Tweedie. Secretary's Department: K.S. Friedman, P. Gotur, A. Mountford. Statistics Department: C.S. Carson, Director. Treasurer's Department: A.W. Lake. Western Hemisphere Department: B.C. Stuart, Deputy Director. Office of the Managing Director: M. Russo. Advisors to Executive Directors: P.A. Akatu, M. Askari-Rankouhi, J.A. Costa, P.M. Fremann, G.M. Iradian, J. Jonáš, J.M. Jones, R. Kannan, B. Konan, A. Levy, M.-H. Mahdavian, M.F. Melhem, S. N'guiamba, O. Otazú, O. Sein, M. Sobel, T. Turner-Huggins, L.B.J. van Geest, S. Zádor. Assistants to Executive Directors: W.F. Abdelati, J.G. Borpujari, K. Brownlee, H.W. Cocker, D.A.A. Daco, C.K. Duenwald, M.H. Elhage, J.C. Estrella, D. Giga, M.A. Hammoudi, E. Jourcin, K. Kask, H. Kaufmann, E. Kouprianova, K. Kpetigo, T.-M. Kudiwu, J.P. Leijdekker, D. Merino, H. Paris, Phan M.H., T. Presečan, J. Roaf, J. Salleh, J.N. Santos, T. Schneider, Zheng H., Zubir bin Abdullah.

1. REPUBLIC OF CROATIA—REVIEW UNDER EXTENDED ARRANGEMENT

The Executive Directors continued from Executive Board Meeting 97/69 (7/9/97) their consideration of a staff paper on the first review under the Extended Arrangement for the Republic of Croatia (EBS/97/115, 6/25/97).

The staff representative from the European I Department noted that an amendment to the proposed decision in EBS/97/115 was required, owing to the delay that had occurred in completing the first review under the Extended Arrangement for Croatia. If the Board agreed to complete that review as part of the current discussion, the proposed decision would be modified to indicate that Croatia would be able to make the second purchase under the Extended Arrangement until August 1, 1997, rather than until July 21, 1997, as originally envisaged.

Mr. Wijnholds noted that the first review under the Extended Arrangement for Croatia had initially been recommended to the Board for lapse of time consideration, in light of Croatia's good performance under the arrangement. In response to an objection by an Executive Director for such approval of the review, the Board had agreed to postpone its consideration of the matter. In view of the comments put forward by the Deputy General Counsel at the previous meeting (EBM/97/69, 7/9/97), which had subsequently been circulated as BUFF/97/73 (7/21/97) on the nature of program reviews, it was to be hoped that the Board would be in a position to complete the review for the current discussion. As any further postponement of the review would materially affect the program supported under the Extended Arrangement, it was important for the Board to reach an agreement on the matter quickly.

Ms. Lissakers made the following statement:

> Earlier this month we indicated that it was premature to conclude the first review of Croatia's Extended Arrangement. We continue to favor an indefinite delay in the Executive Board's consideration and decision on this matter. However, if it would facilitate a consensus, we would be willing to consider a more defined delay.
>
> While a full reprise of our earlier discussion is not warranted, let me just reiterate one point. In an environment following war, as exists in Croatia and the region, economic success requires not only fulfillment of macroeconomic conditionality but also living up to the terms of a peace settlement. Croatia's lack of compliance with the Dayton Accords is jeopardizing regional stability, which is an essential foundation for economic recovery in the region.
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> The heightened risk of intensified tensions or a possible resumption of hostilities goes to the heart of Croatia's capacity to repay the Fund. Indeed, this point has been acknowledged repeatedly by the staff in the recognition stated in its papers that a lasting solution to the regional conflict is essential for achieving the program's targets. It is the Board's duty when Fund resources are being extended, and in bringing forward a review, to make a judgment about the capacity to repay and to secure the Fund's resources. Under current

conditions, we believe that it would be imprudent to complete the review for Croatia at this time and we recommend a postponement.

Mr. Kiekens made the following statement:

Further careful reflection is demanded by the question whether in exceptional circumstances it could be justified to temporarily suspend a country's rights under an international treaty such as the Fund's Article of Agreement, as an economic sanction, to achieve objectives of peace or international security.

I do not think that this Board has legitimate authority to decide to impose economic sanctions without a reference decision recommending or imposing economic sanctions for reasons of peace or international security. The latter requires a transparent rule-based decision making process by representatives of the international community at large, who are charged with the political and institutional responsibility to pursue those very important objectives of peace or international security. Asking for such a reference framework is the best way to protect the Fund's integrity and ability to promote orderly international economic relations which are themselves a necessary condition of peace.

I support the consensus which has been formed among the European authorities, and which will be expressed in the course of this meeting.

Mr. Esdar recalled that, at the previous discussion, the Board had agreed to postpone its consideration of the review under Croatia's Extended Arrangement. As the uncertainties and reservations expressed by some chairs at that meeting regarding the completion of the review continued to prevail, it might be wise to further postpone the review. However, it would not be acceptable to postpone the completion of the review indefinitely. Rather, Directors should agree on a deadline that would provide the Croatian authorities sufficient time to address the uncertainties expressed by Directors at the previous discussion and to overcome existing reservations about the authorities' policy approach. Perhaps, a deadline for Board consideration in the period immediately after the 1997 Annual Meetings would be reasonable.

Although he was reluctant to take such a position for the current discussion, his authorities considered that such a course would provide an acceptable way to avoid any further political pressures on the Fund, Mr. Esdar commented.

Mr. Ogushi said that his authorities would support a further postponement of the review under Croatia's Extended Arrangement, provided a clear deadline was established for further consideration by the Board on that matter and that there was a clear consensus among Directors on the deadline.

Mr. Toribio stated that his chair supported the proposal for a further temporary postponement of the review under Croatia's Extended Arrangement for two reasons. First, a further postponement would provide a good compromise between the two extreme positions taken by Ms. Lissakers and Mr. Wijnholds. Second, it would provide the Board more time to further consider the circumstances of Croatia. He wondered whether any Directors had in mind a specific date for the Board's further consideration of the matter.

Mr. Wijnholds remarked that he did not consider the position expressed by his chair to be extreme. His authorities were merely requesting the completion of the first review under the Extended Arrangement for Croatia based on the country's good performance.

Mr. Kaeser considered that the positions put forward by Directors for the current discussion entailed both procedural and substantive issues. On the one hand, Mr. Wijnholds and management were recommending the completion of the first review under the Extended Arrangement for Croatia and, on the other hand, the U.S. chair had proposed that the Board further postpone the review. In the circumstances, he wondered whether the proposal for a further postponement should be seen as a procedural issue. He also wondered whether Directors were expected to first take a position on that procedural matter and, then, proceed to the substantive issues related to the situation of Croatia, or whether they should take positions on both of those matters together.

The Deputy General Counsel said that Mr. Kaeser was correct to point out that the current discussion entailed a mixture of both procedural and substantive issues.

Mr. Shaalan stated that, following intensive consultations with the members of his constituency, the majority had indicated support for the U.S. position. His chair would be willing to support postponing the Board's consideration of the review under the Extended Arrangement for Croatia until after the 1997 Annual Meetings, provided there was a consensus among members of the Board for that proposal.

Mr. Zoccali made the following statement:

> Giving effect or qualifying the assurances that the Fund has extended to a member within the framework of an arrangement is a duty of the Executive Board involving a forward looking judgment. Generally, this has flowed from the long established practice of the Board of deciding such issues on the basis of widespread consensus. We consider that the exceptional "post-conflict" circumstances surrounding the Croatian arrangement and the region warrant further reflection. To facilitate Board consensus, we could go along with those chairs supporting a temporary postponement of this complex case. As Mr. Esdar, this chair considers it paramount to avoid setting a precedent that would be tantamount to the politicalization of this institution and its aims.

Mr. Al-Tuwaijri said that his chair supported postponing the review under the Extended Arrangement for Croatia. He would be willing to go along with a consensus for a postponement until after the 1997 Annual Meetings.

Mr. O'Donnell stated that he favored postponing the Board's consideration of the review under the Extended Arrangement for Croatia, because any decision taken for the current discussion would be viewed as political, rather than economic, in nature. However, given the important issues involved, it would not be appropriate to postpone the matter indefinitely. Rather, the review should be brought back to the Board for consideration as soon as possible after the 1997 Annual Meetings. It might not be a good idea to take it up before that time, as to do so might risk reopening the issue at the level of the Governors, which would likely exacerbate political pressures.

Mr. Kafka commented that he could agree to a strictly limited postponement of the review under Croatia's Extended Arrangement.

Mr. Autheman made the following statement:

> First, on the substance, my opinion has not changed. On the issue debated so far, which is that of the postponement, I can accept a postponement if it is a way to maintain unanimity of the Board and to preserve the consensus which we painfully reached at the last meeting.
>
> However, my reading of the so-called European consensus elliptically referred to by Mr. Kiekens is closer to Mr. Kafka's interpretation. I think that a postponement beyond the Annual Meetings would heighten the risk of politicization. It is not because the Board would not have met that the issue would disappear and, therefore, the risk that it could be at least mentioned on the fringe of the Meetings would be higher. Therefore, it seems to me that to be reasonable and consensual, the postponement should be more limited and we should resume our discussion no later than before the Annual Meetings.

Mr. Kaeser stated that, as the observations put forward by the staff on the purpose of program reviews at the previous discussion remained valid, it would be appropriate to complete the review under the Extended Arrangement for Croatia for the current discussion. Nevertheless, in the light of new arguments presented by some speakers, a number of Directors seemed to favor a limited postponement of the review. In the interest of preserving the unity of the Board, he would be willing to go along with the consensus among Directors in favor of such a postponement. He would also be willing to go along with the consensus concerning the date on which the matter should be brought back to the Board for consideration. It seemed that the current consensus was for a date shortly after the 1997 Annual Meetings.

Ms. Lissakers said that the preference of her chair was still for an indefinite postponement. In the interest of consensus, she would be willing to support a postponement until after the 1997 Annual Meetings, which should permit some further clarification of the security situation, including with respect to the need to safeguard the Fund's resources.

As the Board's work program was expected to be extremely hectic in the run-up to the 1997 Annual Meetings, it might be appropriate to bring the matter back to the Board for consideration on October 3, 1997, Ms. Lissakers suggested.

Mr. Wijnholds remarked that, given the importance of the issues at stake, the amount of other business before the Board should not be a consideration. More important, he wondered whether a postponement of the review until after the Annual Meetings would change the substance of the review. Given the time frame involved, would the staff need to renegotiate the program before the review was brought back to the Board?

The Deputy General Counsel noted that the program supported by the Extended Arrangement for Croatia envisaged that the first review would be completed by a certain date.

Thus, the status of the first review—and that of the arrangement as a whole—would remain uncertain until a decision was taken by the Board. It was for consideration whether the continued postponement of the first review was tantamount to a refusal by the Board to complete it as originally envisaged.

Although it was always the Board's prerogative to consider the need to safeguard the Fund's resources, the specific purposes of the first review, as defined under the Extended Arrangement, were to assess performance under the arrangement to date and to establish performance criteria for end-December 1997, the Deputy General Counsel recalled. In the event that the completion of the review was postponed for an extended period, the purposes of the review might change. For example, there might be a need to reconsider the appropriate criteria to be used in assessing performance under the program and the linkage between the program and the use of Fund resources, including possibly a rephasing of purchases under the arrangement.

The staff representative from the Policy Development and Review Department considered that the macroeconomic framework currently in place in Croatia would likely remain appropriate over the coming few months. The targets for end-December 1997 recommended by the staff could also be expected to remain appropriate. Therefore, from a purely economic perspective and unless the situation changed dramatically in the period immediately ahead, it might be possible to review performance under the program currently in place at some future date.

Mr. Daïri asked whether the performance criteria for end-March 1997 or for end-June 1997 would be used to assess performance under the program if the review was postponed until after the 1997 Annual Meetings.

The Managing Director of the Fund had the authority to recommend to the Executive Board a member's request to use the Fund's general resources, based on his judgment concerning whether the program was consistent with Fund policies and whether it was likely to be carried out by the authorities, Mr. Daïri noted. He wondered whether the Managing Director had the same authority in recommending the completion of individual reviews under Fund-supported programs. He wondered whether the Managing Director continued to consider that the first review under the Extended Arrangement for Croatia should be completed, given the performance to date and the authorities' commitment to its implementation over the period ahead. In coming to that judgment, had the Managing Director taken into account the Fund's participation in the Dayton Peace Agreement and the risks pointed to by Ms. Lissakers?

The Acting Chairman stated that the Managing Director firmly supported the recommendation that the first review under the Extended Arrangement for Croatia be completed. That recommendation would not have been put forward for consideration on a lapse of time basis had management considered that there was any question about whether the conditions of the review had been met. In the circumstances, the Managing Director considered that it was important to complete the review as envisaged.

The Deputy General Counsel said that the responsibility of management with respect to reviews under Fund-supported programs was the same as its responsibility in recommending financing arrangements. Similarly, the Fund staff would recommend the completion of program reviews only if it felt that the authorities' commitment to the program was sufficient to ensure its success. The issues raised by Ms. Lissakers for the current discussion on the need to safeguard the Fund's resources had also been considered by the staff and management in putting forth their recommendations to the Executive Board.

Mr. Barro Chambrier stated that, in the interest of consensus, he could go along with Mr. Kafka in supporting a strictly limited postponement of the review, taking into account the risks associated with the program.

Mr. Andersen made the following

> I would like to reiterate this chair's grave concerns regarding Croatia's noncompliance with the Dayton and Erdut Agreements as a nonfulfillment of these agreements makes the implementation of the program more difficult in the time ahead. At the same time, I share the points made by Mr. Kiekens on the importance of protecting the Fund. I can go along with a broad consensus in favor of a further limited postponement. We are indeed moving on thin ice and can only hope that developments in the time ahead will ensure that our shoes are still dry when we come ashore. I have no strong views on whether this is most likely before or after the Annual Meetings, but I would, of course, hope that it will be sooner rather than later.

Mr. Taylor noted that the substantive issues under consideration had not changed since the previous discussion. In the interest of consensus, he could agree to a limited postponement of the review under the Extended Arrangement for Croatia. However, the postponement should be a short as possible, bearing in mind the need to use the delay purposefully, along the lines suggested by Mr. Kiekens; otherwise, the Board would risk another postponement when it revisited the matter.

Mr. Grilli commented that it was difficult to differentiate between the political issues at stake, which were very important, and the desire for consensus among members of the Board. In the spirit of consensus, he could reluctantly go along with Mr. Autheman and Mr. Kafka for a very limited postponement of the first review under the Extended Arrangement for Croatia.

Mr. Sivaraman said that he respected the position taken by the U.S. chair. However, he wondered whether the Fund was the appropriate forum for insisting that Croatia comply with the terms of the Dayton Peace Agreement. He agreed with Mr. O'Donnell that, in the circumstances, any decision the Fund took would be seen as political, rather than economic, in nature. The case of Croatia represented a rare instance in which a Fund-supported program was to be interrupted, owing to a failure on the part of the Board to complete a review, rather than to a failure by a country to meet the performance criteria.

It was important to consider that such a decision could send misleading signals, particularly at a time when the Fund was enlarging its role to cover issues related to governance and other aspects of policy, Mr. Sivaraman noted. It would seem particularly important for the Fund to demonstrate that its decisions were based on purely economic considerations related to the interests of the country concerned or the world in general. Although there were strong grounds for forcing Croatia to comply with the commitments it had made elsewhere, it had met all of the performance criteria and benchmarks under the Extended Arrangement with the Fund.

If the consensus among Directors was that a limited postponement of the review was in the best interest of peace, there might be good reason to compromise the Fund's traditional policies on apolitical decision-making, Mr. Sivaraman considered. On that basis, he could go along with the consensus for a very limited postponement of the review. However, the Fund should avoid sending the wrong signal that it would take future decisions in the light of political considerations.

Mr. Shaalan suggested that it might be prudent to consider postponing the review until after the 1997 Annual Meetings in order to avoid further postponements of the review in the future.

Mr. Bernes commented that the main issues for consideration had not changed since the previous discussion. He agreed with Mr. Kiekens that the case of Croatia raised broader questions concerning the appropriate role of the Fund in post-conflict situations that warranted very careful consideration by the Board.

As he had indicated at the previous discussion, his Canadian authorities could support a limited postponement, Mr. Bernes said. The preference of his chair would be for the shortest possible postponement to a date before the 1997 Annual Meetings. However, it would be imperative to ensure that the Board would take a decision when it resumed its consideration of the matter. Therefore, if the consensus among Directors was for a date immediately following the 1997 Annual Meetings, he could go along with it.

Mr. O'Donnell stated that his chair looked forward to being able to support the completion of the review under the Extended Arrangement for Croatia at the next Board meeting on that matter. Thus, his position on a date for the resumption of the Board's discussion was based on the probability of the Board being able to take a decision. Although he could remain open on the date, it would seem that the probability for resolving the remaining issues would be better after the 1997 Annual Meetings.

Mr. Wijnholds considered that there was a material difference between the proposal for a limited postponement and the proposal to postpone the review until after the 1997 Annual Meetings. As the Deputy General Counsel had indicated, the proposal for a long delay in the Board's consideration of the review could be seen as tantamount to a refusal by the Board to complete the review.

Ms. Lissakers noted that one of the main purposes of the postponement was the desire among Directors to be able to support completion of the review at the next discussion. She wondered whether Mr. Wijnholds felt confident that the uncertainties about the security situation and Croatia's compliance with the Dayton Peace Agreement would change significantly before the 1997 Annual Meetings.

Mr. Wijnholds remarked that implementation of the Dayton Peace Agreement had not been included as a performance criterion under the Extended Arrangement for Croatia.

Mr. Zhang stated that the position of his chair had not changed since the previous discussion. The Fund had a clear mandate in the areas of its specialization. Given Croatia's good performance under the Extended Arrangement to date, he fully shared the views expressed by Mr. Wijnholds in favor of completing the review for the current discussion. He also agreed with other speakers on the need to avoid subjecting the Fund to undue political pressure and on the need to avoid sending misleading signals to members concerning the basis for Fund decision making. In addition, an unduly long postponement of the review might jeopardize the momentum of program implementation.

Nevertheless, in the interest of consensus, he could go along with Mr. Kafka in supporting a strictly limited postponement of the review, Mr. Zhang said.

Mr. Palei made the following statement:

> In the statement by the staff representative of July 21, 1997, I read that, "judgment must be exercised against the background of the relevant economic assessment inherent in the review and be based on the data and information presented to the Board."
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> I do not see any discussion in the materials presented by the staff to this Board that would address issues raised by the American chair and by several other Directors. Therefore, based on the data and information presented to the Board regarding Croatia, I cannot take any definite position.
>
> I am willing to go along with emerging consensus which seems to be a postponement of the review until a defined date.
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> On the length of the time, I share the concerns of other Directors. It would be rather odd to gather again at a defined date only to postpone the discussion for the third time.

Mr. Morais said that his chair supported a limited postponement of the review under the Extended Arrangement for Croatia.

Mr. Daïri commented that he fully shared the view expressed by Mr. Zhang on the risk of sending misleading signals regarding the integrity of the Fund's approach in cases like that of Croatia. In the interest of consensus, he could go along with the position taken by Mr. Kafka and Mr. Zhang in favor of a very limited postponement. Given the increased interest of the Fund in greater transparency and the publication of the Fund's views on member country economies, he wondered whether management intended to issue a press release on the case of Croatia, delineating between Croatia's economic performance under the program, on one hand, and the reasons for the postponement of the review, on the other.

The Acting Chairman said that management did not intend to issue a press release on the current discussion. He wondered whether the staff could clarify whether Croatia's performance under the Extended Arrangement would be assessed on the basis of the most recent information available at the time of the review, if the circumstances of the country changed before the next discussion.

The staff representative from the Policy Development and Review Department responded that the most recent available information should always be taken into account in the consideration of program reviews.

The Deputy General Counsel commented that the nature of the review under the Extended Arrangement with Croatia would change over time, in line with developments in the country. For example, a determination would need to be made on whether a review brought to the Board after the 1997 Annual Meetings should be based on the performance criteria for end-June 1997, rather than on the performance criteria for end-March 1997. The proposed decision for the current discussion was to allow for a purchase under the arrangement pursuant to the end-March performance criteria.

The Acting Chairman stated that the request by the Croatian authorities for the completion of the first review under the Extended Arrangement had not garnered sufficient support among Directors, although it remained the recommendation of management that the Board complete the review. Although the consensus among Directors was clearly in favor of a limited postponement of that review, the question of whether the matter should be brought back to the Board before or after the 1997 Annual Meetings remained. He wondered what was the latest date on which it might be possible to take up the review prior to the 1997 Annual Meetings.

The Secretary noted that, although the last Board meeting before the 1997 Annual Meetings was currently scheduled for September 12, it might be possible for the Board to meet on September 15, 1997.

Ms. Lissakers stated that the reason her authorities favored an indefinite postponement of the review under the Extended Arrangement for Croatia was not to terminate the arrangement, but to increase the prospects for the Board to reach a consensus on the completion of that review and the resumption of Croatia's access to Fund resources at the next Board discussion. The timing of further Board consideration would be determined by improvements in the security situation and the reduction of tensions in the region. Establishing a date for the next Board discussion at the present stage would run the risk that conditions would not have improved sufficiently for the Board to reach such a consensus at the next meeting. Against that background, agreeing to a further discussion on September 12 would be particularly risky, given the short time span involved. It might be reasonable to plan to bring the matter back to the Board after the 1997 Annual Meetings, as there were better prospects that the situation would have improved by that time. Moreover, such a postponement would not be outside the norm for delays in the completion of reviews under Fund-supported programs.

Mr. Autheman recalled that many Directors had indicated that they were willing to go along with the U.S. proposal to postpone the review under the Extended Arrangement for Croatia, but not necessarily for the reasons given for that proposal. Rather, Directors had agreed to a postponement in order to preserve the consensus of the Board. The argument put forward by Ms. Lissakers for an indefinite postponement was not acceptable in that it entailed a presumption that the Board would not expect to complete the review unless major developments outside the parameters of the Fund's concern took place. As the consensus among Directors was not for an indefinite postponement, management should be expected to bring the matter back to the Board for lapse of time consideration not later than the 1997 Annual Meetings. Such a postponement would capture the concerns expressed by the U.S. chair as well as the desire of other Directors not to challenge the performance of Croatia under the Extended Arrangement. Of course, such a procedure would leave Directors free to request a Board discussion on the matter at any time.

Ms. Lissakers remarked that she stood by her argument that the prospects for achieving consensus would be greater if a reasonable amount of time were to lapse before the next discussion on Croatia. The concerns expressed by some Directors about the situation of Croatia and the need to safeguard the Fund's resources could be resolved in the intervening period. Those concerns were not outside the parameter of the Board's concern, as Directors always had a responsibility to safeguard the Fund's resources.

Mr. Wijnholds stated that he disagreed with Ms. Lissakers that a further postponement until after the 1997 Annual Meetings could be viewed as reasonable. Such a delay in completing the review under the Extended Arrangement for Croatia would change the nature of the review.

Although the principle of consensus was important, there were fundamental principles at stake, Mr. Wijnholds considered. It would be a mistake to try to cover up the need to address those principles by making appeals to the desire for consensus. From Directors' comments for the current discussion, it seemed a majority would favor a strictly limited postponement.

Mr. Taylor noted that it was the prerogative of Fund management to recommend matters to the Board for consideration whenever it considered that Directors would be in a position to take appropriate decisions. Bearing that in mind, his chair would favor the shortest possible postponement of the review under the Extended Arrangement for Croatia. In the circumstances, perhaps Directors could agree that management should bring the matter back to the Board as soon as possible, but not later than October 3, 1997.

Mr. Kaeser asked whether management was withdrawing its recommendation that the review under the Extended Arrangement for Croatia be completed at the current discussion.

The Acting Chairman responded that management continued to consider that the review should be completed at the current discussion. However, it was bound to accept the Board's decision. Management could agree to bring the matter back to the Board for consideration on the date agreed by Directors. The Board could establish a deadline for its consideration of the matter, with the understanding that management would bring it back sooner if it became clear that a consensus on the completion of the review could be reached.

Mr. Kiekens noted that each member of the Fund had the right to request a decision by the Board. In that respect, the Board was in the hands of the Croat authorities. In the event that such a decision was requested, a refusal by the Board to take a decision would become, in effect, a refusal to complete the review under the Extended Arrangement.

Against that background, the agreement to postpone taking a decision should be seen as a message to the Croat authorities that the Board was not categorically refusing to complete the review, but that it would be willing to consider that issue at a future date, Mr. Kiekens considered. The Croat authorities could request that the matter be brought back to the Board when they felt it would be in their interest to do so. Taking into account those considerations, the Board could agree to postpone the review under the Extended Arrangement for Croatia until after the 1997 Annual Meetings on the understanding that the Croat authorities could request a further discussion before that time.

Mr. Wijnholds remarked that an agreement to postpone the review until after the 1997 Annual Meetings would materially change the nature of that review, owing to the lengthy time frame envisaged. The Croat authorities would likely view such an agreement as being tantamount to a refusal to complete the review currently under consideration. In the event that Directors supported such a long postponement, he would have to request a vote on the completion of the review for the current discussion.

Mr. O'Donnell said that he agreed with a number of other Executive Directors that the goal should be to maximize the possibility that Directors would be in a position to support the completion of the review at the next Board discussion. Given the differences of view expressed about the rationale for such a postponement, Mr. Taylor's proposal would represent a good compromise. Of course, management would be in a good position, in consultation with members of the Board and the Croat authorities, to determine the most appropriate date for a further discussion on the matter. It would be reasonable for Directors to agree for the current discussion that the review under the Extended Arrangement for Croatia would be postponed until a date not later than mid-October 1997, but that with the understanding that management could bring the matter back to the Board earlier if appropriate.

Mr. Esdar recalled that, on previous occasions, reviews under arrangements with other member countries had been postponed for extended periods, of up to four or five months. It was not clear that there would be a material difference between agreeing to hold the next Board discussion in mid-September or in mid-October.

In the current circumstances, his chair had two main interests, Mr. Esdar commented. The first was to complete the review under the Extended Arrangement for Croatia as soon as possible. The second was to maintain the consensus of the Board, thereby, avoiding any significant political divisions among Directors. Given the need, on the one hand, to ensure that Directors had sufficient time to strengthen the consensus and, on the other hand, to ensure that the review was completed as quickly as possible, Mr. Taylor's proposal seemed appropriate.

Mr. Autheman noted that the first review under the Extended Arrangement for Croatia was originally expected to be completed on July 9, 1997. As the program supported under that arrangement was based on quarterly performance criteria, a postponement of that review for three months or longer would clearly have a material impact on the program. Although he was willing to go along with a consensus in favor of postponing the review, he could not support a process that might result in an implicit rejection of that review over time. Taking into account those considerations, he could not support the proposal to postpone the review until after the 1997 Annual Meetings. If such a proposal was the only option for Directors, he would be willing to vote on the completion of the review for the current discussion.

Mr. Kaeser and Mr. Kiekens stated that they supported the position taken by Mr. Autheman.

Mr. Sivaraman considered that it would not be appropriate to ask management to bring the matter back to the Board when a consensus seemed likely. Such an agreement would send the signal that the Board was unduly delaying a process that was already complete. The staff and management had taken a strong position in recommending that the review be completed at the current discussion. In the circumstances, he could go along with a limited postponement, but not a postponement until after the 1997 Annual Meetings.

Ms. Lissakers remarked that an agreement to postpone the review under the Extended Arrangement for Croatia by more than two or three months was not tantamount to termination of the arrangement. The Board undertook such postponements almost as a matter of routine in difficult cases. For example, the Board would likely agree to a similar postponement in the case of Kenya, for which a review was originally expected to be completed in April 1997.

Mr. Kiekens considered that the case of Croatia was very different from that of Kenya. In the case of Croatia, the authorities had formally requested a completion of the review, an action that was clearly within their rights. Indeed, the Board should agree to a postponement only if the Croat authorities were willing to suspend that request for some period.

Mr. Grilli said that, in order to avoid materially changing the nature of the review, there was a need to minimize the period of the postponement. He could support a postponement until not later than September 10, 1997.

The Acting Chairman noted that there was only one option that could be agreed by the Board without precipitating a formal request for a vote by Mr. Wijnholds. Mr. Wijnholds had indicated that, unless the Board agreed to revisit the review before September 10, 1997, he would call for a vote on taking a decision on that review at the current discussion. It was important to note that such a motion would not entail a vote on the review itself. Rather, a decision on the merits of the case for completing the review would need to be taken after the vote on whether to take such a decision at the current discussion was completed.

Ms. Lissakers remarked that an overwhelming majority of Directors had expressed their support for a postponement of the review under the Extended Arrangement for Croatia. It would not seem appropriate to take up a motion calling for a vote for the current discussion.

The Acting Chairman stated that, although Ms. Lissakers was correct to note that the current consensus among Directors was in favor of postponing the review under the Extended Arrangement for Croatia, Mr. Wijnholds was entitled to request a formal vote on the matter.

Mr. Toribio commented that the proposal put forward by Mr. Taylor, which he could support, had the practical merit of postponing a decision on the review to a date not later than October 3, 1997. Thus, it did not preclude the possibility of taking up that matter again at an earlier date. Indeed, it would be understood that Fund management or the Croat authorities could request that the matter be brought back to the Board before October 3, 1997.

The Deputy General Counsel noted that, even if the Board agreed to postpone its consideration of the review under the Extended Arrangement for Croatia, the member, or the Executive Director for that member—on behalf of the authorities—would maintain the right to request that that matter be placed on the Board's agenda earlier. If such a request was made by the Croatian authorities, the Managing Director, within the means available, would need to place the matter on the Board's agenda. In such an event, the Board would need to reconsider the matter when the item returned to its agenda. The Board could not usurp the Executive Director's right to request a Board discussion on the matter.

Ms. Lissakers stated that, in light of the comments put forward by the Deputy General Counsel, she could go along with the proposal put forward by Mr. Taylor and Mr. Toribio that the review under the Extended Arrangement for Croatia be postponed until not later than October 10, 1997.

Mr. Kafka said that he could agree to the proposal put forward by Mr. Taylor.

Mr. Wijnholds stated that he could not go along with that proposal.

The Acting Chairman noted that first possible date for a Board meeting after the 1997 Annual Meetings was October 10, 1997.

Although there remained significant differences among Directors, there seemed to a consensus emerging in favor of postponing the review until not later than October 10, 1997, on the understanding that the matter could be brought to the Board before that date if circumstances permitted an earlier completion of the review, the Acting Chairman considered.

As indicated previously, Mr. Wijnholds could call for a vote on whether a decision on the review should be reached for the current discussion, the Acting Chairman said.

Mr. Kafka asked whether, after voting on whether a decision should be taken for the current discussion, Directors could vote on the proposal put forward by Mr. Taylor.

The Deputy General Counsel replied that the Board could vote on either, or both, of those procedural matters for the current discussion.

Mr. Wijnholds stated that, on behalf of his Croat authorities, he would like to request that the first review under the Extended Arrangement for Croatia be brought to the Board's agenda on September 10, 1997.

The Deputy General Counsel noted that Executive Directors had the right to request that an item be placed on the Board's agenda. However, it was for management to determine precisely how and when that matter would be dealt with.

Mr. Kiekens commented that, although management might have some leeway for taking into account practical considerations in responding to the request of the Croat authorities, that request should be treated in good faith. In other words, if the date requested for a Board discussion was of importance to the country concerned, Fund management could not neglect that fact.

Mr. Autheman considered that, as management had not withdrawn its recommendation that the review under the Extended Arrangement for Croatia be completed at the current discussion, it would not be appropriate for it to object to Mr. Wijnholds's request. Leaving the question of the timing of the next Board discussion to the Croat authorities might be an appropriate solution.

Mr. Kiekens noted that it was ultimately for the Board to take a decision on the request from the Croat authorities, paying due regard to the recommendations put forward by management.

Mr. Esdar asked whether the Board could agree to postpone the first review under the Extended Arrangement for Croatia to not later than October 10, 1997, but note that the

Executive Director for the Republic of Croatia had requested that the review be put on the agenda on September 10, 1997.

The Deputy General Counsel responded that such an agreement would be in accordance with Rule C6 of the Fund's *By-Laws, Rules, and Regulations.*

Following some further brief discussion, the Acting Chairman noted that Directors agreed to postpone the consideration of the first review under the Extended Arrangement for Croatia to not later than October 10, 1997. However, it was noted that, in accordance with Rule C6, the Executive Director for Croatia had requested that the review be put on the agenda on September 10, 1997.

2. JAPAN—1997 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1997 Article IV consultation with Japan (SM/97/176, 7/3/97). They also had before them background papers on recent economic developments in Japan (SM/97/183, 7/10/97; and Cor. 1, 7/22/97) and on selected issues (SM/97/180, 7/10/97).

Mr. Yoshimura made the following statement:

> Although the Japanese economy began to recover from recession in October 1993, the pace of recovery was slow until the end of 1995, mainly due to the rapid appreciation of the yen, as well as adjustments in capital stock and the balance sheets of the corporate and financial sectors following the bursting of the asset-price bubble. However, partly because of the decisive policy actions taken by both the fiscal and the monetary authorities during fiscal year 1995 to stimulate the economy, the economy picked up and had returned to a steady recovery path by the end of 1995. Economic growth in 1996 reached 3.6 percent, the highest among the major developed countries. An increase in domestic demand contributed 4.4 percent to growth, whereas external demand had an adverse impact on growth.
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> For a while after the end of 1995, public demand, including public investment, played a key role in sustaining the economic recovery. Since the middle of 1996, an increase in final demand, in particular in private demand, stimulated production, which not only improved business profits but also led to an increase in workers' income and consumption. It is fair to say that an autonomous business cycle of demand, production, and income has been established. In particular, since last autumn, private demand has sustained the economy in place of public investment, and we can see a shift of the primary force of economic growth from public to private demand. In this context, it is important to put in place various structural reforms in order to achieve medium-term growth maintained by private demand. My authorities share the staff's view that the economy's autonomous recovery has strengthened.
>
> The economy fluctuated slightly in 1997 because of the irregular impact of the rise in the consumption tax rate from 3 percent to 5 percent on April 1. While the first quarter of 1997 showed high annual growth of 6.6 percent, reflecting stepped-up demand just before the increase in the consumption tax

rate, during the second quarter of 1997 there were signs of a reversal in demand. Such fluctuations make it difficult for some economists to make assumptions about prospects after the third quarter of 1997, and there are some who express uncertainty about the future of the economy. In addition, we understand that there is concern about the adverse impact on the economy of the strengthened fiscal consolidation which the Japanese government has been decisively pursuing since the end of last year. In our view, however, it seems likely that the steady economic growth led primarily by private demand will continue. In any event, the following three points can be made from a detailed examination of recent economic data.

The decline in private consumption resulting from the increase in the consumption tax has been within the expected range; moreover, household income has increased steadily, and it is likely that private consumption will continue to recover.

Industrial investment is expected to continue to increase thanks to improved business results.

Because of the correction of the excessive appreciation of the yen, net exports, which for the past few years have had an adverse impact on economic growth, are no longer having a negative effect on economic recovery.

Thus, it is reasonable to conclude that the Japanese economy after the third quarter of 1997 will maintain steady, sustainable recovery, with private demand absorbing the expected fiscal drag. This trend is expected to continue after 1998.

A rapidly changing environment has had a significant impact on the fiscal position. A decrease in the number of children, an aging population, the end of the Cold War, completion of the "catch-up" economy, pressures of greater competition, and a decrease in the working-age population—all these factors have made the fiscal situation critical. Given the urgency of the situation, it is essential to proceed with structural reform to improve the fiscal situation, to establish a more effective and reliable civil service and a secure and prosperous society, and to build a sound and vital economy.

Accordingly, my authorities are putting priority on the reform and consolidation of expenditure, and in June 1997 the cabinet decided on major measures aimed at structural fiscal reform, including a fiscal deficit target of no more than 3 percent of GDP by the year 2003. During the first three years of the plan, a comprehensive review will be made. There will be no "sacred" areas. Moreover, specific numerical targets were established for major expenditures. Along with these measures, my authorities plan to submit draft laws on fiscal consolidation to the Diet.

In order to improve the soundness of local finance, the cabinet decided on measures to reduce the expenditure growth of local governments as much as that of the central government by, among other things, reducing activities which the local government had already planned.

The cabinet also decided that expenditure for FY1997 is to be lower than in FY 1996, and in July the Prime Minister ordered maximum efforts to be made toward rationalization, improved effectiveness, and prioritization of expenditure. Priority was put on improving efficiency in distribution and on improving the social infrastructure, the environment, science and technology, and information and telecommunications. Official development assistance (ODA) is no longer excepted from consideration. The budget for ODA will be reduced by more than 10 percent over FY 1996. In the meantime, careful attention will be paid to prioritizing budgetary allocations to make them more effective, with the view to moving from quantity to quality. On the taxation front, consideration will be given to expanding the corporate tax base, and the tax rates will be reduced. A revision of taxation on financial transactions will be made, along with a renovation of the financial system.

The staff suggests that the fiscal deficit should be reduced by 1 percent of GDP every year for the next four years. As mentioned above, my authorities have set a target of lowering the deficit to 3 percent of GDP by the year 2003. They recognize Japan's fiscal situation as the worst among the industrialized nations, and the necessity of urgent consolidation in light of the rapidly aging population. In this regard, my authorities share the spirit of the staff's suggestion.

With respect to public investment, the cabinet decided the following measures in June:

To maintain the thrust of the basic plan for public investment, which aims at renewing social infrastructure by the early part of the twenty-first century, subject to securing sufficient revenue so as not to carry over the burden to future generations.

To lower public investment to an appropriate level, that is to say the same level as before the significant additional measures were introduced to stimulate the economy.

To substantially reduce the scale of the investment from the initial target of 600 trillion yen to 470 trillion yen, by increasing the duration of the basic plan for three years.

Based on this cabinet decision, the basic plan for public investment was reviewed so as to include measures for reducing the costs and for prioritizing reforms of the social infrastructure, in addition to the above-mentioned increase in duration of the plan.

Prime Minister Hashimoto and his cabinet have announced civil service reform aimed at establishing public administration for the people. They have been examining the role of the public and private sectors, deregulation, decentralization, disclosure of information, and reform of the central government.

The staff urges a further increase in the consumption tax rate. My authorities think that taxation, including a consumption tax, should be discussed at the national level based on the fiscal situation and what is appropriate taxation at the time.

The pension system is also in a critical state: currently pensions are paying only 60 percent of the expected amount of the benefit. My authorities therefore intend to substantially reform the system in order to distribute the burden fairly among generations, and also to create new jobs for older people. My authorities will also address both the corporate and private pension systems in addition to the issues covered by the report, namely, cuts in pension benefits, a further increase in the retirement age, indexation, and contribution rates.

The staff indicated the necessity of identifying the government's contingent liabilities in various special accounts. The cabinet decide on the principle that the government should proceed with the disclosure of public finances, including the general account and special accounts, so as to promote public support for fiscal structural reform.

In light of the fact that public support is indispensable for structural fiscal reform, my authorities have been considering disclosing information by means of seminars and the Internet.

As for ODA, the emphasis needs to shift from quantity to quality. In order to better help the people in developing countries, my authorities plan to attach greater importance to prior consultations with recipient countries and to pay due attention to social development, such as health, education, and the status of women. In addition, my authorities will, among other things, establish a project evaluation system, improve cooperation with nongovernmental organizations and the private sector, and make further progress in disclosure.

In September 1995, the Bank of Japan reduced the official discount rate to 0.5 percent, a historically low level both for Japan and for the world. This rate has been in effect for the past two years. On the monetary operation front, the Bank of Japan continues to supply sufficient funds to short-term financial markets so that the overnight rate is slightly lower than the official discount rate. Long-term interest rates and stock prices increased during the first half of 1996; however, they declined between the fall of 1996 and spring of this year. Although the swings in short-term interest rates were smaller than in long-term rates, they showed a similar tendency. This weak trend of interest rates and stock prices has stabilized recently, as the too pessimistic views on the Japanese economy and financial system have been eliminated.

In the management of current monetary policy, the Bank of Japan will continue to monitor economic developments closely, placing emphasis on further strengthening the foundation for economic recovery, taking into account both the fact that prices are expected to stabilize reflecting the recent appreciation of the yen and stable oil prices, and the potential upside risk which could result from the extremely low interest rates.

Improvement of the transparency of monetary policy as well as increased independence of the central bank are key elements of the amendment of the Bank of Japan Law. Prior to the implementation of the revised law in April 1998, the Bank of Japan has been considering specific measures to improve transparency, such as disclosure of the summarized minutes of the Policy Board. With regard to the transparency issue, the staff suggests the introduction of explicit inflation targeting. At present the Bank of Japan does not think this is appropriate, however, as there are some problems with the inflation targeting that need to be resolved. For example, at the outset of the bubble economy in 1987 and 1988, the increase in the consumer price index was well below 1 percent. If inflation targeting had been introduced at that time, the authorities would have eased monetary conditions further. It is clear that a further relaxation of monetary policy was not called for at that time. Another reason for the Bank of Japan's reservation about inflation targeting is that the credibility of the monetary aggregates as a policy indicator has been less damaged in Japan than in other developed countries.

The staff also notes the usefulness of setting short-term operational targets. It should be stressed, however, that the Bank of Japan has clearly indicated the target level of the overnight interest rates to market participants as "lower than the official discount rate on average." The target level is deliberately vague so as not to distort the free, market-oriented determination of interest rates. My authorities are confident that communication between the central bank and the markets has been secured.

The external current account surplus has decreased in each of the past three years from 3.1 percent of GDP in 1993 to 1.4 percent of GDP in 1996. The decrease in the surplus is, as the staff mentions, due to changes in Japan's trade structure rather than to macroeconomic forces. This structural change was brought about by horizontal international specialization, by the transfer of production overseas, and by improvement of the distribution system of imported goods through deregulation.

It is true that the trade balance in April and May significantly increased; however, a recoiling of the temporary surge in demand ahead of the increase in the consumption tax rate contributed to this increase. Looking ahead, however, concerns that the current account surplus might increase sharply are unwarranted in view of the following: the influence of the increase in the consumption tax will soon end; the appreciation of the yen since late April will work, with some time lag, toward adjustment of the goods and services balance; and the ongoing structural changes mentioned above are expected to continue.

In addition, since the external balance depends to a large extent on exogenous factors such as the exchange rate, oil prices and other countries' economic condition, my authorities do not agree with the staff's projection on the future of Japan's current account balance.

In the light of the above-mentioned assessment and the current economic situation, as the staff correctly pointed out, policies targeting a specific level of the external balance do not seem appropriate.

As noted during the discussion on the World Economic Outlook last spring, in discussing the external imbalance attention should be paid to the balance of goods and services, which has a direct effect on employment in trade partner countries, rather than to the current account balance. It will be difficult for short-term macroeconomic policy to control the income balance, which is a residual part of the current account balance and consists of interest and dividends earned by the holding of external assets.

The significant movement of the exchange rate between mid-1995 and early this year was regarded as an adjustment phase after the excessive depreciation of the U.S. dollar or the excessive appreciation of the yen a few years ago. However, the fevered depreciation of the yen between February and April of this year was cause for another concern—reverse overshooting. It was comforting that the market regained stability, reflecting the statement by the G-7 Finance Ministers in April. My authorities think that stable exchange rate development, reflecting mid-term fundamentals of the economy, is critically important for stable growth of both the Japanese and the world economy. One cannot neglect short-term volatile movements reflecting arbitrage movements in the markets and capricious perspectives on the major economies. For example, perspectives of market participants on the Japanese economy in February and March were unreasonably pessimistic. My authorities will continue to closely monitor exchange rate developments.

There has been significant progress in the issue of the nonperforming loans of banks, which has been a major challenge for the sustainable development of the economy. Based on the three new banking system laws, my authorities have been strengthening the deposit insurance system, creating procedures to deal with insolvent banks, and they will introduce prompt corrective action scheduled for April 1998. These measures are expected to contribute to improving the credibility of the Japanese financial system. At the same time, private banks are making strenuous efforts to resolve these problems through a review of branch allocation, reduction of staff, decisive rationalization, and the aggressive writing-off of nonperforming loans. Some commercial banks announced unprecedented restructuring plans and, in 1996, major banks either closed or merged branches, reducing the number of branches by about one hundred and fifty and the number of staff by about nine thousand. Consequently, the total amount of nonperforming loans of all Japanese banks has been steadily reduced from 34.8 trillion yen in March 1996 to 27.9 trillion yen in March 1997. The amount of estimated problem loans to be disposed of (i.e., total nonperforming loans, less provisions in special accounts for loan loss write-offs and estimated collateral coverage) has been reduced to less than 5 trillion yen. In light of the operational revenue of nearly 7 trillion yen in recent years and the unrealized profit from securities of nearly 14 trillion yen, although the operating situation among banks varies, it would be reasonable to judge that Japanese banks as a whole can cope with and overcome this difficult problem. In particular, as major banks with overseas branches finalize the accounting adjustment related to the nonperforming loans within one or two years, we are cautiously optimistic that the solution of this issue seems to have progressed to the point where the Japanese banking problem will no longer affect the world economy.

The staff makes an interesting comparison analysis of the amounts of the nonperforming loans. The possibility of recovery of bad loans is not a black and white area. What is important is to have a clear definition of bad loans and a good method for calculating the amounts of the bad loans. In particular, it is important to monitor the chronological changes in the amount, and not only the gross amount but also the net loss from the loans. My authorities are confident that the amount of nonperforming loans, which is disclosed semi-annually, is based on a clear definition, and that, together with the additional information provided in the footnotes of the announcement, they have been providing sufficient information to market participants and economists. I agree with the description in Box 2 which says that the difference between the official figures and IBCA's is due to the different treatment of loans sold to CCPC. Bad loans that have a book value of 13.5 trillion yen have been sold to CCPC for 5.4 trillion yen. This amount is based on an evaluation of the collateral at market price, and it is reasonable to assume that the Ministry of Finance regards the figure as being settled. In addition, the IBCA estimate still includes the *Jusen* loans. Thus, in light of the fact that IBCA seems to overestimate the amount of nonperforming loans and that their calculation of net loss to be disposed of, in comparison with the Ministry of Finance's estimates, is based on rough estimates, the staff's view that the banks' net losses are close to those of IBCA is hard to accept.

In order to further help solve the problem of nonperforming loans, it is important for banks to speed up the collection of debt by liquidating the collateral real estate. My authorities intend to support the collection through the implementation of measures (Overall Package for Stimulating Real Estate Liquidity) that were decided upon at the end of March. Some of the specific measures in the package, such as securitization of loans with real-estate collateral, have already begun.

In addition, the staff report indicates that the authorities' support to major banks is ad hoc and that it lacks a clear framework. It should, however, be noted that the resolution of major banks' problem loans is within reach through their own efforts toward drastic restructuring and writing-off of bad loans. Furthermore, my authorities have clearly indicated their position that they would assist major banks so that the functions of the financial institutions will not be destroyed. This policy stance will not change. Moreover, in assisting the banks, my authorities are closely investigating the responsibility of the financial institutions' management, and they are demanding that the banks make their own best efforts toward drastic restructuring. The staff report also refers to the "use of Bank of Japan funds," but this description could be open to misunderstanding. To be precise, this means support from an account funded by the Bank of Japan, an account that is managed strictly separately from the other account in the "New Financial Stabilization Fund. " The use of funds from this account is subject to Bank of Japan's approval, which is based on the "four principles" for the provision of Bank of Japan funds for the purpose of financial system stabilization. In sum, I would emphasize that my authorities are following clear guidelines in their support to commercial banks.

We recognize that there is criticism, as in the staff report, but we would like to draw attention to the fact that it is a sign of progress that my authorities' measures and relevant parties' efforts have been successful in avoiding possible financial crisis, which was discussed often in the first half of this year.

In March 1995, the cabinet decided the principles and specific plan for deregulation, which consists of 1,091 items. The plan covers housing, real estate, information, distribution, standardization, licensing, imports, and finance. The cabinet decided to front-load the implementation beginning in April 1995, and they are making steady progress.

In March 1996, the cabinet decided on a revision of the deregulation plan, adding 1,797 items. The plan was revised further in March 1997 to increase the number of items to 2,823.

In November 1996, Prime Minister Hashimoto announced a plan for financial system reform, including deregulation,—the so-called Big Bang. This reform is characterized by three words, "free," "fair," and "global." It is based on the recognition that financial sector reform is indispensable for the development of the economy. As the first step, the Foreign Exchange and Control Law was revised by the Diet in May, and will be implemented in April 1998. This amendment strives to abolish prior permission and notification requirements on cross-border financial transactions, and to abolish the foreign exchange bank system. Plans for other reforms in the areas of banking, securities, insurance, and accounting were decided in mid-June. The plans include specific measures and clear timetables for their implementation. Necessary amendments of laws and regulations are expected to be implemented in due course.

Extending his remarks, Mr. Yoshimura said that he would comment on three main points, namely, the system pertaining to the budget and public finance, the relationship between the Bank of Japan and the government following the amendment of the Bank of Japan Law, and Japanese bank financing to the east Asian financial markets.

As to the transparency of government operations, it should be noted that the cabinet had recently taken a decision that the government should proceed with the disclosure of information pertaining to the public finances, including the operations of the general account and special accounts in order to promote public support for fiscal and structural reforms, Mr. Yoshimura stated. The government would also streamline and rationalize public corporations currently funded by budget subsidies and financing from the Fiscal Investment and Loan Program (FILP). For example, the Export-Import Bank of Japan and the Overseas Economic Cooperation Fund would be merged over the coming years. More recently, a decision had been taken to narrow the operations of the Japan Development Bank and to reorganize it in a way that would allow for the absorption of another regional development corporation. The Public Housing Corporation was also to be reorganized and it would withdraw from areas covered by private housing companies.

An advisory group of the Ministry of Finance had put forward a recommendation to review the role of the FILP, including the extent to which it complements private financing, and to ensure the repayment of past lending to the Japan National Railway System Corporation (JNRSC), Mr. Yoshimura commented.

The postal savings system was very popular in Japan, because the extensive network of post offices all over the country addressed the needs of local communities, Mr. Yoshimura noted. The postal savings system was also very efficient; the salary levels of postal workers were much lower than those of staff in private financial institutions. Thus, private institutions would need to rationalize their operations in order to compete with the postal savings system. Those considerations and the very large presence of the postal savings system in the overall financial system would need to be addressed in the move to deregulate the financial market.

The issues related to the role of the government and the public sector in post-industrial Japan were clearly challenging, Mr. Yoshimura said. The government would need to carefully examine and review the operations of the public sector in the context of the administrative reform effort committed to by Prime Minister Hashimoto.

The new Bank of Japan Law stated that the Bank of Japan's policy must be consistent with the basic principles of the government's economic policy, Mr. Yoshimura stated. Thus, it would be important to develop more efficient communication between the Bank of Japan and the government in order to ensure coherent economic policy management.

The new Bank of Japan Law also stipulated that the Minister of Finance and the head of the Economic Planning Agency, or their representatives, could attend meetings of the Policy Board of the Bank of Japan, Mr. Yoshimura continued. They could also request a postponement of monetary actions in exceptional circumstances. However, those representatives would not be permitted to vote on monetary policy issues. The nine-member Policy Board would include the Governor of the Bank of Japan, the two Vice-Governors of the Bank of Japan, and six members—outside the Bank of Japan and the government—would be appointed by the government.

The new Bank of Japan Law would enhance the accountability of the Bank of Japan in its conduct of monetary policy, Mr. Yoshimura went on. Although the Japanese authorities clearly had a good track record in containing inflation, the real test for the Bank of Japan would come once the new law was enacted and it became solely accountable for the country's monetary policy performance.

According to data received by the Bank for International Settlements, the exposure of private financial institutions in Indonesia, Malaysia, the Philippines, and Thailand had risen from \$9 billion to \$16.1 billion from 1994–96, Mr. Yoshimura noted. According to the most recent estimates, based on a survey of Japanese banks, their exposure had increase by about 40 percent over the same period. The share of Japanese banks in the total exposure of all private financial institutions had declined by about 10 percent, from about 60 percent at end-1994 to less than 50 percent at end-1996.

Mr. Shaalan made the following statement:

The clear and concise report and the two sets of excellent background papers clearly point to the strengthened recovery in 1996 following several years of recessionary conditions. The recovery was broadly based and the economic climate improved with the use of supportive fiscal and monetary policies and a correction of the excessive appreciation of the yen through the spring of 1995. The financial performance of the corporate sector has also improved considerably, and substantial progress has been made in addressing the problems of the banking system. Notwithstanding these favorable developments and in addition to the delicate task of steering financial policies in the period ahead, decisive steps are needed to effect further deregulation in and outside the financial sector in order to sustain economic growth over the longer term. The report before us today, clearly identifies a number of challenges facing policy makers. I shall limit my remarks to the more immediate issues which I believe merit consideration.

Financial policies, both monetary and fiscal, will need to be coordinated closely in the first instance to support the still fragile economic recovery. Given the large slack in the economy, and the virtual absence of underlying inflationary pressures, there is merit to the view that monetary policy should remain unchanged until the recovery is firmly entrenched. However, it is important to note here that monetary policy should have as one of its main objectives the avoidance of sharp and abrupt increases in interest rates. This will require the vigilance of the newly independent central bank to raise interest rates in small incremental steps when needed. In our view this would be in the best interest of both Japan and the international community. The passage of legislation that formally establishes the independence of the Bank of Japan in setting monetary policy is welcome. However, as for establishing formal inflation targets, we note that the Bank of Japan has functioned well under the current system, and the monetary authorities have built substantial credibility. We therefore, like the authorities, do not regard setting monetary targets at this time a priority policy tool.

Undoubtedly, fiscal policy should aim at reversing the expansionary stance that was appropriate in the past year or two. In this regard we welcome the important steps taken in the 1997 budget. However, the timing and nature of additional measures, the degree of fiscal consolidation, and the time frame within which consolidation is to take place, are all difficult issues to contend with and for which there are no easy answers. In order to safeguard the prospects for continued recovery, it may be desirable to postpone further increases in consumption taxes and focus fiscal consolidation efforts primarily on reducing public investments whose waning effectiveness has been the subject of recent debate. Initiating reforms of civil service and privatization of public enterprises should also have a positive fiscal impact in the medium-term. Once the recovery is firmly in place, we would encourage further fiscal consolidation to limit undue pressure on interest rates as economic activity picks up further. This policy mix could particularly benefit the weaker banks in the system as further financial deregulation is introduced. I would therefore sympathize with the approach of a rolling medium-term framework in which policies are directed, for the time being, at progress in the short-and medium-term balances. At this point in time, it seems unnecessary to focus on the longer term targets. Taking actions geared to a 30-40 year framework does seem premature at this stage.

To develop a meaningful medium-term framework to guide policy formulation, it is important to have a better measure of the overall fiscal stance than is embodied in the current government budget and to take account of future fiscal liabilities. The timely background paper provides an excellent statement on the subject. With its less than complete coverage, the general government account provides only limited information on overall fiscal operations and on the path of future fiscal deficits. In addition, and apart from the issue of unfunded future liabilities associated with an aging population, there are large current unfunded liabilities stemming from deferred payment practices, government intervention in financial intermediation through postal savings, banking sector losses with potential budgetary costs, and provision of loan guarantees. A more comprehensive budgetary compilation would contribute to further transparency in fiscal operations.

Financial sector reform is a particularly sensitive issue where timing and sequencing are of critical importance. On the one hand, Japan has lagged behind other industrial countries in this area. Lingering weaknesses in some banks, notwithstanding the corrective steps taken in the past two years, render the system as a whole still vulnerable to shocks. This would suggest a need to implement speedy deregulation, in order to encourage innovation, improve the environment for effective competition and eliminate the risk of spillover effects from weaker banks. On the other hand, weak banks in the system may not weather the impact of deregulation if the "Big Bang" reforms were accelerated since bank profitability would be expected to decline. As the staff did not address this particular issue in the reports, I would appreciate some elaboration on the potential risks, particularly as they relate to the sequencing of actions arising from deregulation and strengthening of the banking sector.

On a related matter, I was struck by the contrasting assessment of the banking system as portrayed in the International Capital Markets report (EBS/97/128) that was recently circulated. Paragraph 159 of this report refers to "serious difficulties" in the banking sector and indicates that nonperforming loans remain at the same level as in 1993 and could be significantly higher if they were more fully reported. The staff report, however, states that "non-performing loans are on a downward track" and it is generally more favorable regarding the efforts to stem problems in the financial sector. I wonder if the staff could explain this difference in spirit between the two reports.

The strong commitment of the authorities to extend deregulation beyond the financial area is well-placed in order to maintain strong productivity growth to match rates those attained in the eighties. In this regard, we welcome the recent proposals in the areas of transportation, telecommunications and power generation, and look forward to their implementation and to similar steps in other areas such as land use, electricity distribution, rice distribution and wholesale and retail marketing in general. Similarly, increased flexibility in working hours and in the activities of job placement firms would facilitate a more efficient use of the labor force. Finally, while the trade liberalization of recent years is welcome, there is considerable room to remove existing barriers to market access and in particular, in agriculture. With these remarks, we wish the Japanese authorities every success in addressing the delicate issues that lie ahead.

Mr. Bernes made the following statement:

At this time last year, the Japanese economic recovery was far from firmly established. It is therefore heartening that, following the drawn-out recession of the early 1990s, the Japanese economy finally registered above potential growth in 1996, recording the largest real GDP expansion among the G-7 countries. I think the Japanese policy makers can look with satisfaction upon these results, which they helped to bring about through prudent policies. The growth momentum appears to have carried into 1997, although several forces are likely to produce slower growth in the short and medium term. The fiscal consolidation effort, which is necessary to avoid an explosive path for the debt-to-GDP ratio, as well as the yen's recent appreciation, if sustained, will undermine growth in the short run. Over the medium term, population aging is likely to reduce potential growth. As the staff notes, this latter consideration underscores the need for strengthened efforts at structural reform in Japan to raise productivity and offset the impact of demographic trends.

The staff has produced an illuminating set of papers, which contain policy prescriptions that I can broadly endorse. My comments are therefore aimed at accentuating some of the report's key messages as I see them, while pointing out some nuances where my view differs slightly from that of the staff.

I agree with the staff, and Messrs. Yoshimura and Ono, that economic prospects in Japan have improved over the past year, but would note that some major uncertainties could result in lower-than-expected growth in the short run. The sources of these uncertainties include the impact of fiscal restraint, the recent appreciation of the yen, and continuing problems in the financial sector. Indeed, it is unclear how sustainable the expansion in domestic demand is when one takes into account the important influence temporary factors have had. Moreover, the extent of the adverse impact that ongoing fiscal consolidation will have is not known with certainty. External demand has been an important contributor to growth, but the recent renewed appreciation of the yen, especially against the currencies of major Asian trading partners, could encourage large corporations to continue their downsizing efforts and force them to further shift production overseas. The ongoing problems in the financial sector also pose a risk to the strength of the recovery as further banking problems will limit the sector's capacity to support economic growth.

In light of these uncertainties, and the sizable estimated excess supply gap, I would agree with the staff that an increase in policy-related interest rates is not called for at this juncture, as continued record low interest rates remain supportive of the domestic economy, particularly private investment, and the still fragile financial sector. Although I concur with the staff's view that interest rates at current levels are not sustainable over the medium term, I would caution against a premature tightening of monetary policy. Indeed, expectations of continued excess supply conditions and ongoing fiscal consolidation suggest that the stance of monetary policy may need to remain accommodative well into 1998. Moreover, the authorities should also take into account that monetary conditions have already tightened as a result of the appreciation of the exchange rate in recent months. The staff's inclusion in the baseline projection of a modest increase in interest rates toward the end of 1997 therefore appears to me a little overly cautious. The slower growth that is expected in the second half of this year implies that an excess supply gap, and thus subdued inflation, is likely to persist in the foreseeable future.

An expansionary fiscal stance, supported by easier monetary conditions, has been an important factor in strengthening the economic recovery. However, successive fiscal packages aimed at providing economic stimulus, along with weak economic activity, resulted in a deterioration of the general government budget position from approximate balance at the beginning of the 1990s to a deficit of about 7 percent of GDP in FY 1996 (excluding the social security surplus), with gross debt approaching 100 percent of GDP. It is therefore appropriate for the government to withdraw fiscal stimulus over the short and medium term in order to prevent public indebtedness from rising continuously. In view of this requirement, the government's recent announcement regarding FY 1998 is encouraging. In particular, the proposal to eliminate the system of across-the-board increases (or decreases) of funds for programs based on previous allocations to one where apportionment is based on the merit of the individual program is critical in rationalizing overall government expenditure.

It is, of course, difficult to decide on the appropriate pace of fiscal consolidation. The challenge for the authorities will be to balance the need for a front-loaded approach with the need to ensure a strong sustainable pace of economic expansion. In striking the appropriate balance, and while I recognize that significant fiscal consolidation is needed, I would nevertheless underscore the potential downside risks associated with an excessively rapid tightening at this point in the cycle. While I agree with the staff that the government's medium-term fiscal target is not very ambitious, I would be more reluctant to put in place a more ambitious medium-term target. Rather, I would underline the importance of using ambitious but realistic short-term targets in the conduct of fiscal policy, as the use of medium-term targets, however ambitious, could lead to a postponement of austere fiscal measures. In this regard, I would point out that the experience of my Canadian authorities with short-term fiscal targets has been a very positive one. Naturally, the use of such targets would not obviate the need for increased transparency of government operations and fiscal accounts in Japan, as called for by the staff.

As I noted above, monetary conditions should remain easy for the time being to support the recovery, particularly as underlying inflationary pressures remain negligible. With regard to the framework for monetary policy, I welcome the decision to formally establish the independence of the Bank of

Japan in setting monetary policy. However, I am disappointed with the Bank of Japan's rejection of inflation targeting, an approach that has served my Canadian authorities, and those of other countries, well. Like the staff, I believe that the Bank of Japan should adopt inflation targets as a means of further reinforcing the Bank of Japan's independence, providing a clearer framework for setting policy, and improving the effectiveness with which the ultimate objective of monetary policy is communicated to the public. I believe that important benefits can be derived from inflation targets even for central banks, such as the Bank of Japan, that do not lack anti-inflation credibility. As well, the authorities stress that price stability is the appropriate objective of policy, but I would submit that failing to define what price stability means can obscure communication with the public and thus complicate monetary policy implementation.

A healthy and competitive financial sector is crucial in sustaining the momentum of the current expansion. While Japan's larger banks have made notable progress in reducing their nonperforming loans, the financial health of several smaller bank and nonbank financial institutions remains more uncertain. It is therefore encouraging that the Japanese authorities have made some progress in deregulating and strengthening the financial sector. Last November, the government tabled its financial deregulation plan. Since that time, major financial sector reform bills have passed, including the reform of the Foreign Exchange Control Act, the revision of the Bank of Japan Act, and the establishment of a separate Financial Institution Supervisory Agency to take over supervision of banks and securities companies from the Finance Ministry. I would expect that as the financial market reform plan is implemented, weaker financial institutions could and should be permitted to fail as competition intensifies. I would underscore that financial failures in the short term should not cause the authorities to slow the implementation of their reform plan. Indeed, the plan should be implemented in as front-loaded a manner as feasible.

I strongly encourage the authorities to complement ongoing financial deregulation with further improvements in banking regulation and supervision. Such improvements should also include strengthened disclosure requirements across all financial institutions as enhanced transparency will minimize uncertainty as to the true financial position of institutions. This point is highlighted by the divergence between official and private sector estimates of problem loans (as detailed in Table 3 of the main report).

I agree with the staff's assessment that the recent appreciation of the yen is a reflection of market sentiment and changing perceptions of the Japanese economy's growth prospects, and that current levels of the exchange rate appear to be better in line with fundamentals. With regard to movements in the external current account balance, I am in complete agreement with the staff that such movements reflect saving-investment balances, and that policies should not target a specific level of the external balance. The staff's analysis suggests that economic forces point to an appreciation of the yen in the medium term, which, in addition to demographic factors, should result in a narrowing of the current account surplus over time.

Mr. Kaeser made the following statement:

After several years of stagnation, the recovery of the Japanese economy has gained momentum. Supported by public investment, and also private final demand, real GDP growth accelerated to 3.5 percent in 1996. The outlook for 1997 is rather positive, as confirmed by data for the first half of the year. However, the recovery remains fragile and subject to sizable downside risks. The impact of the increase in the consumption tax on private consumption is still uncertain. Weak business confidence of domestic-oriented companies may restrain private investment. Uncertainties also exist with respect to the evolution of the exchange rate and foreign demand.

Low interest rates have certainly contributed to the pick-up of growth last year. In light of the remaining slack in the economy, the expected effect of fiscal consolidation, and the absence of inflationary pressures, we agree with the staff that the time has not yet come for monetary tightening. However, the current interest rates cannot be maintained in the medium term without threatening price stability. If the recovery proceeds as projected, authorities must stand ready to tighten in before inflationary pressures materialize.

We much welcome the revision of the Bank of Japan Law which gives the Bank of Japan formal independence in conducting monetary policy. As to the framework of monetary policy, we were somewhat surprised to read that the staff favors an approach of inflation targeting for Japan. In a very interesting chapter in the selected issues paper, the staff shows that the information content of financial variables in Japan is relatively limited and unstable. We are not sure if, under these circumstances, the setting of an inflation target is appropriate. We agree with the Japanese authorities that the benefits of inflation targeting are more relevant for countries with a weak anti-inflation credibility. The Bank of Japan does obviously not have a credibility problem. The staff also states that an inflation floor could provide a buffer against the emergence of deflationary pressures. We would appreciate it if the staff could elaborate on this point and give us some empirical evidence for the effectiveness of inflation targeting in fighting deflationary pressures.

The deterioration of Japan's public finances following the adoption of several stimulus packages has already been discussed last year. The same applies to the medium-term challenge for fiscal policy posed by demographic pressures. Both problems call for the implementation of an ambitious fiscal consolidation strategy. In this respect, the 1997 budget goes into the right direction. Bolder consolidation measures are needed in the medium-term, though. The current plan of the authorities does not prevent the ratio of government debt to GDP from increasing. We therefore agree with the staff that measures averaging 1 percent of GDP per year over the next four years would be needed. We are aware, however, that the removal of such a large amount of fiscal stimulus entails certain risks for the recovery in an economy where the prospects for a substantial improvement of investment and growth through fiscal consolidation (non-Keynesian effects) seem to be small.

The staff's simulations in the annex to the report confirm once again that the credibility of fiscal consolidation is an important factor for the effect of fiscal tightening on economic growth. Increasing transparency is one measure that can improve the credibility of consolidation. This is particularly true for Japan, where much of the fiscal problems are not yet visible. Thus, the complexity of Japan's fiscal accounts should be reduced and unfunded liabilities should be identified.

In the report and in the Economic Policy and Development paper, the staff devotes particular attention to the state of the Japanese financial sector. The general picture that emerges from these papers is cautiously positive. According to the staff, the worst of the banking crisis following the burst of the asset price bubble is now over. However, while the Japanese banks have generally improved their balance sheets through the use of their operational profits, the inadequacies of the criteria for disclosure of problem loans and the remaining weaknesses of some major banks whose failure might have a systemic impact give rise to a somewhat more pessimistic assessment. The Japanese banking system is not yet sufficiently solid to absorb another economic shock and its response to the planned liberalization of the financial sector is hard to predict.

That the Japanese financial sector urgently needs comprehensive reform cannot be doubted. We therefore welcome the government's intention to deregulate the country's financial markets in a "Big Bang" by the year 2001. This ambitious reform project has already gained the confidence of private investors, as reflected by the deal announced last week between the Swiss Bank Corporation and the Long-Term Credit Bank of Japan. The general direction of the government's reform project, aimed at removing restrictions and increasing competition between financial companies, seems to be adequate. These reforms will contribute to the consolidation of the financial industry. However, it will take time until they will change the particularities of the Japanese financial sector, such as the practice of major banks to bail out their clients. We agree with the staff that these reforms should be implemented aggressively and comprehensively and that they should be accompanied by a scale-back of government financial intermediation. In this respect, we concur with the staff that reforms of the Postal Savings system (Yucho) are needed, but we would like to stress that the large and increasing deposit-taking role of the Yucho is more the symptom of the banking sector's weaknesses rather than one of its causes.

One point that is missing in the staff's analysis of the financial sector reforms is its potential impact on the real economy. While the reforms will increase the efficiency of resource allocation in the medium term, there will be substantial transitional costs. Specifically, it will be more difficult for weak companies to obtain credit. The staff may want to comment on this point.

Mr. Daïri made the following statement:

Following four years of economic slowdown, Japan's growth performance in 1996 was the highest among the G-7 countries. The long-awaited recovery resulted from well designed demand supporting measures as well as structural reforms in key areas. We commend the authorities for their skillful macroeconomic management and strong commitment to structural and fiscal reforms that have improved confidence in the durability of the recovery.

We agree with the staff that the current easing of monetary policy should be maintained, and that the major policy challenge facing the authorities is the unwinding of the fiscal stimulus introduced during the economic downturn. We welcome the fiscal consolidation measures implemented in the 1997 budget. While the revenue measures compensate for the losses incurred during the first phase of the 1994 tax reform plan, we wonder whether a more expenditure-based fiscal retrenchment could not have been implemented. We agree with the authorities that public and political support is paramount to the success of consolidation; however, expenditure restraint may be more acceptable than tax increases and may help to dissipate concerns about inefficiencies and low social rates of return to public investment projects. We are pleased to learn from the excellent statement of Mr. Yoshimura and Mr. Ono that the authorities are taking the necessary steps to rationalize expenditure and improve its effectiveness and prioritization.

The medium-term consolidation strategy recently announced by the authorities is a step in the right direction. In view of the sharp increase in debt to GDP ratio since the early 1990s and the prospect of continued high increase under the authorities medium-term plan, the staff's call for stronger fiscal consolidation deserves careful consideration. This is all the more important in view of the rising pressures from future population aging. Further action is also needed to bring the pension system to long term sustainability.

The revised Bank of Japan Law strengthens the independence of the central bank and would further enhance the already strong credibility of monetary policy. In view of Japan's track record in maintaining virtual price stability, I agree with Mr. Yoshimura and Mr. Ono that inflation targeting in the case of Japan may not be appropriate.

Recent developments in the exchange rate of the yen reflect a closer coordination among G-7 countries. The narrowing of the trade and current account surpluses is consistent with improved trade relations with its major partners. Excluding investment income, the balance in goods and non factor services declined to 0.5 percent of GDP in 1996 from 2.2 percent in 1992. Could the staff comment on the distribution of investment income between interest and return on equity? While we agree that policies should not target a specific level of the external balance, we should keep in mind that one of the major purposes of the Fund is to shorten the duration and lessen the degree of disequilibrium in the international balance of payments of members. Some clarification of the staff view is welcome.

The measures taken by the authorities to address the weaknesses in the financial sector following the economic bubble are bold and timely and have contributed to the revival of confidence. We welcome the increased transparency and the dramatic strengthening of loan loss provisioning. We join the staff in recommending the adoption of a comprehensive plan to deal with future problems, including a detailed assessment of banks' financial position, and bold contingency measures that do not give rise to moral hazard. Use of public funds should be limited to the minimum and restricted to cases where the integrity of the whole financial system is at stake. The efforts made by private banks to address their nonperforming loan problems and achieve higher efficiency as indicated by Mr. Yoshimura and Mr. Ono are encouraging. Greater disclosure is also warranted for nonbank financial institutions to provide incentives for sound management.

We welcome the "Big Bang" financial sector reform program. While we support the main objectives of the program, we encourage the authorities to move with caution in its implementation in order to ensure sustainability of the reform and avoid backsliding. Transparency, competition, innovation, risk management, enhanced reliance on market mechanisms, and strong supervision are key to the success of the reform.

The progress achieved following deregulation of telecommunications and retail trade should strengthen the authorities determination to move ahead in other key areas. Japan's commitment to multilateralism and greater openness is encouraging. Improved access in the agricultural sector would be facilitated if matched by similar opening in other major markets.

We are disappointed by the further decline in ODA in Japan, a country that has traditionally played a leading role in assisting developing countries. We do not share the staff view that the decline in ODA is unavoidable, and that foreign aid is an obvious target for cuts in an environment of fiscal austerity. First, as recognized by the staff, savings in this area are too small to make a significant contribution to fiscal consolidation while having a detrimental effect on recipient countries not only directly but also indirectly as a result of contagious effects on other donors. Second, while foreign aid may constitute a drain on domestic resources, it does not affect domestic demand the way other expenditures do. While we agree with the staff recommendation to improve the quality of aid, the Japanese authorities are encouraged to reverse the declining trend of ODA toward achieving the UN goal of 0.7 percent of GNP.

Mr. Palei, speaking on behalf of Mr. Mozhin, made the following statement:

We welcome evident positive developments in the Japanese economy over the past year. It is very important in the context of international economic situation that one of the world's largest economies has resumed growth at a healthy pace. It is especially important in the regional context, given recent turbulent developments in the economies of some East Asian countries. Economic recovery in Japan may well provide a firm anchor for the regional stabilization. At the same time, we are broadly in agreement with the staff's conclusion that significant policy challenges still face Japan and more efforts are needed to back up the recovery and establish reliable foundations for a sustained economic growth. Below we will address four major issues.

With regard to the fiscal stance, the price paid for the rebound of economic activity was high—in 1996 the general government deficit (excluding the social security surplus) deteriorated to more than 7 percent of GDP, gross debt and estimated unfunded public pension liabilities stand now at about 100 percent of GDP. Measures envisaged by the Japanese authorities in FY 1997–98 budgets to restore fiscal health are highly commendable, especially now when there are signs that the recovery path is becoming self-sustaining. However, we agree with the staff's proposal to aim at more advanced medium-term consolidation, which takes into account the forthcoming demographic pressures. Of course, suggested consolidation measures (averaging 1 percent of GDP per year up to 2001) require rather tight fiscal adjustment, but they seem to be appropriate in the face of advancing challenges from future population aging.

We share the common view of the authorities and the staff that the current accommodative stance of monetary policy in Japan is appropriate for entrenching of the recovery. However, it is necessary to avoid the risk of delaying needed adjustments, since short-term interest rates are now obviously well below their long-run levels. As the Japanese authorities are well aware of this dilemma, we believe that they will succeed in striking a right balance between the need to provide further support to the economy and to reverse the very easy stance of monetary policy.

We were not quite convinced by the staff's arguments that setting medium-term inflation targets by the Bank of Japan would considerably reinforce the benefits of formal Bank of Japan independence, coming into effect on April 1, 1998. Given Japan's exceptionally good record with regard to inflation, and a high Bank of Japan credibility in preserving stable prices, the staff's proposal to establish an explicit target for measured inflation of "somewhat above zero" seems "somewhat" peculiar. At the same time, we agree with the staff that setting an operational target for the overnight call rate may be useful to communicate the short-term policy stance to markets, and this suggestion could well be considered by a new Policy Board of the Bank of Japan after it is established.

We welcome considerable progress achieved in resolving the problems of the financial sector, including the implemented plans to liquidate the insolvent *jusen*, reduction of the amount of nonperforming loans, and increasing the viability of banks. However, the financial sector still remains one of the problem areas and consolidation of weak financial institutions will certainly take some time and require considerable further efforts of the authorities. The announced "Big Bang" reforms aimed at comprehensive liberalization of Japan's financial markets look encouraging. We would like to join the staff in its recommendation that the financial deregulation plan need to be implemented aggressively and comprehensively.

We strongly support the stuff's view that the Japanese current account surplus should not be targeted at a specific level. Also we think that the authorities are right in their perception of the current account surplus as not posing any significant problems for global macroeconomic management.

Notwithstanding the reduction of this surplus from 3.1 percent of GDP in 1992 to only 1.4 percent in 1996, even a more pronounced drop in the balance on goods and nonfactor services was observed, with a decrease of nearly 80 percent over the same period. Under such circumstances, a rise of the surplus to a level of 2 percent of GDP in 1997–98 (projected by the staff, but contested by the Japanese authorities) does not seem to be a problem, as this reflects not only trade expansion, but also a rise in Japan's net foreign asset position. Moreover, as the yen is expected by the staff to appreciate over the medium term in line with past trends, the current account surplus is likely to have a downward tendency. To the extent that surplus debates reflect the existence of trade barriers, the latter should be discussed explicitly within the World Trade Organization (WTO) framework, and we welcome an increased use of this dispute settlement mechanism by the Japanese authorities.

Mr. Mori made the following statement:

We wish to thank the staff for the quality and information content of the papers on Japan. The analytical studies presented in the selected issues are interesting and necessary to explore in more depth complex issues such as the instruments of monetary policy and determinants of the yen exchange rate.

Improvements in Japanese economic performance are significant and welcome, particularly given her importance in the world economy. In 1996, real GDP grew 3 ½ percent, and the consumer price index inflation remained near zero. The prospects for continued economic recovery seem to be favorable despite fiscal consolidation. Among the factors contributing to the recovery are (i) the stimulative effects of low interest rates and expansionary fiscal policies; (ii) a rise in confidence since the Kobe earthquake and terrorist attacks in 1995; (iii) progress in completing capital stock and balance sheet adjustments; and (iv) a rise in net external demand. In the short term, there remains the challenge of reversing in a timely fashion the monetary and fiscal stimuli without hampering the economic recovery process. Moreover, an aging population calls for further deregulation and structural reforms, as well as measures in the fiscal area, to ensure robust long-term growth.

On monetary policy, a difficult question for the Bank of Japan is to determine the appropriate timing and pace of increase in the short-tem interest rates. We agree with the staff's view that the current monetary policy stance should be maintained until it is clear that the economy has weathered the initial effects of fiscal tightening and is firmly on a self-sustaining recovery path. One should also consider the recent developments in important trading partners of Japan in Asia, where financial market turbulence may hamper the economic performance of these countries. As exports have been an important component of the economic recovery in Japan, a slower growth in the region could also affect the process of recovery. Another aspect is that given their close trade relationship and the so-called "reverse imports" a steady recovery in Japan and the resulting increase in her imports will contribute to improve the trade performance of emerging countries in Southeast Asia and, therefore, to offset in part any adverse impact of financial turbulence on these countries' growth.

In this context, the economic developments have to be carefully monitored by the Bank of Japan in view of domestic and external repercussions.

The authorities have made important progresses in addressing fiscal imbalance, banking sector difficulties, and structural reforms. In 1997, the general government deficit, excluding social security, is projected to fall to 4.9 percent of GDP from 6.9 percent of GDP in 1996, as the economic recovery allowed the necessary unwinding of some fiscal stimulus and a rise in the consumption tax. In the banking sector, plans were implemented to liquidate the insolvent jusen, and financial laws were enacted to strengthen regulators' discretionary powers. Concerning structural reform, deregulation measures were approved in the area of transportation and electricity generation, as well as further deregulation in telecommunications. In addition, we welcome the progress also made with regard to the liberalization of Japan's financial markets, as well as the revision of the Bank of Japan law.

However, demographic changes and slower potential output growth point to the need for the authorities to persevere in their structural reforms and fiscal consolidation. The current impetus for reforms should be strengthened as significant economic gains from deregulation remain to be exploited in certain sectors such as distribution, the labor market and land use with the objective of reducing the impact of future declines in the working-age population. The issue of population aging also underscores the need to strengthen further the fiscal management over the medium-term in view of large unfunded liabilities for the pension system. In this respect, schemes that unduly undermine work incentives have to be avoided.

We commend the Japanese authorities for their continued contribution to ODA. In this respect, we are in agreement that it is important to improve the quality of aid, and budget constraint should be considered. However, we share the staff's view that ODA spending is too small to make a meaningful difference to Japan's overall fiscal situation, but may have a significant impact on the welfare of individual recipient countries.

Mr. Andersen made the following statement:

We agree with the broad thrust of the staff's appraisal. The rebound in economic activity in Japan is most welcome and, while economic prospects generally are favorable, there are some important uncertainties, as noted by Mr. Bernes, that would need proper attention in the period ahead to ensure that the upswing is being sustained. The mixed signals from business sentiment in the corporate sector reflected in the Bank of Japan's latest Tankan survey underline the uncertainty of the recovery's strength. Moreover, several areas are still suffering from structural impediments to growth and it is important that authorities are not complacent at this stage, but give high priority to structural policies.

We welcome that the central government balance improved last year and is projected to continue to do so through the end of the century. Government debt measured as a percentage of GDP, however, develops further along the worrisome path it embarked upon in the beginning of the nineties. The central government budget will be burdened to an increasing extent by the subsidies paid to the basic pension scheme and to the health insurance plan. Furthermore, the staff reminds us that the demographic pressures in Japan are very severe, with a significantly rising ratio of elderly to the working age population and, in addition, a falling working age population in itself. In addition, social welfare costs in general will rise considerably. To our minds, such trends underline the need for more ambitious fiscal consolidation than presently aimed at and, as seen in other countries, one should be careful in assuming that fiscal consolidation necessarily leads to a slowing of growth, even in the short term. If the measures are perceived credible and seen as part of a medium term consolidation plan, they can easily result in a much improved confident int eh private sector and in markets with potentially beneficial effects for the strength and durability of the upswing. The simulations done by the staff seem to support this argument. Also, with this in mind, the staff's view that the government should undertake measures averaging 1 percent of GDP per year over the next four years seems fully justified. A more transparent fiscal system is also rightly called for by the staff. An accountable and transparent fiscal system is important in itself as well as for enhancing the credibility.

We would like to emphasize the possible danger of resorting to further stimulus measures in case the economy would appear to be slipping back into recession. The staff is right in stressing that such measures would clearly risk undermining the credibility of the consolidation efforts.

Monetary conditions have been very easy since the end of 1995 when the discount rate was cut to its present record low level. As yet, the financial markets have not seemed too concerned about the implications of this loose stance, something that is reflected in low and relatively stable long term yields during 1997. We tend to concur with the authorities that no immediate change in policy seems necessary at this stage. Nevertheless, vigilance in monetary policy in this early phase of the recovery is of course of utmost importance. We, therefore, share the view that the authorities should return to a more neutral stance in monetary policy as soon as it is clear that the recovery has become firmly entrenched.

The institutional set up for monetary policy is an important and often debated issue, not only in Japan. Academic literature provides underpinning to the view that an independent central bank held accountable for a clear monetary objective in general has a better track record in achieving long run price stability, but we sympathize with the Bank of Japan in that their good track record reduces the need for introducing explicit inflation targets. We warmly welcome the legislation passed in June, aiming at improving the transparency and independence of the Bank of Japan.

We note with satisfaction the steps taken by authorities during 1996 to address the strains in the financial sector. Further measures should include a reevaluation of the true capital position of the major banks based on a realistic, independent valuation of their unrecoverable losses. It is somewhat unsatisfactory that official estimates of problem loan stocks still differ considerably from private sector estimates. Experience shows that such a valuation should be undertaken at a much earlier stage in order to facilitate possible winding downs and mergers. In order to strengthen capacity to handle possible future problems, the mentioned measures should be accompanied by the adoption of more transparent accounting standards and more efficient financial supervision. The latter will hopefully materialize as the new independent financial supervision agency starts operating in mid-1998. Moreover, we also welcome the authorities' intentions to comprehensively liberalize Japan's financial markets. Financial market deregulation has been advocated by a large part of the international community for some time, and we concur with the staff that it is now important to establish a concrete timetable for the implementation of the measures. At the same time, we believe that a reform of the financial sector should not be conducted as a mere deregulation process. Rather, it should be undertaken with the view of creating an internationally competitive market and making it attractive to all participants.

Beyond the financial area, further deregulation and structural reforms are also needed in the trade area. In this context, we share the staff's view that far-reaching actions are needed to remove remaining barriers to market access and thereby take advantage of the benefits of free multilateral trade. This seems particularly important in the field of agriculture. Another important area for the authorities' reform agenda is of course the labor market. Recent findings suggest that Japan's labor market will become more diversified with a smaller proportion of long-term employees and a larger share of part-time and temporary workers. It will, therefore, become increasingly important to provide proper training and education in order to facilitate mobility between different sectors of the economy. In addition, it will be important to increase labor force participation by older workers to reduce the burden on the public pension system and to increase flexibility in working hours.

The staff mentions several other fields (such as electricity, transportation and land use) which are necessary candidates for deregulation and reform. We fully share their view that it is important for Japan to reap the economic benefits associated with deregulation in these areas to reduce the impact of future declines in the working age population.

While Japan remains one of the world's largest donors of ODA in nominal terms, we regret that the assistance as a percentage of GDP has been and will be further reduced, away from the UN target of 0.7 percent. We concur with the staff that everything possible should be done to raise the quality of ODA spending.

Ms. Lissakers made the following statement:

The staff has prepared an interesting and readable set of papers for Japan's Article IV consultation. They are to be commended for their prolific work.

Japan's post-war performance has been remarkable because of the outstanding attributes of its society, including a disciplined and educated labor force, sound macroeconomic policies and an enviable savings performance. But this decade, Japan's economy has been mired in low growth and its fiscal situation has deteriorated sharply. During this period, heightened recognition of the forces of globalization and the foundations of sound market economies have led to greater appreciation of the challenges facing Japan. These challenges are formidable. The first relates to achieving a sustained recovery against a background of fiscal consolidation. The second is to achieve a macroeconomic policy mix that supports domestic demand-led growth. The third is to correct structural weaknesses in the Japanese economy that have led to a decline in potential output, as highlighted in Box 1 of the staff paper.

Growth was strong last year, but will apparently be less robust in 1997. Views on 1997 growth have been converging—the staff marked down last autumn's World Economic Outlook projection from the 2¾ percent range to 2.3 percent currently, while more conservative forecasters have raised their estimates from around 1¼ percent to the range of 1¾ to 2 percent.

Nonetheless, there is a difference in the tenor of the forecasts. The staff's projections paint a picture of optimism about cyclical forces that are becoming self-sustaining. This view may prove correct. But the weakness in Japan's index of leading indicators suggests the staff's optimism may be premature. It is still difficult to assess the underlying state of the economy in the wake of various fiscal measures, including the hike in the consumption tax. The contraction in the general government deficit foreseen by the staff for FY 1997 is large in its own right. We estimate that both this figure and the ensuing impact on aggregate demand could be slightly higher than the staff envisages. (We would like to thank the staff for producing the table on page 22, which usefully advanced our understanding of the staff's thinking in this area.) Further the trend in nonwage income this year, especially proprietary and asset income, may weigh on personal income growth, despite the firming of employment growth and bonuses.

Japan obviously must consolidate its finances over the medium term given their recent deterioration and demographic trends. But in the short term, fiscal consolidation should neither be so front-loaded nor so rapid as to weaken the prospects for, or inhibit, an autonomous recovery. Regarding the outyears, while we would agree with the staff that a credible fiscal effort will have fewer costs than an ad hoc one, the staff may be too sanguine in its supposition that credibility and confidence effects will mitigate fiscal drag.

A final point on fiscal policy, we would again reiterate that the general government deficit, including social security, is the most relevant measure for assessing economic policies and performance and we are again struck that the staff uses the deficit excluding social security only for Japan among the major countries. Perhaps the staff could explain this seeming divergence in the measurement of fiscal balances across the major countries.

The path of domestic demand will have important implications for Japan's external balances. In recent months, Japan's external surpluses have risen strongly. At the time of last autumn's World Economic Outlook, the staff projected a $70 billion current account surplus for Japan, some 1.4 percent of GDP. Now it is projecting an $89 billion surplus, 2.0 percent of GDP. For 1998, the staff projects a $93 billion surplus, little changed in terms of GDP. But the momentum of growth in the current account may continue. The staff believes that structural changes will moderate growth in Japan's external surpluses. This may be true over time, but the staff does not provide compelling evidence in our view that these changes will prevent the current account surplus from rising next year. Also, the small increase in the staff's projected current account surplus for 1998 seems inconsistent with export volume growth of 8 percent. Our analysis suggests that the contribution of net exports to Japan's growth next year will be larger than the staff indicates.

The staff's view that the current account surplus should be seen as a desirable redistribution of global demand pressures that moderates cyclical asymmetries is an interesting economic argument. However, the argument suggests the international community should be indifferent as to whether the second largest economy in the world is growing on the basis of export-led or domestic demand-led growth. As Secretary of Treasury Rubin said recently, "Current account balances will naturally rise and fall, but it is critical that Japan's current account surplus not rise again to a level that harms global growth, that causes trade fictions with Japan's trading partners, and that could fuel protectionist sentiments in other parts of the world."

On monetary policy, we believe that the Bank of Japan has made a cogent case that it would be premature to consider any tightening at this time as recovery is not yet firmly entrenched. Also, given the large output gaps, the continued uncertainties regarding the growth outlook, the modest growth in broad monetary aggregates, underlying inflation near zero, and persisting strains in the financial sector and the balance sheets of small firms, we see little risk to the economy from maintenance of the accommodative posture. In this regard, could the staff clarify for us its 1998 inflation forecast—if this year's rise in inflation is largely attributable to the one-off effect of the consumption tax hike, which is not replicated next year, why should 1998 inflation be on the order of 1997's projected outcome? Also, to what extent is Japan's inflation overstated by measurement bias?

We welcome the efforts to strengthen the Bank of Japan's independence and we read with great interest the discussion of current thinking on this issue. While this discussion highlights that the ministry of finance "explicit" control over the Bank of Japan will be significantly reduced, we are uncertain as to how the ministry of finance's continuing rights and responsibilities with respect to the Bank of Japan will be exercised. Undoubtedly, this relationship will evolve over time. However, perhaps the staff or Mr. Yoshimura could tell us whether the ministry of finance intends to follow a "hands off" approach. Also, we have some sympathy for Japan's views on inflation targeting.

The staff again highlights the need for deep-seated structural reform and deregulation and also underscores a new area for structural reform—enhancing the transparency and organization of fiscal policy. The budget's complexity and lack of consolidation make it very hard to understand and assess. In particular, the operations of the Fiscal Investment and Loan Program have long struck us as opaque and as helping to preserve the position of the Japanese Postal Savings System. The Postal Savings System should be reformed both to strengthen the banking system and to lessen recourse to directed lending, which seems unnecessary in a society as advanced as Japan. Off-budget operations are a major source of vulnerability as reflected in the debts of the Japanese National Railways. In the United States, under "credit reform" policies, the risks of guarantees are included on budget. Is Japan considering adopting similar policies?

Strengthening the banking system is another structural priority. Last year's financial stabilization legislation included important measures and there have been other positive developments. The process of stronger banks absorbing weaker institutions has begun, although Japan, like the United States, remains "over-banked" and more consolidation is in order. Banks have been forced to recognize more losses and provision against impaired assets. The real estate market is finally beginning to clear. Low interest rates and reviving credit demand provide scope for stronger banks to grow out of their problems. One cautionary note: the easy monetary stance is consistent with Japan's economic situation. However, it has led to heavy intermediation by Japanese banks of yen loans to foreign borrowers and to a build-up in exposure in emerging markets in particular, including the recently volatile Southeast Asian market. Does the staff see any risk to Japanese banks in this exposure?

The low-interest rate environment may also have adverse implications for life insurance companies, whose financial condition is difficult to assess. We welcome the liberalization on restrictions on the operations of these firms, but could the staff offer its assessment of the strength of the life insurance sector? Was the failure of Nissan Mutual Life a one-off development or did it underscore the risk of further failures?

More generally, we endorse the staff's recommendations regarding the need to strengthen accounting and disclosure standards in the financial sector, the transparency of balance sheets, and supervision and regulation, as well as more generally to intensify efforts to establish a rules-based and arms-length credit culture. In this connection, we welcome the creation of the Supervisory Agency for Financial Entities as an indication of Japan's desire to accelerate efforts in this area. We hope this new agency will be strong, independent and able to operate freely from principal-agent problems. Also, we would again underscore our support for the "Big Bang" reform proposals. The passage of the Foreign Exchange Law is a good start. It will be important to build on this progress by implementing the other necessary legislation and regulations as rapidly as possible and in a liberal fashion and multilateral context.

More rapid and fundamental deregulation of the economy generally is another key aspect of the structural agenda and of the effort to address Japan's future demographic trends. In this area, some important efforts are now under way. While the estimates of the benefits of deregulation cited by the staff are imprecise and cover a wide range, in all cases the potential gains are significant. The useful OECD study that is referenced suggests Japan—which could raise potential GDP through deregulation by 6.4 percent of GDP—has farther to go than many of its major industrial country partners (especially the United States which could gain 0.9 percent). This kind of conclusion is also suggested by the staff's work in the U.S. Article IV on total factor productivity performance in the G-7, as well as by Japan's balance of payments data which show that foreign direct investment in Japan is extraordinarily small (only $230 million in 1996).

In short, we welcome Japan's stepped up efforts in this area and we fully share the staff's recommendations, especially the view that it would be regrettable should the momentum of deregulation slow in the years ahead. Japan's trading and investment partners would clearly benefit from a more open and deregulated Japanese economy; recent analyses make clear that Japan's incomplete integration in the global economy has large and growing costs for Japan itself as well.

Mr. Kwon made the following statement:

Let me firstly extend my compliments to the Japanese authorities for the positive signs of coming out a recession and back on the road to a robust recovery. The real GDP growth rate of 3.5 percent recorded in 1996 is in fact the highest among the G-7 countries.

I will focus my intervention and questions to the staff on a few specific points, namely in relation to monetary policy, in particular short-term interest rates, and to the financial sector reforms.

The staff notes that short-term interest rates are extremely low (para. 3, p. 4) and that the challenge is for the authorities to address the timing of the return to a more neutral stance while not jeopardizing the positive signs of recovery. While I agree it is important to select the right timing, I also think it is essential to do this at the correct pace. The current scenario of very low interest rates have had both a positive and a negative effect: On the one hand, the low rate has helped stimulate or boost investment but on the other hand, it has had its own costs, such as capital outflows on account of the excessively low short-term interest rates. Investors have been channeling Japanese funds in say, the U.S. market where the returns potential are higher than in Japan, thus taking advantage of the interest rate differentials.

Can the staff indicate how much this capital outflow represents in terms of size? Would a narrowing of the interest rate differential be warranted? But more importantly, given that both the first and second quarter published economic figures look quite promising, I would like to know whether, in these circumstances, the staff feel it would now be an appropriate time for the authorities to adjust the short-term interest rates?

I concur with the view expressed by the staff in paragraph 44 that policies should not target a specific level of external balance as the current account surplus was the outcome of other macroeconomic forces. But when the staff states in para 42 that in the medium term economic forces pointed to a yen appreciation, I think we have to recognize it is also related to short-term capital movements which are influenced by interest rate differentials.

Like Ms. Lissakers and Mr. Sobel, I welcome the efforts to strengthen the independence of the Bank of Japan with regards to its setting of monetary policy. However, I understand that a new Banking Supervisory Board or Committee is supposed to be set up under the portfolio of the Prime Minister's Office to oversee only the banking sector in Japan.

In recent times, we have seen a number of different approaches being adopted as countries make adjustments to their respective frameworks for conducting monetary policy. The United Kingdom recently revised its framework and opted to set up a special committee that consolidates all financial sector supervision under one roof, while retaining the operational independence of the Bank of England. Australia's Wallis Report seems to be recommending a similar approach and in Korea, legislation is expected to be passed next month (August) broadly along the same lines as that of the U.K. and the Australian report.

I would be interested to hear the staff's comments on the merits or otherwise of these two broadly differing approaches? What does the staff feel about the suggestion of perhaps having a seminar at some future date to discuss these different, emerging systems? I think there are important lessons for Fund member countries to draw from a wider understanding of these various systems.

Furthermore, I would like to know what is the impact of these developments on the general deregulation efforts with regards to other ministries in Japan?

Still under financial sector reforms, let me make a brief reference to the Postal Services scheme. I understand that the market share of government financial institutions is roughly one third of all intermediation. Among the government financial institutions, the Postal Savings system takes a major part, and the funds raised through this system is used for various purposes by the government. The system is a well-known bottleneck that the staff have alluded to in the past. There is a suggestion to transfer its deposit-taking role to the private sector.

In this regard, I would like to ask what plans the government has for the Post Savings system. The staff paper did not mention anything about such plans. And Mr. Yoshimura also mentioned that there are some merits to the Postal Savings system, but the government has the intention of making some sort of reform to this sector. I would like to hear what the government plans are, if any, at this time.

Finally, with reference to developments in the financial markets, I note that land prices have been one of the major factors that caused difficulties in the financial sector, with several banks being unable to recover their loans as urban land prices dropped steadily and their collateral lost their market value. The staff notes that land prices are now bottoming out.

Does the staff see the land prices are adjusted enough? If they are adjusted enough, then is the current level of land prices still high, or appropriate, or low in normative sense? The reason I am asking this is that the land price still seems high as is shown by the graph in paragraph 12 on page 12. I would also be interested to know how has the banks lending practices changed vis-à-vis using land as collateral following the banking crisis?

In conclusion, I very much welcome Japan's efforts at deregulating the economy as a key aspect of their structural reform program. I commend the Japanese authorities for their continued efforts. I wish them well in their endeavors and show a successful story for other countries to use it as a benchmark in many areas.

Mr. Toribio made the following statement:

The staff paper on Japan constitutes a clear and concise summary of the country's economic background, evolution and policy challenges. I congratulate the staff for their successful effort to make this Board understand many of the complexities of the Japanese economy.

We welcome the resumption of growth in Japan after five years of stagnation. The gradual intensification of economic stimulus—both in the fiscal and monetary fields—seems to have finally paid off. The question is now to assess whether the Japanese economy has already reached enough inertial speed to allow for a removal of the extraordinary fiscal and monetary supports and, if so, how to do it in an orderly and prudent way. In both accounts (assessment of the situation and reduction of policy stimulus) the staff's appraisal seems very reasonable and this chair broadly supports the recommendations contained at the end of the paper.

On the fiscal side, the main risk for the Japanese government and society comes from the temptation to protract the substantial adjustments on which a medium-term fiscal consolidation should be based. Experience shows how easy it is to engage in fiscal economic stimulus and how difficult to recognize the appropriate time to discontinue their application. Even in a country with such a high private savings rate as Japan, large fiscal deficits, if persistent, may end up by eroding the economic pillars of balanced and sustainable growth, especially when either legitimate interests or plain rent seeking get encroached in the mechanism of public deficit. Since the Japanese social security system shows a strong (even though declining) financial surplus, the adjustment effort should obviously be made on government investment and government consumption and, in this respect, the staff's advise to go beyond the authorities' current targets seems very reasonable. In my opinion, this board should give an explicit support to that recommendation of the staff, which constitutes the core of the present economic challenges for Japan. The rest of the world will also benefit from a more prudent approach to the medium-term budget consolidation, on the part of the Japanese authorities.

I also share the staff's suggestion to maintain the current stance of monetary policy, at least until it is confirmed that the upswing of the Japanese cycle does not get interrupted by the necessary fiscal adjustment. There are, however, two points about Japanese monetary policy on which I would like the staff to make some comments. First, it is not entirely clear to me how expansionary (a term repeatedly used by the staff) the Japanese monetary policy actually is at this particular moment. Certainly, we get that obvious impression of being very permissive if we only look at the record-low official discount rate of 0.5 percent. It is difficult to imagine what else a central bank could do within its field of responsibility to stimulate the economy. And yet, monetary aggregates show very little reaction, so that bank lending hardly grew 0.4 percent in nominal terms during 1996 and total domestic credit increased by only 1.4 percent. There seems to be a kind of "financial trap" about which an explanation may be needed, and perhaps the staff could provide it today. How is, for instance, the burst in residential investment and industrial equipment being financed?

Second, I am not sure that, under such circumstances, setting a specific target rate for inflation—as recommended by the staff to Japan's monetary authorities—would serve any clear purpose. Less still if fluctuations in that inflation rate are expected to provide any guide for changes in short term interest rates. Intervention rates could hardly go down any further anyway, and their effects on the real economy seem to be blocked by that sort of "financial trap." I frankly do not see any urgency for the Bank of Japan to announce an inflation target or any other fixed monetary policy guide at this particular moment.

Moving to exchange rate policy, I am also a little puzzled about the small effect of the substantial fall of the yen's real exchange rate during 1996. In fact, the yen's depreciation in real terms amounted to almost 15 percent and represented the first real fall of the Japanese currency in the last seven years. And yet, net exports contribution to GDP was strongly negative and the current account balance showed the smallest surplus of this decade. The staff may be right in associating these phenomena to a temporary "J" effect, and in expecting a full reaction of the Japanese external sector for the whole of 1997 or perhaps for the coming 1998. But I also wonder whether this apparent slow response of the Japanese foreign sector to its new competitive advantage may not also reflect some more profound structural changes. In my opinion, we would do well in watching very closely the coming events on the Japanese foreign sector. I would appreciate to know, for instance, if the available figures for the first two quarters of 1997 show already any clear signal of a stronger reaction to the past downward movement of the yen's parity.

As for the problems of the Japanese financial sector, I am glad to know the positive assessment of the situation made by the staff's team, which confirms the favorable reports from other sources during the past months. The

Japanese authorities are to be commended for their decisive reaction to solve the main banking problems and to improve the market expectations about financial events in Japan. Yet, the banks' large holding of equities—which is a distinctive feature of the Japanese system—strikes to other analysts as a particular risk factor, subject to the volatility of stock markets. Strengthen financial disclosure and an adjustment for that peculiar kind of risk in banks' financial statements would be welcome steps, as suggested by the staff. If we are to witness a Japanese "big bang" in the near future, with a higher degree of competition and a faster path of financial innovation, new prudential regulations will be needed.

Finally let me make a brief comment on the issue of structural reforms, as presented by the staff report. I think we all read with satisfaction the reform proposals currently considered for the sectors of transportation, telecommunications, and power supply. However, the postponed reforms of the labor market, land use, and retail trade (especially the first two) refer precisely to those sectors in which deregulation would become more crucial. All structural reform programs need a clear set of priorities, according to their relative importance and/or urgency. In the Japanese case, the order of implementation does not necessarily correspond to what a logical sequence of priorities should have advised. I certainly hope the staff's call on the Japanese authorities to accelerate and reorganize the deregulation agenda is given serious political consideration in the country.

I wish the Japanese authorities good luck in their endeavors, not only as a sign of friendship but also as an expression of self-interest. To some extent, our well-being also depends on their success.

Mr. Kiekens made the following statement:

The staff has provided a set of thought-provoking papers which describe the challenges facing the Japanese economy.

The prospects for continuation of the economic recovery in Japan are favorable. This should encourage the authorities to vigorously continue their fiscal consolidation. The Bank of Japan must be ready to effect a gradual increase in interest rates, possibly as soon as this fall.

Based on the widening of the gap between potential and actual output, the staff estimates that the growth slowdown in the period 1991-1996 was about two-third cyclical. The staff concludes that the "pessimistic" view that structural factors were the principal cause of the slowdown in the early 1990s was misplaced. I think a more nuanced interpretation would be more accurate. Calculating growth potential depends critically on a correct assessment of the functional relation between production factors and trend of productivity. Most of all, the persistent poor performance of actual output, consistently falling short of a perceived stable growth potential, could in itself be taken as a strong indicator of rigidities in the economy.

Admittedly the fiscal stimulus packages, and the easing of monetary policy, have contributed to the recovery. Since the monetary easing was probably the more effective of these measures, perhaps it should have been used sooner. Indeed, the fiscal stimuli, especially those based on tax cuts, were less effective in increasing output and have left the economy burdened with a swollen public debt. The public debt to GDP ratio should be stabilized immediately and steadily reduced in the medium term.

The fiscal consolidation amounts to an impressive 1.8 percent of GDP this year. Of this, 1.3 percent of GDP was attributable to revenue increases, and 0.5 percent to spending cuts. Since it is calculated that the constraining effect of this consolidation on aggregate demand has been calculated as 1.2 percent, it was probably the most ambitious target the authorities dared to set without unduly risking the ongoing recovery. I tend to agree with the authorities' view that their policies will indeed enable the economy to continue its recovery: the domestic demand will remain relatively strong, while the dependence on external demand will diminish. If this expectation is fulfilled in the third and fourth quarters, the government should consider strengthening its fiscal consolidation plans for 1998, which presently aim at a deficit reduction of 0.6 percent. The staff recommends achieving, over the next four years, an annual average deficit reduction of 1 percent of GDP. This recommendation is amply justified by the medium- and long-term debt dynamics clearly laid out in the staff report, as has been argued by many Directors during today's discussion. If accompanied by measures to enhance the transparency of the government accounts, and implemented with vigor, the credibility enhancing effects of the fiscal consolidation will alleviate or even offset its inhibiting effects on aggregate demand. If accompanied by structural measures to increase the flexibility of the economy, fiscal consolidation will not necessarily inhibit the recovery, as convincingly shown by the experience of the United States.

Turning now to monetary policy, I welcome the new law on the status of the Bank of Japan, a main purpose of which is to grant independence to the central bank. And although granting legal independence is a necessary step, it has to be accompanied by a more general attitude, in political circles and even on the part of public opinion, to understand, respect, and support the independence of the monetary function. The markets will be watching carefully to see how well these principles are honored in Japan.

I do not think that the Bank of Japan needs a policy of formal inflation targeting to underpin its nascent independence, which I hope will very soon be firmly established.

An important test and challenge for new status of the central bank will come in the not to distant future, when the Bank of Japan will have to decide on when, and how fast, to tighten monetary policy. The staff gives very balanced advice on this point. If the data in the course of the second half of the year provide sufficient assurance that the fiscal tightening is not holding the economy back as it moves toward a strong and sustained recovery, a cautious and gradual increase in interest rate would be appropriate.

Obviously a tightening of monetary policy may somewhat reduce the presently comfortable interest margin, enabling the banks to grow out of their problems. This will take another one to three years depending on the different categories of financial instability, and assuming that no new accidents occur and that the presently disclosed figures are reliable. In this connection, the great differences in the standards for accounting and disclosure in the United States and Japan are most striking. The staff has provided illuminating information on this aspect in the background documents which is very useful.

I think—at least I hope—that the position of the Japanese banking sector is strong enough not to prevent an independent use of the monetary instrument. However, this is not to say that the authorities should be blind to the effects of their actions on the banking industry, which is doubtless still fragile. The staff gives very valuable advice in this connection, when it states that the pace and timing of interest rate increases that will ultimately be needed can be moderated if the government implements a strong and sustained fiscal consolidation effort.

A tightening of Japan's monetary policy could have substantial effects on the international capital markets, since large amounts of credit to the emerging markets and investments in equity and real estate in Asia and else where are financed directly or indirectly by very cheap, short-term yen loans. The very low interest rate on yen liabilities has resulted in large amounts of liquidity in the world markets. The relatively sharply in U.S. short-term interest rate in early 1994 caused an unexpected rise in the long term rates due to a massive sell-off of investments in long-term assets that had been financed by cheap, short-term capital. Similarly, the rise in short-term yen interest rates may cause a fall in equity and real estate prices, particularly outside Japan. It will therefore be advisable for the Japanese authorities to prepare the markets carefully for the possibility of such a tightening, and to implement the tightening gradually.

Mr. Yoshimura provided the Board at the outset of this meeting with some additional numbers of the outstanding short-term claims of the Japanese banks on Thailand, the Philippines, Malaysia, and Singapore. If my calculations based on his numbers are right, the Japanese banks own about $8 billion out of a total of $16 billion of short-term bank claims on those four countries. Hence, Japan has a major interest in preventing further financial market turbulence in Southeast Asia, which should also be a major concern of financial centers all over the world. This consultation is a good occasion to call on Japan not to offer support for a rescue package before the framework of a Fund supported program is in place. A Fund program offers the best assurance that the strong adjustment policies will be implemented and serves not only as a safeguard for the Fund's resources, but also as a safeguard for other creditors whose support is catalyzed by the Fund's participation. Also, I wish to express the hope that we can avoid, in Thailand, a Mexican-type bailout which would serious increase moral hazard on the part of private investors.

Japan's current account has been expected to run a surplus of some 1.4 percent of GDP. According to recent projections, however, it may even be as high as 2 percent of GDP, a number which the staff also assumes will be the surplus for next year. Ms. Lissakers, in her stimulating statement, believes that the growth of the current account surplus may continue to gain momentum and finish even higher. She takes issue with the staff's view than Japan's current account surplus represents a desirable redistribution of global demand pressures that smooth out cyclical asymmetries. She reiterates the well-known position of her authorities that the international community should not be indifferent as to whether the growth of the second largest economy in the world is mainly based on exports or on domestic demand. I would like to observe that Japan's current account surplus of 2 percent is no larger in relative terms than the United States' current account deficit of 2 percent of GDP. I think that U.S. industry is highly competitive and in principle has no reason to fear competition from Japanese exporters. The Japanese current account surplus should therefore not fuel protectionist sentiments in other parts of the world, provided that Japan, via structural reforms if necessary, continues to effectively open its markets to foreign competitors. This brings me to the last point of my intervention, namely structural reforms.

I am heartened by the government's commitment to structural reforms. The momentum they have accumulated should lead to further concrete actions to deregulate the financial and other sectors of the economy. Where possible, the government should expand and accelerate structural reforms. This will increase productivity and convert the present cyclical upturn into sustained growth. By doing so, Japan will better prepared to deal with the economic implications of its rapidly aging population.

Mr. Al-Tuwaijri made the following statement:

It is encouraging that the expected downside risks to Japan's recovery failed to materialize. Instead, the growth rate jumped more than twofold in 1996 to the highest for a G-7 economy. The expansion is also expected to continue, albeit at a more moderate pace. Meanwhile, inflation remains marginal with unemployment and capacity utilization rates pointing to a still substantial slack in the economy.

The favorable turn of events is above all a tribute to the authorities' skilled management of policy priorities. Steering of the economy's growth source to private investment and consumption, banking sector reforms, and renewed commitment to fiscal consolidation are all evidence of a strong policy resolve. The key policy challenge now is to press fiscal consolidation and sustain the recovery. The statement from Mr. Yoshimura and Mr. Ono is reassuring in that regard.

On the fiscal front, the steps already in place are a sizable down payment toward the official goal of a fiscal deficit of no more than 3 percent of GDP by the year 2003. While I see merit in the staff's case for more effort, on balance I can appreciate the authorities' cautious approach at this early stage of the recovery. Regarding the policy package, I welcome the determination to match the central government's spending restraints with cutbacks at the local level. The improved prioritization of expenditures is also welcome. It will now be important to move on to a more proactive stance on reform of the civil service and the pension system.

The strong agenda on spending containment notwithstanding, the fiscal goals may well require supplementary steps on the revenue side. In that regard, it is encouraging that the authorities will consider expansion of the corporate tax base.

Regarding monetary policy, the wait-and-see stance is clearly the right one at this stage as there is no sign yet of a need for tightening. Indeed, emergence of such a need depends critically on whether fiscal consolidation progresses as planned. Given the authorities' record on inflation, the staff's suggestion that the anti-inflation commitment be anchored to specific targets appears unnecessary. Here, the caveats that Mr. Yoshimura and Mr. Ono have noted for such targeting are instructive.

On the structural reform front, the improved credibility of the financial system has been a major contributory factor in the economy's recent progress. Indeed, the financial sector has been arguably the leading beneficiary so far of the authorities' ongoing reform drive. In that connection, I welcome the priority for a clear definition of bad loans, speed up of collections, and a discriminating approach to assistance for resolution of the problem loans facing major banks. It is important now to build on the progress already made.

Let me stress that a more proactive stance on structural reforms on a broader front is crucial for sustaining the recovery. Indeed, more progress in deregulation and opening of the Japanese economy to external competition is important to improve domestic as well as global economic efficiency and welfare. Faster progress in that regard could also deflate protectionist pressures in trading partners.

Finally, I hope every effort will be made to preserve Japan's commendable record on the provision of official development assistance.

With these remarks, I wish the authorities continued success.

Mr. Disanayaka made the following statement:

I join previous speakers in commending the Japanese authorities for turning around their economy after a period of sluggish growth. The recovery in the Japanese economy that followed the fiscal stimulus package in late 1995 has continued into 1997. This favorable growth outturn was the result of growing confidence in the recovery process; increases in investment, both public and private; and the favorable external position following the depreciation of the yen. However, as the staff has pointed out, it would be premature to consider phasing out the easy policy stance until definite signals emerge showing that the recovery is well entrenched.

As in the past, the recent rebound from the consequences of the bubble economy in 1990 bears ample testimony to the resilience of the Japanese economy and the skill with which the authorities have been able to manage it during periods of stress.

The well-written staff report for the 1997 Article IV consultation and the background papers provide an in-depth analysis of various aspects of the Japanese economy and assess the pros and cons of the various policy measures being put in place or are being contemplated for early implementation. The staff report, in particular, highlights several important areas of concern and puts forward valuable policy suggestions for consideration by the authorities. As we concur with the general thrust of the staff assessment, I will offer only a few comments to further emphasize some aspects of the current economic situation.

We welcome the consolidation measures taken by the authorities to arrest the deteriorating fiscal situation. Such measures should send the correct signals to markets about the authorities' resolve to bring the deficit firmly on a downward path so as to reach the deficit target of 3 percent of GDP by 2003. They should also lend credibility to the medium-term consolidation strategy recently announced by the authorities. However, as in previous years, the staff has recommended a more ambitious consolidation path. The staff report indicates that a 4 percent deficit reduction by 2001 at the rate of 1 percent per year over the next four years would be a more effective way to reduce the country's growing debt burden in the face of rising demographic pressures. As the Charts on page 24 of SM/97/176 show, the alternative consolidation path proposed by the staff would reduce the Japanese debt to below 65 percent by 2003, compared with an estimated level of 75 percent under the authorities' plan. We agree with the staff that there is enough room for expenditure cuts to achieve this alternate path, particularly in the areas of public investment, civil service reform, and the privatization of public enterprises. We would encourage the authorities to give careful consideration to these proposals, as well as those made concerning the pension reform and increasing the transparency and accountability of the Japanese fiscal system.

We agree with previous speakers that the time does not appear ripe yet for tightening the current accommodative monetary policy stance, which has contributed much to the recent recovery. As the underlying inflationary pressures are negligible at the present stage, some tightening could be considered perhaps toward the end of the year, if such action was warranted by developments in the economy.

We welcome the revisions introduced in the new Bank of Japan Law, conferring independent authority to the Bank of Japan in setting monetary policy. We hope that the new authority will strengthen the hand of the Bank of Japan in taking more bold and transparent decisions in the monetary policy area. I appreciate the comments made by Mr. Yoshimura in this connection. The ball is now squarely in the Bank of Japan's court with respect to monetary policy. This is a good sign.

Turning to structural reforms, we welcome the recent steps taken by the authorities toward strengthening the financial system and accelerating the process of deregulation. However, we are concerned about the serious problems in the banking system, particularly relating to the high ratio of nonperforming assets and its heavy exposure to volatility in equity markets. In addition, some of the nonbanking financial institutions appear to be under stress. The staff report and background papers discuss these weaknesses rather comprehensively. We appreciate the measures the authorities have put in place, or are contemplating, to address these deficiencies in the system. We appreciate the explanations given in Mr. Yoshimura's very helpful opening statement about issues related to the financial sector. However, we support the staff in urging the authorities to formulate a comprehensive plan to deal with these issues early, in a more systematic manner. Stronger supervision and the imposition of more stringent disclosure and accounting procedures should be put in place soon. An independent assessment of the capital position of the troubled banks should be undertaken in the very near term. Insolvent banks should be made to exit early, and those found viable, but weak, should be encouraged to strengthen their positions through mergers or recapitalization.

With regard to the deregulation of the financial sector, we would like to see early implementation of the proposals envisaged under the "Big Bang" strategy. We welcome the laws that have already been passed, such as the new Foreign Exchange Law to implement several important market liberalization measures. Such measures will certainly bring greater competition and dynamism to this sector and facilitate its early integration into the global financial system.

We would also wish to see a faster deregulation of other sectors of the economy, such as electricity generation, marketing, and transportation. This would facilitate greater involvement of the private sector in these areas.

The decline in Japan's official development assistance in 1996 and the prospects of a further decline in this area are a cause for concern. We hardly need to stress the valuable role Japan has been playing in supporting the development programs of many developing countries over a long period. It would be a pity if this major source of bilateral aid to poor countries were to weaken at the present juncture, when global official development assistance is falling rapidly. Therefore, we would urge the Japanese authorities to make best efforts to maintain the level of official development assistance at traditional levels.

With these remarks, we wish the Japanese authorities well in their efforts.

Mr. Esdar made the following statement:

To begin with, I would like to commend the staff for the well readable and organized and comprehensive staff report. I can go along with most of the policy recommendations. I also share the analysis of the Japanese economic situation.

Indeed, the economic situation has improved significantly since our last review. The promising growth performance of 1996 has continued in 1997, however, at more moderate rates due to increases in consumption taxes. The major driving forces behind the upswing were the easy monetary conditions but also the demand stimulus provided by a series of fiscal packages. While public demand and especially public investment has played a key role in launching the economic recovery, now private business investment and private demand have also gained momentum. In addition, the depreciation of the Yen which has continued until this spring has strengthened the recovery on the export side. However, in order to maintain this momentum, it is now crucial to bolster confidence of domestic demand by accelerating the necessary structural reforms and by bringing fiscal and monetary policies on a more sustainable footing. The business climate is still characterized by some degree of uncertainty not at least due to the continuing problems in the financial sector. Although recent polls by the Bank of Japan found that optimism has increased significantly among the big companies, they also found that smaller industrial enterprises and the service sector are assessing the economic situation less favorable.

On fiscal policy. I fully share the staff's view that the economic recovery should provide the opportunity to bring the fiscal deficit back on a more sustainable level. Even if the pickup of economic activity should turn out to be slower than expected, fiscal consolidation should continue to be given the highest priority. I share the view of Mr. Kiekens that the confidence effect of a credible fiscal consolidation would offset potential short-term effects on demand. The main impediments to growth continue to be on the structural side. I doubt whether additional fiscal stimuli would be the appropriate prescription. Insofar, I appreciate Mr. Yoshimura's and Mr. Ono's emphasis on putting in place various structural reforms in order to achieve medium-term growth. A structural deficit in the range of 6.2 percent, an increasing public debt ratio that is already close to 100 percent of GDP, combined with the economic effects of an aging population demonstrate the urgency of corrective action.

Against this background, we very much welcome the intention to reduce the deficit in 1997 by about two percentage points to 5.2 percent. However, given the magnitude of the problem, in our view the medium-term consolidation objective to further bring down the deficit only by two percentage points within the next six years seems to be rather on the unambitious side. We strongly endorse the staff's recommendation to strengthen the efforts here.

We would also like to put some question marks with regard to the structure of the envisaged fiscal consolidation. There is a lot of emphasis on the revenue side. Revenues will increase by nearly 8 percent in 1997. Taxes and social security contributions are expected to increase significantly in the next six years. If we add the public deficit, the total of these three elements will increase from 40 percent of GDP to 50 percent until the year 2003.

In general, the most urgent need for bringing expenditures under control is certainly in the pension and the health systems. However, this has been discussed in detail in recent years, and I can fully endorse the views expressed by the staff on this topic.

Let me now turn to monetary policy. The very low interest rates, indeed, in our view, have been one important driving force behind the recovery. Somewhat in contrast to the staff's recommendation, in our view, the current upswing would provide the appropriate opportunity for careful tightening of monetary conditions early in advance of signs of inflationary pressures. We very much share the view expressed by the Bank of Japan that the short-term interest rates are well below levels that would be appropriate from a longer-term perspective. Interest rates which are close to negative in real terms should not be maintained longer than absolutely necessary. Otherwise they risk giving the wrong signals to the markets and generate an unbalanced financial structure of the banking and enterprise sectors. It is also true that the effects of monetary decisions are subject to significant time lags. Therefore, in our view, an early but cautious action might be well advised.

Further on monetary policy. You will certainly not be surprised that this chair welcomes the revision of the law directed at formally establishing the independence of the Bank of Japan in 1998.

I also noted the recommendation to further strengthen monetary credibility by setting transparent and quantitative targets. Not too much to my surprise, the staff in this regard advocates inflation targeting. But according to the background paper the role of monetary aggregates as a leading information variable has increased. Therefore, I feel encouraged to suggest to consider the use of the monetary aggregates as intermediate targets.

Finally, on structural policy, the most urgent task ahead certainly is to further consolidate the financial sector. No doubt, progress has already been achieved, however the high level of problem loans of Japanese deposit-taking institutions still remains a matter of concern. The recent decline in bank equity prices and the increase in the "Japan premium" caused by the effect of falling equity prices on banks' hidden reserves and the impacts of deregulation plans on bank profitability reflect the fact that the situation is still very fragile. Especially the weakest of the banks were affected by an additional loss of confidence. I share the staff's view that in order to further avoid systemic risks, nonviable banks should be closed down as soon as possible.

We welcome the government's new reform initiative to liberalize the banking sector which, due to many observers, has been one of the most regulated sectors of the Japanese economy. Insofar, a "big bang" was urgently needed. We would encourage the authorities to implement the envisaged initiative as soon as possible, paying due regard to the appropriate sequencing. For instance, the envisaged liberalization of foreign exchange transactions should be complemented by a further deregulation of Japan's financial system in order to increase its competitiveness and to prevent business from moving abroad. Needless to say that the envisaged liberalization of Japan's financial markets will put even more pressure on the need to overcome the problems in the financial sector.

Furthermore, on the financial market liberalization package, I have some specific questions: First, which tax measures are envisaged to increase the efficiency of Japan's financial markets? For example, existing tax regulations discriminate against establishing financial holding companies; Second, there is some evidence that public financial institutions are treated favorably under existing tax laws in comparison to private financial institutions. Are there any intentions to address these imbalances? Third, according to the staff, the financial sector is lacking an adequate rules-based regulatory system. Are there any indications to address this problem.

Finally, what are the reasons for the relatively small number of foreign financial institutions in Japan's financial markets. Are there any expectations that under the liberalization package a more even-handed participation would be achieved?

Mr. Zhang made the following statement:

Like Mr. Fischer I would also like to start by commending the staff for the comprehensive and excellent set of papers. I am in broad agreement with the staff's analysis and appraisal. Mr. Yoshimura and Mr. Ono also present a very informative and helpful statement. I would like to make some comments for emphasis.

Since the last consultation, we have seen a further strengthening in Japan's economic developments and an enhanced prospect for sustaining the recovery, which is largely reflective of a series of supportive macroeconomic policy measures. The improved economic environment has provided a good opportunity for adopting decisive steps toward structural reform and deregulation, so as to make the economy more adaptable to demographic shifts and to solidify the foundation for sustaining economic growth over the long term.

Although the downside risks still exist, it is increasingly evident that cyclical forces are becoming self-sustaining and no actions are needed to provide further stimulus. Indeed, attention should be focused on reversing the deterioration in the fiscal deficit and public debt position to create favorable conditions for longer-term economic growth and help prepare against the eventual pressures on the budget associated with population aging. A high priority in the current cyclical stage is to unwind the past fiscal stimulus measures in a way that can avoid entailing protracted fiscal consolidation, and prevent an undermining of the recovery momentum. The strong measures taken in the FY 1997 represent a good start in the consolidation process and, we wish these will help the authorities make accelerated efforts toward achieving a sustainable fiscal position over the medium-term.

The significant easing of the monetary policy stance has greatly contributed to the rebound in economic activity, and has also served to facilitate fiscal consolidation measures. However, such an accommodative stance is certainly not sustainable over the long run, even though the risk of fueling inflation is rather remote for the time being. The authorities face a delicate decision on when would be an appropriate time to start adjusting monetary policy. We share the assessment that the current stance of monetary policy should be maintained until the economy is firmly on a self-sustaining recovery path, and the steps toward reversing the easy monetary stance should be taken in consideration of factors affecting the strength of the recovery and in close coordination with the fiscal consolidation process.

Given the close linkage between the Japanese economy and other economies in the region, Japan's monetary stance should also be assessed in the context beyond its border. The impact of Japan's monetary and exchange rate developments in recent years has been increasingly felt in its neighboring economies in terms of capital flows, and monetary and reserve management. To my mind, the large interest rate difference between Japan and other countries in the region has probably been an important factor, among other things, in mobilizing capital flows in the region, although it would not be easy to estimate its specific impacts. With the tightening of Japan's monetary policy in the near future, there would be new uncertainties for other countries in the region, and it is worthwhile to closely monitor its effects. In this respect, I associate myself with Mr. Shaalan that the future conduct of monetary policy in Japan should avoid sharp and abrupt increases in interest rates.

We commend the authorities for the considerable progress in addressing the difficulties in the financial sector, particularly noteworthy is that nonperforming loans are on a downward track and the legal framework has been further strengthened. Nevertheless, the financial sector still faces significant strains and uncertainties, as recently demonstrated by the impacts of deregulation plans and falling equity prices. To promote the soundness of the financial sector on a lasting basis, it would be advisable to develop a comprehensive restructuring plan for dealing with the problems, particularly the problems of major banks. The authorities are also encouraged to further strengthen accounting and disclosure standards. Like the staff, we welcome the authorities' intention to undertake an extensive liberalization of the financial market and encourage early implementation of the measures.

Accelerated structural reform and deregulation would best serve to translate the current recovery into a sustained long-term growth path and elevate the economy toward a more service-oriented one. It is essential to ensure that the strengthening of the recovery will not lead to a diminished impetus of structural reform and deregulation. With a strong commitment to structural reform and deregulation, the authorities should take advantage of the improved cyclical situation to act promptly, so as to bear the consequent economic costs in the short-term, and materialize the positive effects in the medium- and long-term.

We share the staff's concern over the decline in Japanese official development assistance and its negative impacts on the recipient countries. We believe it is in the interests of both Japan and recipient countries to have the declining trend arrested.

In conclusion, I wish the Japanese authorities further success in their future endeavors.

Mr. Zoccali made the following statement:

We join other speakers in commending the staff for the quality and the depth of the analysis on the Japanese economy. The interesting comments put forward by Directors for the current discussion underscore the pivotal role of the Japanese economy in continued global expansion and in maintaining orderly conditions in international financial markets. Nevertheless, the recent performance has been marked by contrasts.

The impressive growth of the late 1980s was abruptly followed by a period of sluggish economic activity extending for almost five years, despite proactive macroeconomic policies. In this context, the balanced budget position, excluding social security, at the beginning of the 1990s, gave way to a deficit of 7 percent of GDP in 1996 and to a level of public indebtedness that could become worrisome in the absence of tough fiscal actions over the medium term.

Unfunded social security liabilities equivalent to 100 percent of GDP are now the second largest in the world. At the same time, however, the external sector consistently runs a current account surplus, and only its size seems to be dependent on the relative value of the yen. Japan's official foreign exchange reserves, exceeding $220 billion, excluding gold holdings, are by far the largest in the world, and the flexible exchange rate system under which it operates affords it the uncommon luxury of exercising true monetary sovereignty. Against this backdrop and the lingering uncertainties about the robustness of the strong recovery initiated in 1996, we broadly agree with the staff's conclusions regarding the significant policy challenges still facing the authorities.

Most of the staff's analysis revolves around the fiscal area. Having agreed with the authorities that the fiscal situation does not permit adjustment delays, the staff convincingly argues in favor of increasing the intensity of fiscal reforms to ensure a more sustainable level of public debt. As noted in Annex 1 of the staff report, the impact of fiscal adjustment on output growth is likely to be very modest, provided policy actions are credible. Such an assertion at an earlier stage might have avoided the use of substantial amounts of public funds in fiscal stimulation packages, which did little to energize growth.

We welcome the authorities' substantial fiscal retrenchment effort, which attests to their recognition of the need to proceed with structural reforms to improve the fiscal situation. The additional consolidation measures suggested by the staff for this year and next could, in particular, benefit from expenditure reductions in the area of public investment, where inefficiencies and low social rates of return seem most prevalent. The staff mentions privatization of state-owned enterprises as another area where expenditures could be trimmed. We would welcome some further clarifications about the extent of state-owned enterprises' participation in the telecommunications, transportation, and energy sectors, and the potential contribution of privatizations in those areas could make to public debt reduction.

The staff's suggestion that the primary deficit be cut by 1 percent of GDP per annum more than envisaged over the next four years would reduce the government debt ratio by an additional 10 percent of GDP by the year 2003. Even this suggested consolidation path, however, seems low when measured against the estimated level of unfunded social security liabilities and the pressures from future population aging. From this angle, it is difficult to envisage a sustainable consolidation in Japan's public finances without a substantial reform of the social security system to avoid resorting to very large hikes in future private pension and health care contribution rates, not least because of their impact on competitiveness. Does the staff consider the authorities' long-term commitment to keep the sum of tax revenue, social security contributions, and deficits to below 50 percent of national income a helpful binding constraint for achieving a better balance between social security burdens and expenditure?

We commend the authorities for their initiatives to increase the transparency and accountability of the public finances as a means of fostering support for the needed structural reform effort. We agree with other Directors that the accommodative monetary policy stance since 1995, which brought the official discount rate to an unprecedented one half of a percentage point, remains appropriate, but that Japan should move toward a more neutral stance once the uncertainties about the impact of the fiscal tightening on the overall economic recovery have subsided. Like other speakers, we do not see an urgent need to adopt an inflation targeting approach at the present time.

The timing of monetary tightening is not inconsequential for the health of the domestic financial system or the general direction of capital flows in an already volatile southeast Asian market. Perhaps it would be useful to clarify the validity of the assertion in a recent *Economist* article that 50 percent of Thailand's external debt is with Japanese banks.

Past monetary easing undoubtedly contributed to the increase in banks' profitability and to the buildup of reserves against nonperforming loans, as well as to the availability of low-cost funding within the region. Could the staff clarify the impact of the probable monetary tightening on these two fronts, keeping in mind the estimate that 20 main banks would need another year to completely overcome the problem loan issue? We are encouraged to note authorities' confidence that the eventual increase in short-term interest rates in Japan will not need to be as dramatic as that in the United States during 1994, after a similarly protracted period of monetary easing that helped the banking system overcome its own bad debt problems.

Having said this, it is also worth keeping in mind that the expected shift in monetary policy will impact on aggregate demand not only through the interest rate, but also through the exchange rate. The alternative medium-term scenario in Annex 1 of the staff report, in which the yen exchange rate follows an expectation-consistent path and appreciates steadily through the forecast period, results in GDP growth slightly higher than that depicted in the baseline projection. In addition, the current real exchange rate level is close to the equilibrium implied by the MULTIMOD model.

This representation of current developments tends to underplay the main characteristic of the yen/dollar bilateral exchange rate—that is, its volatility. Neither the baseline scenario, which takes the present exchange rate as given, nor the expectation-consistent path, which assumes uncovered interest rate parity, are considered realistic, and suggest the need to incorporate into the analysis the short- and medium-term consequences of large recurring exchange rate volatility not only for Japan, but also for the world economy.

As to the financial sector, the authorities' assessment that problem loans no longer represent a threat of systemic proportion and that the remaining difficulties are confined to only a few major banks should reassure the markets. The staff questioned the lack of a clear framework for providing support for bank restructuring. While we fully concur with the recommendations put forward by the staff, including the call that public funds not be used to forestall the needed retrenchment of excess capacity in the banking sector, due credit should be given to the authorities for their handling of a very difficult situation. In this regard, we agree with Mr. Yoshimura that the possibility of recovery of bad loans is not a black and white issue.

A final judgment will have to internalize all the domestic and international consequences of the upcoming shift in the monetary policy stance. In any event, we welcome the renewed impetus to financial sector deregulation from the so-called Big Bang financial reform, which also covers the postal savings system, and would underscore the importance of the staff's observation that, for financial deregulation to be truly effective, a fully rules-based approach aimed at encouraging innovation and ensuring a level playing field for all institutions should be put in place promptly.

It is equally important that the determination of the authorities to push ahead with structural reforms in other areas be maintained, particularly as the economic recovery continues and steadfast implementation may appear less necessary. Japan has the most to gain from widespread deregulation among the five major industrial countries. According to a recent OECD study, which estimates the potential long-run gain of deregulation to GDP to be 6.4 percent, the foregone opportunity cost is of a size that no government can ignore. We are confident that the current deregulation drive, covering over 2,800 items, will be promptly implemented with logical prioritization. More generally, the trade-off between the potential GDP gains and deregulation should appear in Article IV consultation reports as frequently as possible in light of the availability of data.

While we welcome Japan's commitment to the WTO framework for dealing with trade issues, we can associate ourselves with the staff's call for more ambitious actions aimed at market opening, particularly in the agricultural sector.

With these comments, we wish the authorities the greatest success in dealing with the challenges ahead.

Mr. Joyosumarto made the following statement:

I join the other Directors in commending the staff for their efforts in coming up with a concise report on the major economic accomplishments of Japan in the past year. The background materials that accompany the report provide excellent references to the various issues of interest which deserve our careful consideration.

As reflected in Mr. Daïri's statement, it is no exaggeration to say that the overall achievement of the Japanese economy in 1996 had been remarkable judging from the difficult situation they were in. Supported primarily by the continued easing of monetary conditions as well as by further fiscal injections, and in the later stage, by the favorable movement in the yen, the economy has been able to register 3.5 percent growth rate in 1996. But the challenge is far from over. The main question that we should address ourselves at this stage is whether the attainment of stronger growth in the past year and the development in recent months have provided adequate signals that the economy had in fact fully recovered. As pointed out by Mr. Shaalan in his statement, the answer is not straightforward. An appropriate policy mix that takes into account a delicate balance between expansionary monetary policy and incrementally contractionary fiscal stance may have to be considered at this stage in order to bring the economy to a more durable path of recovery.

The stronger performance of the Japanese economy in 1996 provided an encouraging evidence that the economy is gathering its strength. However, such an achievement was made possible through an adoption of a series of expansionary fiscal packages in the past few years which resulted in the further deterioration of the fiscal position of the economy.

As quoted in the staff paper, the fiscal balance had worsen from 3.5 percent of GDP in 1991 to 4.25 percent of GDP in 1995 and the trend was growing. Under this scenario, I could see some merits that a gradual reversal of the fiscal strategy from being stimulative to restrictive, might be necessary.

The recent introduction of consumption tax plus the removal of temporary income tax cut in April 1997 certainly served as a test to see whether the economy had reached a sustainable footing. The preliminary estimates had suggested that the impact would be minimal and temporary because the gains in increased private investment particularly in the residential and manufacturing sectors and even in private consumption as a result of favorable monetary conditions would more than offset any anticipated drawback as a result of the fiscal tightening. As adequate assessment on the full effects of the recent tax hikes will only be possible by at least the end of the year, any plan to further tighten the fiscal stance should be considered in a great care, for fear that it might derail the steady economic recovery thus far. In addition, as pointed out in Messrs. Yoshimura and Ono's helpful statement, considering the sensitivity of the matter, issues relating to taxation should at best be discussed at national level in order to gather opinions and support of the people.

The debate surrounding the monetary stance primarily centers on the question of whether the economic recovery has achieved its sustainable path. If inflationary pressures were to be the sole factor for consideration, the current easy stance of monetary conditions should stand. Looking at other factors particularly the recent movement of the yen, the status in the current account balance, the interest rate differentials between Japan and its major trading partners, and the development in the financial market, there are no strong grounds to support the need for some tightening of monetary stance at this stage. As the staff and most of the statements have indicated a quick signal for any necessary shift in the monetary stance will perhaps be indicated by the ability of the economy to absorb the recent fiscal consolidation exercise but in a more realistic assessment, this chair believes the momentum in the implementation of deregulation package should also be given due attention.

In regard to the conduct of monetary of policy in Japan, this chair would like to welcome the bold initiatives recently undertaken by the Japanese authorities. The inaugural revision of the Bank of Japan Law, 1942 which came into effect April 1, 1997 has established the Bank of Japan as the sole agency responsible for monetary policy. However, noting the substantial credibility that has been developed by the Bank of Japan, as pointed out in Messrs. Yoshimura and Ono's statement and Mr. Shaalan's statement, inflation-targeting approach may not be appropriate as a primary policy tool at this stage even under the new framework.

We welcome the significant progress made by the Japanese authorities over the past year in addressing the banking problems. The passing of 3 financial laws and the setting up of a new financial supervisory body (SAFE) in June this year constitute an additional foundation which will allow the authorities to deal effectively with some of the remaining problems in the financial industry. This chair particularly welcomes the framework laid out by the authorities to deal with the problems of smaller financial institutions. As indicated in Mr. Shaalan's statement, the banking problems in Japan have been long overdue. Without timely and systematic corrective measures, the banking problems would remain embedded in the still fragile economy.

The 4,600-point deregulation package announced in March and May this year by the Japanese authorities perhaps represents the most ambitious program ever which included deregulation in the transport, telecommunication and energy sectors. The significance of this development is obvious. The backbone of long-term economic recovery largely lies in the success of these reforms.

In reviewing the progress of the reforms, it is encouraging to note the speed with which the authorities had begun their implementation. Decision of the Diet to abolish exchange controls provided a clear signal on the commitment of the authorities. In October last year, for the first time in 46 years, four new domestic airlines were given permission to operate on some of the lucrative routes within Japan. In spite of all these encouraging signs, it is still too early to say whether the deregulation exercise will fully materialize.

We view with some concern on the further planned cut in the financial contributions of the Japanese government to the ODA in FY 1998. As stated in the staff paper, since any gains that might be realized will be insignificant, the inclusion of ODA contribution in the fiscal consolidation exercise should appropriately be avoided. We believe that the objective of improving the quality aspect of the contributions is not necessarily on the expense of the quantity of financial contributions to the ODA as the needs for assistance have never diminished.

Last but not least, I would like to place on record our appreciation on the role of the Japanese financial authorities in providing timely assistance to Southeast Asian countries during the difficult time in facing the attack of foreign exchange speculators. I hope that the support will be a continuing effort.

With this remark I wish the Japanese authorities every success in their future endeavors.

Mr. Grilli made the following statement:

It is clear that growth and stability in the Japanese economy are important not only to Japan, but also to Asia and the world economy at large. For this reason, resumption of growth and achievement of financial stability have been a main concern not only of the Japanese authorities but for the Fund membership at large. We are happy to see that real progress has been achieved so far on both points.

Recent economic developments have been favorable as indicated by the considerable strengthening of economic growth in 1996. These results reflect an appropriate use of policies to support demand, including fiscal stimulus and low interest rates, and return of confidence in consumers and investors following the steps taken to address the problems that had arisen in the financial sector. Moreover, economic growth has remained robust so far in 1997. The redirection of fiscal policy made in 1997 was swift and apparently well calibrated. It should permit a substantial budget deficit reduction without unduly sapping the underlying strength of demand. We welcome the authorities' resolve to reestablish fiscal sustainability in the medium term, but also the objective to do so while maintaining growth. The output gap remains large in Japan and room exists for gradual fiscal retrenchment. In fact, despite the pick up in economic activity and a weak yen until recently, underlying inflationary pressures are still negligible

The considerable improvement in the financial performance of the corporate sector in recent years should help sustain business investment into the medium term. Balance sheet and capital stock adjustments are by now largely completed within the business sector. Improved labor market conditions should also contribute to sustain household consumption. A substantial external contribution to growth should be ensured this year and the next by the lagged impact of the Yen depreciation on trade volumes. These effects should largely offset the impact of the fiscal consolidation in 1997. The economy should, therefore, be able to absorb this initial consolidation effort without undermining the ongoing recovery. Recent developments in the financial markets, including the rise in bond yields and the recovery of the Nikkei, all show improved confidence in the strength of the economic recovery. Assuming a prudent stance of policies, especially monetary, private demand and investments should strengthen further in the next years. Productivity increases would nonetheless remain very important, and depend to a considerable extent on effective openness, strengthened competition and investments in research and development, a good deal of which will be helped by internal deregulation of product markets, and by the climate prevailing for investments (domestic and foreign). Recently stated intentions by the government augur well for the future.

Among the downside risks to this scenario is the possibility of rapid appreciation of the yen, a trend that has started recently. This might determine weaker-than-projected net exports. Moreover, any worsening of the problems faced by the still weak financial institutions could adversely affect the stock market and business confidence, leading to a slower recovery of investment and overall private demand. This might be the case if the balance sheet of real estate and construction firms, which are still suffering from the collapse of land prices and account for a significant proportion of outstanding bank loans, continues to deteriorate, leading to a further increase in performing loans and the spillover effects of recent and unfortunately persistent difficulties in South Asian countries turn out to be substantial on Japanese banks.

Considerable progress has been achieved in banking and financial system reform, with major banks improving their balance sheets through and greater provisions against nonperforming loans. The fall in interest rates was instrumental in boosting the banks' operating profits, which were essential to help resolving their bad debt problems. But the current level and time profile of interest rates cannot be expected to last indefinitely. Interest rates will likely go up in the short-term and the yield curve may well flatten out. The staff may wish to elaborate on the likelihood and the possible effects of interest rate changes on the banking sector.

Despite progress made, additional steps are likely needed to write-off non performing loans, which are already on a clear downward trend, to raise the banks capitalization while adjusting for the risks implied by the banks' large holdings of equities, and to further strengthen financial disclosure and accounting practices. Bank capital positions are still too dependent on equity investments and exposed to changes in the Nikkei. It may very well be advisable for the Japanese monetary authorities to take steps to reduce bank holdings of equities or to adjust capital requirements. Progress is also needed to reduce the direct government's role in financial intermediation and to promote more opportunities for private sector involvement in the financial sector.

The challenges created by a more deregulated financial environment must be quickly addressed by financial institutions. In this regard, financial supervision and accounting practices might have to be strengthened as the system becomes more deregulated.

Finally, as far as trade policies are concerned, let me note with satisfaction a notable movement away from bilateralism, especially in the resolution of emerging trade disputes, and the greater reliance shown by Japan on multilateral (i.e., WTO) procedures. This illustrates both the usefulness of the Uruguay Round in strengthening the multilateral order and offering key members, like Japan, an alternative to bilateral initiatives that tend instead to fracture the uniformity of treatment of situations and members, as well as the willingness of Japan to take advantage of them.

Mr. O'Donnell noted that fiscal policy was the key issue facing Japan. Despite the recent impressive progress made in reducing the deficit/GDP ratio from 4.2 percent in 1996 to the projected level of 2.4 percent in 1997, the staff report and background papers for the current discussion showed that the fiscal position was not sustainable over the longer term.

The problems related to population aging in Japan were well-known, Mr. O'Donnell said. The authorities were clearly taking significant steps in the right direction to deal with that problem, such as through the recently announced measures to increase the retirement age. With respect to the authorities' intention to move away from indexing pensions to wages to indexing pensions to wages net of taxes, the authorities might wish to consider the move taken by the United Kingdom some time ago to index pensions to prices. Experience showed that such a change could make an enormous difference in the long-term sustainability of the pension system.

Perhaps the most important issues pertaining the long-term fiscal health of the Japanese economy were covered in the staff papers on transparency in government operations (SM/97/174, 7/2/97) and on fiscal policy rules (SM/97/175, 7/2/97), Mr. O'Donnell commented. Without preempting the forthcoming discussion on those papers, it should be noted that they contained interesting analyses on issues related to generational accounting, which would seem particularly relevant in the case of Japan. They also suggested a variety of ways in which to make government accounts more transparent and to frame them in a medium-term planing context. Such measures should be given serious consideration by the Japanese authorities, as they would facilitate more accurate assessments of the efforts aimed at fiscal consolidation not only by the Fund, but also by policymakers in Japan.

With respect to monetary policy, he agreed with the staff that a formal inflation target warranted serious consideration by the Japanese authorities, Mr. O'Donnell said. The arguments supporting such a position in the case of Japan were a little different than they were for the United Kingdom. For the United Kingdom, the primary objective had been to establish greater monetary policy credibility, and that goal had been achieved first through the adoption of an inflation target and, second, by making the Bank of England operationally independent.

In the case of Japan, there was no credibility problem, especially in light of the authorities' good track record for combating inflation. However, there was a need to make the monetary authorities more accountable. In that respect, the move to grant the Bank of Japan greater independence was particularly welcome. With respect to the new Bank of Japan Law that would permit representatives from the Ministry of Finance to attend meetings of the Bank of Japan Policy Board, it was his understanding that those representatives could also request delays in interest rate increases. He wondered whether such requests would be made public. Would they be recorded in the minutes of Policy Board meetings? While the overall performance with respect to inflation was very good, it was important to note that the discount rate had been maintained at one half of one percent for a sustained period. He wondered whether liquidity problems were likely to emerge.

With respect to the financial sector, transparency was, again, the key issue, Mr. O'Donnell considered. He supported the comments put forward by other Directors on the need to improve accounting and disclosure standards.

The authorities' strong commitment to deregulation was very welcome, Mr. O'Donnell commented. As Mr. Zoccali had indicated, the OECD estimates on the sizable gains to be realized by moving to deregulation came as good news not only for Japan, but also for the world economy. It was to be hoped that such measures would be implemented effectively.

He supported the comments put forward by Mr. Grilli on the benefits of better multilateral trade relations, Mr. O'Donnell stated. Improvements in the area of trade would also enhance the overall current account position.

After adjourning at 1:05 p.m., the meeting reconvened at 2:30 p.m.

Mr. Morais made the following statement:

I welcome the improvement in the Japanese economy in 1996. It is gratifying to note that the fledgling recovery, which had earlier been surrounded by some uncertainty, has remained on course.

The staff's projections indicate that growth is likely to continue at the strong, albeit more moderate, pace in 1997, with inflation remaining low. Credit for this success goes to the Japanese authorities who, through the introduction of a carefully designed fiscal stimulus package coupled with supportive monetary stance, helped to create the domestic conditions for the revival of activity.

We are encouraged by the progress that has been made on the structural policy front, especially the steps that have been taken to deal with the strength of the financial system. Nevertheless, much more remains to be done in these and other areas of structural reform to underpin robust long-term growth.

The recent developments do not appear to suggest the need for efforts to provide additional support to activity in the near term. The fiscal stimulus measures appear to have served their purpose, and the time seems right for the authorities to continue in the direction of reversing the sharp deterioration that has occurred in the fiscal position. In this respect, the staff is advocating a fiscal consolidation proposal designed to place the fiscal position on a sound footing early in the next decade.

Although the authorities do not consider such a goal achievable in the current circumstances, we welcome their intention to explore all avenues for achieving cost savings with a view to making some progress in the short run.

On monetary policy, we can agree with the staff that the current policy stance should be maintained at least until the effects of the recent fiscal tightening on the recovery become clear. In this connection, I recall that the staff expressed a similar view at the last Article IV consultation, although the relevant considerations then were in some ways different.

At that time, the staff had been concerned that the downside risks to recovery could not be ignored. In addition, they felt that the addition margins of slack were large and that inflationary pressures were negligible. I wonder whether the present situation is all that different.

More important, I wonder whether, given the absence of significant deflationary pressures, there is a serious need to worry about the precise timing of the shift to a more neutral monetary policy stance. Perhaps the staff could comment on this point.

We commend the authorities on the decisive steps taken toward addressing the strains in the financial sector. In this regard, we note the declining trends in nonperforming loans and the establishment of a framework for effectively dealing with smaller institutions. The progress achieved in this area helps to strengthen the ongoing recovery in activity, while further progress is necessary to underpin more robust medium-term growth. In this connection, we welcome the intention of the government to undertake a comprehensive reform of the financial system by the year 2001.

It is encouraging to note that the process of structural reform has moved ahead in other areas, including transportation, telecommunications, and power generation. Productivity gains from these reforms will help Japan cope with the initial impact of population aging on the country's potential growth rate.

On behalf of the countries in my constituency, I wish to thank the Japanese authorities for the generous official development assistance Japan has provided over the years. We regret, however, that this support is being curtailed at a time when many more countries in need are showing greater determination to face up to the challenges of economic reform.

While our countries understand Japan's concern about quality, as Mr. Yoshimura and Mr. Ono stressed in their informative opening statement, we do not believe that this emphasis necessarily implies a cutback on quantity. We, therefore, urge the authorities to reconsider plans for further cuts and, indeed, call on them to augment their level of assistance as soon as the budget situation improves. With these remarks, we wish the authorities success.

Mr. Autheman said that he agreed with the thrust of the staff analysis. It was pleasing to note that the confident tone of recent Article IV consultations with Japan had proved to be well justified, despite widespread skepticism. Indeed, the Fund staff's assessments on the prospects for the Japanese economy had proved to be among the most accurate available.

As there were no major problems with the authorities' overall policy stance at the present juncture, he could limit his comments for the current discussion, Mr. Autheman stated. He was somewhat less optimistic than Mr. Yoshimura with respect to Japan's growth prospects, especially given the low level of confidence in the small business sector, which could be taken as a signal of lingering weaknesses. The staff projection on the growth potential of the Japanese economy was moderate, it might prove to be overly optimistic.

Although the fear of a major crisis in the financial sector had subsided, the authorities should bear in mind that suspicions lingered abroad, Mr. Autheman commented. Therefore, the prospects for future bouts of financial market tensions could not be ruled out.

He agreed with the staff that fiscal policy should be oriented toward the medium term, Mr. Autheman continued. In that respect, the Japanese authorities seemed to have placed too much stress on the speed, rather than on the sustainability, of the adjustment required. Perhaps it would have been best to have adopted a slightly less ambitious program of fiscal consolidation in the coming year, while better clarifying the steps be taken toward structural fiscal reform in the future.

Although he had a great deal of respect for the views of Fund management on monetary policy, he would be reluctant to endorse a policy of inflation targeting for all countries, Mr. Autheman went on. The Bank of Japan had a good track record for maintaining low rates of inflation and it had established a high degree of credibility for its monetary management. Therefore, there was little reason for major changes in monetary policy. With respect to the recommendation that the Japanese authorities postpone further interest rate increases until clear signals emerge to indicate the recovery is clearly under way, it should be noted that the Japanese authorities had been very successful in convincing the markets that interest rates would need to rise at some point. Therefore, it might be costly to delay action for too long. In addition, the excessive weakness of the yen earlier this year shows that this might be the time to act. Also, the authorities should be careful to avoid any expectation in the banking sector that mismanagement problems could be shielded by sustained low interest rates.

The strong emphasis placed by the Prime Minister on deregulation, especially in the financial sector, was clearly welcome, Mr. Autheman stated.

Mr. Barro Chambrier made the following statement:

> At the outset, I would like to commend the staff for providing this Board with a very useful set of papers for today's meeting.
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> Like previous speakers, I am pleased to learn from the staff report and from Mr. Yoshimura and Mr. Ono's helpful statement that following four years

of economic stagnation, Japan's economic performance in 1996 has ranked among the highest level in the major industrial countries. This outcome has been the result of strong stimulative fiscal and monetary policies. The strong performance has also been reflected in the rate of inflation, which has remained low and in the strength of the external current account balance. Moreover, both the financial performance of the corporate sector and conditions in the labor market have improved. I am also pleased to note that the outlook for 1997 seems favorable, as evidenced by the data available for the first half of the year.

While commending the authorities for these positive achievements, I am, however, concerned by the fact that the Japan's economic recovery remains fragile and is also subject to downside risks. Indeed, as clearly mentioned in the staff report, among the major possible risks that could threaten to jeopardize the hard-won gains achieved so far are: the uncertainties about the longer term impact of the increase in the consumption tax on private consumption, the effects of increased income taxes and medical insurance costs, the declining labor force, and the uncertainties surrounding developments in the financial markets as well as future domestic and external demand. Also, it is worth noting that structural areas present many weaknesses, particularly given the serious problem of demographic pressures in Japan. These weaknesses need to be addressed, in order to ensure that Japan continues with a sustainable high rate of economic growth over the medium-term. Notwithstanding these risks, the authorities' recent firm commitment to medium-term structural and fiscal reforms augur well for the prospects for continued economic recovery.

I would like to make a few remarks on some issues highlighted in the staff report for emphasis.

In the fiscal sector, in light of the severe deterioration recorded in the fiscal area during the previous years, I find appropriate the decisive steps taken under the 1997 budget to reverse some of the exceptional stimulus measures used to support activity during the downturn period. As expressed by this chair during the last review, this action is an important step in laying the ground for fiscal consolidation. I also welcome all the fiscal consolidation measures contemplated in the 1997 budget and encourage the authorities to implement them forcefully. On the expenditure side, like others, I am pleased to note from Mr. Yoshimura and Mr. Ono's statement that the Japanese authorities have decided to intensify efforts to rationalize and improve the effectiveness and prioritization of expenditure. Should the need occur, I could agree that the authorities should implement a more ambitious fiscal consolidation to enhance credibility in their macroeconomic management.

On monetary sector, I welcome the revision of the Bank of Japan Law, which aims at improving the transparency and independence of the central bank. However, while noting the fragility of the recent economic recovery in Japan, it would be advisable that close and well defined collaboration be maintained between the Ministry of Finance and the Bank of Japan, in order to preserve the economic gains achieved so far. On the framing of monetary policy, I found the staff's statement that the Japanese authorities introduce a system of formal inflation targets intriguing, but not completely convincing.

First, it is not clear how inflation targets can work without reliable empirical relationships linking monetary policy action today with inflation in the future. Unfortunately, the staff's own empirical work concludes that the information content of financial variables in Japan has been unstable in recent years, perhaps reflecting the weakness of the financial sector. Lack of stable relationships on which to base monetary policy decisions would seem to cast doubt on the feasibility of inflation targets.

Second, like Mr. Yoshimura and Mr. Ono, I find it hard to see how inflation targets could have helped the Japanese economy avoid the slowdown of the early 1990s. Indeed, since inflation was fairly low during the time of the most rapid increases in asset prices inflation targeting might have exacerbated the bubble economy, by encouraging the authorities to lower interest rates.

Finally, with inflation already very low, it is hard to see what practical usefulness would follow from introducing inflation targets today: interest rates cannot fall any lower, and, even if inflation were to pick up a little, it is not clear how much weight monetary policy should put on price stability as opposed to sustaining the real economy.

However, I do agree with the staff that greater transparency in monetary policy could be of benefit, particularly when the output gap in the Japanese economy has reached more normal levels.

On the financial sector reforms, I would like to underline the staff's message of the importance of strengthening the financial sector. Relatively loose monetary policy is essential to prevent the necessary fiscal consolidation from depressing the economy. But loose monetary policy can only work if banks are healthy enough to extend credit. Interest rates are already low, but monetary growth seems relatively slow. A healthier financial system would surely help make monetary policy more effective.

I wonder whether more rapid deregulation of the financial is completely appropriate given the weaknesses of parts of the Japanese financial system. Allowing banks to enter new areas of business may simply encourage weak banks to engage in more risky behavior, in an attempt to stave off losses. If these new operations turn sour, this could exacerbate the problems of the weak banks. I would be interested to know the staff's assessment of the possible risks to deregulation and the measures needed to contain them.

On ODA, while commending the Japanese authorities for their continued efforts to provide financial assistance to the developing world, I note that in terms of ODA/GDP, it is still well below the U.N. target of 0.7 percent of GDP. We understand the budgetary constraints facing the authorities, however, Japan's strong economic position and taking into account the increasing needs of individual recipient countries, I would encourage the authorities to intensify their financial support efforts, so as to approach the U.N. target in the near future.

Finally we would like to wish the Japanese authorities further success in their economic recovery and fiscal consolidation efforts.

Mr. Yakusha made the following statement:

We agree with the staff that the approach taken by the Japanese authorities to financial sector restructuring seems to lack a clear framework for dealing with problems at the major banks. The use of public funds to support big banks on an ad hoc basis does not adequately take care of the problem of moral hazard. However, the staff's suggestion to preemptively close down nonviable banks seems to be rather radical at the present stage, when a large part of bad debts have been written off. It might be seen as a break from past approaches and, therefore, could lead to unnecessary unrest in the financial markets.

Ideally, measures to improve the health of the banking sector should be linked to the envisaged reforms and regulations of the financial system. In this context, we wonder whether the staff could comment on the recent publication on the financial sector reform in Japan, which suggests integrally that the envisaged reform would hurt the banking sector much more than advertised. Does the staff share this view?

The Deputy Director of the Asia and Pacific Department said that there was no universal agreement on how the fiscal deficit should be calculated. The staff had chosen to focus its analysis on measures of the deficit that both included and excluded the social security fund to take into account the unique demographic circumstances of Japan. In particular, although the social security fund was in surplus at the present stage, it faced huge unfunded future liabilities, owing to the prospect of a large increase in the number of retirees. Therefore, looking at the fiscal balance without excluding the substantial current surpluses of the social security system would underestimate the fiscal problem.

Both the general government deficit and the social security fund would face mounting problems over the next two decades and beyond unless substantial corrective actions were taken in the near term. For example, even taking into account the measures included in the 1994 tax reform plan, the situation with respect to social security was projected to worsen rapidly over the period ahead, owing to population aging, unless significant pension reforms were put in place. In particular, the net debt of the government, excluding social security, was projected to reach nearly 75 percent of GDP by 2003, and gross debt, including social security, could reach more than 100 percent of GDP. Those projections clearly highlighted the need for substantial measures, including pension reform, to bring the fiscal situation onto a sustainable longer-term path.

Against that background, the Deputy Director noted that the increases in income taxes and consumption taxes that became effective in 1997 were part of the 1994 tax reform plan that had been delayed, owing to the recession. The staff supported the authorities' resolve to put those measures in place as soon as the economic environment would permit, especially as further delays could ultimately risk the overall credibility of the fiscal consolidation program.

The staff considered that the goal to contain the sum of revenues, the government deficit, and social security contributions to less than 50 percent of GDP was appropriate, as it would help to contain future increases in the contribution rates of social security—including for health benefits—which were projected to rise from 14.5 percent in 1994 to over 34 percent by 2025, the Deputy Director said. As such contribution rates over time would clearly place an undue burden on future generations, there was a need for urgent actions to preserve intergenerational equity. The fiscal goal advocated by the staff was certainly ambitious, but it was attainable. However, it would require more ambitious fiscal efforts than currently envisaged by the authorities. According to the staff's estimates, consolidation measures amounting to about 1 percent of GDP per year over the next four years would be required to place the fiscal position on a sustainable basis by the beginning of the next decade.

It should be noted that, in the case of Japan, the staff's recommendations in favor of inflation targeting were not based on the need to enhance the credibility of monetary policy, the Deputy Director stated. Indeed, the staff would agree with Executive Directors that the Japanese authorities did not lack inflation-fighting credibility. Rather, the staff considered that setting quantitative goals for monetary policy would reinforce the benefits of formal Bank of Japan independence by enhancing transparency and, therefore, accountability. In the case of Japan, it was important not only to contain inflation, but also to set a lower bound for inflation. Such a lower a bound could provide a buffer against deflationary pressures that could arise as a result of, inter alia, a possible liquidity trap.

It was important to bear in mind that part of the value of inflation targeting was in its forward-looking approach, the Deputy Director commented. The use of inflation targeting might have been helpful in 1994–1995 in prompting more timely policy easing. At that time, inflation rates had been low and the pressures had been on the downside, particularly given the sharp appreciation of the yen and the large excess capacity in the economy. Similarly, the rate of inflation had been low in 1986, but at that time, the pressures had been in the opposite direction, owing to the huge increase in asset prices, and the economy had been operating at a level above capacity. Against that background, the important issue was not the adoption of formal inflation targeting so much as taking a forward-looking and transparent approach to monetary policymaking.

The staff considered that it would be premature to raise short-term interest rates at the present stage, the Deputy Director continued. The question of appropriate monetary tightening in the case of Japan clearly entailed a matter of timing, as there was a need to strike a careful balance between a preemptive tightening, which could thwart the recovery, and waiting too long. There were no clear signs of building inflationary pressures in Japan at the current juncture. Despite the effects of the recent increase in consumption taxes, there were no strong upward pressures on wages and the economy still had excess capacity of about 3 percent of GDP. Nevertheless, there might be a need for a moderate increase in short-term interest rates later in the year, as the recovery began to take hold. Even then, the rise in interest rates would likely be gradual.

The staff did not expect such a gradual increase in interest rates, when it occurred, to have a significant adverse impact on banking activities, the Deputy Director added. Indeed, interest hikes would likely represent a positive development, as they would reflect the effect of economic recovery. The banks would be subject to more difficulties in a weak economy, since this would likely exacerbate their balance sheet problems, than they would be in a stronger economy experiencing somewhat higher interest rates. Similarly, a stronger recovery in Japan, associated with higher interest rates, would be beneficial to the regional economy. Moreover, the effect of a small increase in Japanese interest rates could easily be offset by other monetary and exchange rate developments within the region or by the domestic circumstances of individual countries.

The staff projected only a decline in inflation to about 1.3 percent for 1998, the Deputy Director added. That projection had taken into account the lingering impact of the increase in consumption taxes, which would likely continue until the end of April 1998. As the economic recovery got under way and excess capacity diminished, somewhat stronger inflationary pressures could emerge, but they were not likely to be significant.

The staff was not in a position to comment in detail about the extent to which the consumer price index in Japan might contain measurement bias, the Deputy Director said. The same considerations related to the measurement of the consumer price index in other industrial economies would likely apply to Japan. On that basis, the index could contain a modest bias, of, say, ½ of 1 percentage point.

The staff's recommendation that policy not target the level of external balance—despite the role of the Fund to help lessen the duration and degree of disequilibrium in members' balance of payments—was centered on the question of how disequilibrium should be defined, the Deputy Director stated. For a mature economy, like that of Japan, where the national savings rate was very high relative to other countries, and there was less scope for higher future growth rates, there was reason to believe that a certain portion of savings would be channeled through international capital markets to other economies, where the rate of savings might not be as high and/or where there was more room for productive investment. It was also important to note, in the case of Japan, it was not clear that the external surplus was the result of substantial structural rigidities. Over the past two and one-half decades, Japan had consistently followed liberalization policies. Although it was questionable whether the progress made toward liberalization had been sufficiently rapid, it was clear that continued economic liberalization was under way, and, at the current stage, fluctuations in the current account reflected mainly cyclical considerations.

The staff projections showed that the current account surplus was likely to remain in the area of 2½ percent of GDP over the medium term, the Deputy Director noted. In the longer run, the surplus was likely to decrease, owing the aging of the population and the associated decrease in savings. In the staff's view, a surplus of this magnitude was not large enough to create problems in the global capital markets.

Taking into account those considerations, it would be best to focus policies on continued progress toward liberalization and the removal of remaining trade distortions, the Deputy Director considered. Focusing policies on the size of the current account surplus alone could lead to inappropriate macroeconomic adjustment and distract from the liberalization effort.

The major objective of the "Big Bang" policy was to enhance the efficiency of the financial system, the Deputy Director said. It was envisaged that some of the smaller, nonprofitable banks would be absorbed by larger, more efficient banks. In that context, it should be noted that almost all of the recent mergers between foreign financial institutions and domestic Japanese banks had involved relatively weak Japanese banks. It was hoped that the liberalization program would act as a catalyst for further efficiency gains in the system.

Nevertheless, there was no room for complacency. Since there were clearly problems within the banking sector that needed to be addressed. It was for that reason that the staff had called for a comprehensive plan to deal with nonperforming loans and for improvements in banking supervision and regulation.

With respect to the Japan's exposure to Thailand, it should be noted that although Japanese banks accounted for one half of Thailand's $70 billion loans, the amount of exposure represented less than 1 percent of the assets of Japanese banks, the Deputy Director of the Asia and Pacific Department commented. Also, much of the loans from Japanese banks were to enterprises in Thailand in the traded goods sector. As those industries were export-oriented, they would likely benefit from the devaluation of the baht. Against that background, recent events in Thailand were not considered to be a serious cause for concern for the Japanese banking sector.

The staff representative from the Asia and Pacific Department said that the staff report for the current discussion did not differ significantly from the staff paper on developments, prospects, and key policy issues in international capital markets (SM/97/190, 7/16/97) in terms of the staff's assessment of the bad loan problem in Japan. However, those papers differed somewhat in their focus. The staff paper on international capital markets had focused on the level of nonperforming loans in Japan, which had not changed significantly since 1993, and had concluded that the actual level of such loans was likely much higher than indicated by the official data. Those findings were consistent with the data contained in the staff report for the current discussion. However, the staff report for the current discussion was based on the view that the best indicator of developments with respect to the nonperforming loan problem was the net uncovered losses of financial institutions, rather than the gross amount of problem loans in the system. From that perspective, the staff report showed that the problem had worsened in the period 1993 to 1995, but that it had improved substantially, especially with respect to the major banks, over the past two years.

The data in the staff report for the current discussion was also consistent with the view expressed in the staff paper on international capital markets that the bad loan problem in Japan was moving toward a resolution, the staff representative stated. Present indicators suggested that the major banks as a group should be in a position to cover their existing nonperforming loans out of operating profits within the next year or two.

A number of tax measures aimed at enhancing the efficiency of the financial sector were currently under consideration by the Japanese authorities, the staff representative noted. One proposal was to change the corporate income tax system for holding companies to make the establishment of financial holding companies more attractive. That would allow consolidation in the financial industry to take place in a way that was less costly relative to other possible means of consolidation. The authorities were also undertaking a review of the securities transactions tax with a view to reducing or eliminating it in 1998–99. Such a move would likely encourage a greater volume of trading in the Japanese financial markets. In addition, the authorities were reviewing the tax treatment of securitized assets with a view to encouraging development of the market. Such measures should also help further the process of financial market liberalization.

The staff would agree with Mr. Esdar that the tax advantages of public financial institutions might help to explain their relatively large size, the staff representative continued. For example, the postal savings system was exempt from paying deposit insurance premia or corporate income taxes. There were also a number of explicit and implicit subsidies on lending through government financial institutions. Although a number of proposals for mergers of some government financial institutions had been put forward, they were not likely to have an impact on the basic system. While some suggestions had been made about possible privatization of the postal savings system, no concrete plan of action was expected to emerge in the period immediately ahead.

However, measures to improve transparency and supervision in the financial sector were expected to take effect over the coming year, the staff representative went on. There would be a shift from the current registrations to a licensing system for financial companies, which should make it easier to start up new financial institutions. Of course, much would still depend on how the "Big Bang" policies were reflected in the implementation of existing regulations in Japan.

In theory, there was a level playing field in Japan, which was among the most open economies in terms of access by foreign financial institutions to the Japanese market, the staff representative added. However, in practice, the level of new entries was very low. The reasons often cited for not entering the Japanese market included the complexity of the regulatory framework and the limitations on the activities of specific types of institutions. In addition, the costs of entering the Japanese markets, such as the high cost of land, were prohibitive. The "Big Bang" policies should provide a more transparent system of regulation and supervision and reduce the barriers between the activities of different types of financial institutions. That should make the Japanese market more attractive for foreign financial institutions. At the same time, foreign institutions had the kind of expertise that would be needed in a deregulated financial environment.

Although the "Big Bang" policies might lead to a weakening of profitability, especially for large wholesale banks, the deregulation of the market would make them more attractive targets for mergers, the staff representative commented. Indeed, some foreign financial institutions had already expressed considerable interest in some of the weakest of the Japanese banks.

Although, as Ms. Lissakers had noted, there were market concerns about whether a large number of life insurance firms could be in serious difficulties, the staff did not have sufficient information to comment on those concerns at the present stage, the staff representative said.

It was interesting to note that Japan's current account surplus—which was roughly equal to total capital outflows through the balance of payments—had fallen substantially from over 3 percent of GDP in 1993 to less than 1.5 percent of GDP in 1996, at a time when interest rates in Japan had been cut substantially, the staff representative commented. The relationship between interest rate changes and capital outflows was complicated, and dependent on the savings/investment balance. Lower interest rates in Japan had boosted domestic spending, which, in turn, had contributed to lowering the current account surplus and Japan's capital outflows. At the same time, however, the depreciation of the exchange rate had had the effect of raising net exports and domestic savings, but that had been offset to some extent by structural changes to trade flows.

With respect to whether privatization proceeds could play a role in fiscal consolidation, it should be recalled that the privatization of the major sectors, like the railways and telecommunications, had begun in the late 1980s, the staff representative noted. However, the government had remained a major shareholder in those companies, and it still held a large volume of shares in the privatized companies that it intended to sell. Although the staff did not have full information on the aggregate value of those shares, it was likely to be significant. For example, the government's holdings in Nippon Telephone and Telegraph, which amounted to about 65 percent of remaining shares, were worth about ¥12 trillion, or the equivalent of about 2.5 percent of GDP.

The government was still a major financial intermediary, the staff representative said. In addition to the postal savings system, which was a depository institution, there were a number of government lending institutions that benefited from both explicit and implicit subsidies. While there would presumably be some fiscal advantage if the government were to divest itself of those financial institutions, the staff was not in a position to assess the overall effect such divestiture might have. Based on the available information, the staff considered that the advantage could be on the order ½ of 1 percent of GDP.

As the staff report indicated, in terms of GDP, land prices had fallen to below the levels prevailing prior to the asset price bubble, the staff representative stated. From that perspective, a more reasonable relationship between land prices and economic activity had been established. Prices for commercial land in Tokyo had fallen below those in Hong Kong, China and in Singapore. Thus, there was no evidence to suggest that land prices in Tokyo were currently overly priced compared with the Asian region. The general perception within the markets was that land prices had bottomed out in Japan. Although no increase in land prices was expected in the period ahead, it was envisaged that the market for land would likely become more liquid since the reduction in prices.

Banks in Japan were continuing to rely on land as collateral to a significant extent, the staff representative from the Asia and Pacific Department commented. However, that was likely to change in the period ahead, as banks developed more sophisticated systems for assessing risk and judging the quality of borrowers on the basis of criteria other than land collateral. In addition, steps were being taken to make the market for securitized assets more attractive. That was expected to lead to the creation of a new market for collateralized loans that would not be intermediated by the Bank of Japan, but by broader capital markets. Those two developments suggested that the reliance on land as collateral for bank lending might decline in the future.

Mr. Yoshimura thanked Executive Directors for their comments in support of the thrust of both fiscal and monetary policies in Japan.

As to the balance between revenue-enhancing and expenditure-reducing measures in the fiscal program, the Cabinet had agreed in early June on further efforts to reduce public expenditure, including in social security and public investment, Mr. Yoshimura noted. The authorities were making every effort to decrease public expenditure in order to achieve lasting fiscal consolidation.

Directors had offered useful advice for the future course of monetary policies, Mr. Yoshimura said. The Bank of Japan was fully committed to take appropriate monetary actions at the appropriate time in order to enhance its credibility and to strengthen its formal independence.

With respect to the external surplus, the Japanese authorities were committed to the promotion of a recovery led by domestic demand, Mr. Yoshimura stated. Although the recovery process had been led by an increase in investment, it had been followed by increases in production and employment, and the recent rise in consumption. Against that background, the Japanese authorities hoped to promote the virtuous cycle currently in place in order to put the recovery on a more sustainable footing and to realize higher rates of growth led by domestic demand.

As to the recent improvements in the financial sector, which had been widely recognized by Directors, the staff was correct to point out that the net losses caused by the bad loan problem had decreased considerably over recent years, Mr. Yoshimura commented. The authorities were making every effort to enhance transparency by clarifying and improving disclosure requirements based on the standard of circulating nonperforming loans. Recent estimates on the amount of nonperforming loans, based on Japanese standards and the U.S. Securities and Exchange Commission standards, indicated that they totaled about 10 percent of all loans in the case of Tokyo Mitsubishi Bank and the Industrial Bank of Japan. Those two banks were listed on the New York Stock Exchange.

As in other countries, Japan's official development assistance was subject to public scrutiny and the need to ensure that government activities were fully effective, Mr. Yoshimura continued. The matter of external financial assistance would likely be subject to further debate in Japan, and reductions in the level of official development assistance were possible. Nevertheless, the Japanese authorities continued to attach significant importance to the assistance made available through multilateral financial and development institutions, like the Fund and the World Bank.

The activities of Japanese financial institutions in Asia were closely linked to the development of Japanese manufacturing industries within the region, Mr. Yoshimura noted. From that perspective, the commitment to Asian markets was firm and, thus, not swayed significantly by short-term developments.

As some Directors had pointed out, it was not easy for foreign financial institutions to enter into the Japanese market, especially along the same lines traditionally expected by Japanese businesses and consumers, Mr. Yoshimura commented. The same was true for Japanese banks trying to enter into European or other markets. Nevertheless, the "Big Bang" policies were aimed at deregulating the financial sector and enhancing opportunities for foreign financial institutions to participate in the Japanese market. For example, the recent alliance between the Swiss Bank Corporation and the Long-Term Credit Bank of Japan seemed to have good prospects for participation in the Japanese market both in private banking and investment banking.

Although the details of the arrangements concerning the Policy Board of Bank of Japan had not yet been decided, it was expected that the government would announce its contents to the public soon, Mr. Yoshimura stated.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the staff appraisal. They welcomed the robust growth of the economy in 1996, which reflected the impact of policies to support aggregate demand and the correction of imbalances that had contributed to the prolonged downturn. Directors broadly endorsed the staff's view that the recovery was becoming self-sustaining, although some speakers pointed to uncertainties in the short term, including the effects of the recent consumption tax increase and continuing financial sector problems. Most Directors observed that the central challenge for policymakers was to return the fiscal balance to a more sustainable level over the medium term. Directors believed that the current easy stance of monetary policy should be maintained for the time being, but that it would likely be desirable to begin tightening later in the year, when the full effects of tax increases on activity would be apparent. While important steps had been taken to resolve the strains in the financial sector, Directors noted that a clear framework was needed for dealing with problems among the weakest of the major institutions. They emphasized the importance of deregulation and structural reform in ensuring robust growth in Japan over the longer term, particularly in light of the aging of the population.

Directors endorsed the fiscal correction measures enacted in the 1997 budget as a step in the right direction, given the large budget deficit and to prevent a further increase in the already high level of public indebtedness. Looking ahead, Directors welcomed the government's announcement of plans for medium-term fiscal consolidation and proposals for spending restraint in next year's budget. A number of Directors, however, thought that a faster pace of consolidation would be desirable to address the fiscal strains associated with population aging in the longer term, and broadly endorsed the staff's suggestion that consolidation measures averaging 1 percent of GDP per year be taken over the next four years. In this context, some Directors noted that the confidence gains from the prior announcement of a credible fiscal consolidation plan could go a long way to help reduce the associated output costs. Several other Directors, however, considered that, while medium-term fiscal consolidation remained crucial, it would be important to balance the need for a front-loaded approach with the need to ensure a strong and sustainable pace of economic expansion. Several Directors noted the sharp rise in social security contribution rates that would be needed to keep the system solvent under current plans, and urged that measures be taken to moderate benefits and achieve a more balanced adjustment.

Noting the complexity and lack of consolidation of the Japanese budget, Directors agreed that increased transparency of government operations in fiscal accounts would permit a clearer assessment of the fiscal position, as well as enhance policy credibility. The inclusion of off-budget items and the identification of unfunded liabilities in the budget were of particular importance in that regard. Several Directors also held the view that reforms to the process by which government investment outlays were allocated would be helpful in ensuring fiscal restraint over the longer term.

Directors noted that, while the current low levels of short-term interest rates had played an important role in stimulating the economy since mid-1995, they were not appropriate over the medium term. The key monetary policy issue was, therefore, how to maintain support for the recovery, while not unduly delaying needed adjustments. Most Directors agreed that the current monetary stance should be maintained at present, and that the pace and timing of future interest rate increases would depend on indications of the strength of the recovery, including the effects of medium-term fiscal consolidation measures. A few Directors, taking into account the very low level of current interest rates, suggested that there was scope for an early, albeit cautious, move to raise interest rates in a preemptive manner.

Directors welcomed the increased independence granted to the Bank of Japan, and recommended that that policy be given full operational effect. While a few Directors considered that setting a target range for inflation with a lower bound somewhat above zero would clarify monetary objectives and enhance accountability, most Directors were not convinced that the present policy framework needed changing, especially given Japan's enviable record of low inflation.

Directors believed that the current level of the yen was broadly in line with fundamentals. Most Directors agreed that the associated rise in the current account surplus reflected a desirable redistribution of global demand pressures. They thought that the present level of the current account was not a cause for concern and that policies should not target a specific current account position. The view was held, however, that a rise in the surplus, if sustained, could fuel protectionist pressures abroad.

Directors strongly supported the government's commitment to deregulation and structural reform, which would be an important element in ensuring robust, longer-term economic growth in the face of an aging population. Noting that the financial system remained vulnerable to shocks, Directors endorsed the "Big Bang" financial sector reform plan, and urged that it be implemented forcefully and fully. They also noted that the envisaged reforms heightened the need for a strengthened supervisory framework and a more arm's length approach to regulation. Directors urged the authorities to push ahead with deregulation on a broad front, expanding and accelerating existing commitments.

Some Directors welcomed the recent proposal aimed at deregulating transportation, telecommunications, and power generation, and encouraged the authorities to press ahead with similar reforms in the areas of land use, distribution, and marketing. While noting the recent progress in trade liberalization, some Directors called for further actions to remove existing barriers to trade and to increase market access, including in agriculture. Such efforts would serve to enhance Japan's welfare, as well as that of Japan's trading partners. Directors also welcomed Japan's commitment to the multilateral trading system and the World Trade Organization. Pointing again to demographic trends in Japan, some Directors underscored the importance of labor market reforms, including steps to enhance education and training, facilitate labor mobility, increase the flexibility of working hours, and encourage participation by older workers.

Directors welcomed the progress made over the last year in addressing financial sector problems, but noted that the strengthening of the banking system should remain a priority. Several Directors pointed to the continuing need to accelerate the pace of writing off bad loans. Actions were also needed to guard banks' balance sheets against swings in share prices, to improve financial disclosure and accounting standards, and strengthen supervision and regulation. Directors believed that a clear framework was needed for resolving problems among the weakest of the major banks in a way that would avoid burdening healthy institutions. Some Directors also believed that an explicit commitment of public funds could help reduce systemic risks, while others expressed concern about the fiscal costs and the effects on incentives of such an approach. In addition, several Directors were of the view that market-oriented reforms should be applied to nonbank financial institutions.

Directors commended Japan for its role as the world's largest donor of official development assistance (ODA). However, they also noted that ODA spending had fallen in 1996 and was projected to continue to fall in the future. They urged Japan to try to find new resources even during this period of fiscal restraint, and to ensure that everything possible was done to raise the quality of ODA spending.

In conclusion, Directors were gratified by signs that Japan's recovery was becoming self-sustaining. They emphasized the need to ensure that the recovery matured into a balanced expansion by complementing fiscal consolidation with appropriate monetary policies, and vigorous deregulation and structural reforms. Directors welcomed the promising start made by the authorities in those areas, and urged that the current impetus for reform be used to accelerate and expand those initiatives.

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

3. GUINEA-BISSAU—ENHANCED STRUCTURAL ADJUSTMENT FACILITY—THIRD ANNUAL ARRANGEMENT

The Executive Directors considered a staff paper on Guinea-Bissau's request for the third annual arrangement under the Enhanced Structural Adjustment Facility (EBS/97/129, 7/10/97). They also had before them a policy framework paper for the period 1997–99 (EBD/97/82, 7/10/97).

Mr. Barro Chambrier made the following statement:

Guinea-Bissau has made significant progress in some areas in the framework of a medium- term adjustment program supported by a three-year ESAF arrangement covering 1995-1998. The rate of GDP growth accelerated in 1995 and 1996, and the external current account deficit (excluding official transfers) declined by over 7 percentage points of GDP during this period. The primary budgetary balance recorded surpluses equivalent to 4 percent of GDP in 1995 and 3.3 percent of GDP in 1996. As regards structural reforms, notwithstanding a limited administrative capacity, significant progress was also made in the privatization program. Despite some delays in the liquidation of the national airline and the restructuring of the Road Fund, a number of public enterprises were liquidated, eight enterprises were put up for tender, of which three were sold at end 1996. The census of civil service was completed and will provide the basis to accelerate the civil service reform.

On the inflation front, performance was less satisfactory, mainly because of difficulties to control the growth of money supply fueled by increases in net foreign assets. Another factor that contributed to inflationary pressures in 1996 was the 31 percent devaluation of the country's currency that took place during the third quarter.

Against this background, the authorities have revised their medium-term adjustment program and emphasis has been put on strengthening the financial policies and deepening the structural reforms. They recognize that fiscal policy should play even a more important role in their medium-term adjustment strategy, particularly after Guinea-Bissau adhesion into the WAMU on May 2, 1997. While the WAMU membership is expected to be beneficial to Guinea-Bissau, it also places additional requirements on the strengthening of the country's fiscal situation. With that in mind, the authorities intend to further increase the primary surplus of the budget from the equivalent of 3.3 percent of GDP in 1996 to 5.6 percent of GDP in 1999. To achieve this improvement, efforts will be made to mobilize a higher level of fiscal revenue and tightly control expenditure and net lending. On the revenue side, it should be noted that total revenue at 12.4 percent of GDP in 1996, remains below its potential, because of revenue shortfalls largely attributed to the delay in exporting part of the cashews crop. To improve revenue performance, the authorities have already taken appropriate steps to implement a comprehensive tax reform package that includes, the introduction of a generalized sales tax, the revision of excise taxes and of petroleum taxation, as well as a reduction in export taxes. Furthermore, my authorities intend to harmonize and simplify the external tariff in line with the common external tariff to be adopted in the regional integration context. An improvement in tax administration is also expected to contribute to an increase in government revenue.

On the expenditure side, efforts are being made to shift resources from non productive outlays to priority sectors of health, education and basic infrastructure. To this end, the system of expenditure control is being strengthened. The system of prior authorization of expenditure commitment will become effective for all ministries by the end of 1997. With regard to the government wage bill, it is being reduced, while an improvement of the compensation system of skilled personnel is taking place. At the same time, efforts will be made to reduce the size of civil service and military personnel. Nonpriority expenditure items including travel and embassies will be compressed The budget will provide adequate room for consumption of public utility services, in order to avoid the accumulation of payment arrears. All these measures will help to keep a close track of expenditure commitments. As regards capital outlays, the authorities objectives are to promote rural development and labor-intensive projects to be included in three-year rolling public investment programs.

Guinea-Bissau's monetary policy will be conducted within the framework of the WAMU. Like in other member countries of the BCEAO, monetary policy will aim at strengthening the international reserves position and at containing the growth of domestic credit, in order to bring the rate of inflation down. As a consequence of the WAMU membership, interest rates have become subject to negotiations between the commercial banks and their clients. This membership has also enabled domestic banks to have access to the monetary interbank and financial market of the Union. This access will, no doubt, permit an efficient management of bank liquidity. Bank credit expansion will also now be limited mainly by the prudential regulations on the capital-asset ratio. With the expected improvement in the monetary system, which will bring about price stability, it will be possible to improve credit conditions for the private sector. Apart from the banking system, the authorities also intend to develop a network of mutual funds and loans institutions, which will extend to rural areas, thus providing support to small scale projects.

In the structural area, the authorities recognize the need to accelerate public enterprise reforms. To that end, they intend to launch the divesture of some enterprises. They will also pursue their actions in the area of civil service reform, with the objective of establishing a more efficient public administration. A comprehensive action plan to reduce the size of the civil service will be prepared and submitted to the donor community in about 12 months.

On the external sector, it should be noted that Guinea-Bissau is one of the heavily indebted poor countries. The net present value of its external debt represented over 19 times the value of its exports of goods and nonfactor services at the end of 1995. In 1996, debt service obligations were equivalent to 110 percent of receipts from exports of goods and nonfactor services, and 72 percent of government revenue. These indicators are out of line when compared to the averages of HIPCs. Under the circumstances, a timely and substantial debt relief in concessional terms will be critical for Guinea-Bissau to pursue its medium-term adjustment program successfully .

In conclusion, there is no doubt that the Guinea-Bissau authorities have recorded significant improvements in the implementation of their macroeconomic and structural reforms. They are aware that more sustained efforts are needed to reduce financial imbalances further and to maintain a strong economic growth. As a new member of the WAMU, Guinea-Bissau expects a new impetus in the management of its economy, including the implementation of structural reforms. They are confident that they will be able to achieve their medium-term objectives. However, the continued assistance of the Fund and other donors will remain critical to this end.

Mr. Mori made the following statement:

We welcome Guinea-Bissau's entry into the West African Monetary Union (WAMU) and the West African Economic and Monetary Union (WAEMU). This important step will contribute to the country's monetary and exchange rate stability, and foster regional integration. However, it also places additional requirements on the strengthening of government finances to reap the macroeconomic benefits of monetary union.

Economic performance in 1996 was encouraging with real GDP growth estimated at 5 percent. Inflation surged early in 1996, but it was sharply curtailed toward the end of the year, through strict monetary policy actions, declining further in the first quarter of 1997. The external current account deficit, excluding grants, declined to 20.5 percent of GDP from 23.6 percent in 1995. Primary budgetary surpluses of 4 percent of GDP in 1995 and 3.3 percent of GDP in 1996 were attained, and progress was also made in the privatization program. The overall record of program implementation was broadly satisfactory. For the medium-term adjustment strategy, however, efforts are necessary to improve further the budgetary performance and accelerate structural reforms.

In this context, the proposed adjustment program seems to be appropriate to address weaknesses in the fiscal and structural areas. The fiscal program contemplates an increase in the primary surplus to 5.0 percent of GDP in 1997 and 5.3 percent in 1998. On structural reforms, the program focuses on (i) accelerating the privatization program, (ii) reorganizing the energy sector; (iii) continuing civil service reform; and (iv) improving the management of infrastructure. In addition, the staff informs us that the authorities took action recently to reinforce macroeconomic management and improve the basis for sustained economic growth.

A high and sustainable growth rate is essential for development and poverty alleviation. However, well-targeted actions are necessary, especially in health and education sectors, where serious shortcomings persist. The authorities' strategy in this respect is appropriate, as priorities of the public investment program are centered on (i) stimulating rural development; (ii) strengthening resources for education, infrastructure, and health; and (iii) promoting labor-intensive programs. However, given the heavy external debt burden, substantial external assistance in the form of grants and concessional loans continues to be fundamental to support Guinea-Bissau's macroeconomic and investment programs.

We support the proposed decision in light of the progress achieved so far, and the comprehensiveness of Guinea-Bissau's adjustment program.

Mr. Gruber made the following statement:

We thank the staff of the Fund for the preparation of this excellent document which provides a comprehensive overview over the key issues of Guinea-Bissau's economic policy. We can fully agree with the general thrust of the paper which concentrates on (i) the issues arising from the country's adhesion to the WAMU, (ii) on the direly needed reforms in the fiscal area and in the social sectors, and (iii) on the remaining problematic external debt situation and the importance of the HIPC Initiative for Guinea-Bissau.

Progress under the economic and structural reform program has been slow, but nevertheless significant. Guinea-Bissau has mastered, after all, the transition from a planned economy to an open market economy in a very short time. Economic activity has been restored, mainly due to a rapid evolution of the agricultural export sector, and the government has made an exceptional effort to privatize key industries and to restructure the civil service sector. Drawbacks on the front of monetary policy can be partially explained with exogenous factors, and under-performance in this area will disappear with the entry of Guinea-Bissau into the WAMU. Thus, the government will be able to focus on the challenges in the fiscal area and in the health and education sectors.

As we broadly agree with the thrust of the staff's assessment, we confine ourselves to a few remarks with respect to the proposed program:

On the fiscal policy, we agree that fiscal reform is one of the most urgent areas that need to be addressed by the government, and we believe that the combination of a customs' tariff reform and an introduction of a consumption tax points in the right direction. There is, however, a risk that revenue losses will occur in the short-run due to the transition to the new system, especially if there is a delay in the introduction of the consumption tax. We therefore call upon the authorities and the staff to closely monitor the development of revenues in the short term.

On the monetary policy, Guinea-Bissau will clearly benefit from its entry into the WAMU in terms of exchange rate stability, low inflation and a rebirth of a functioning banking sector. However, there still remain a number of issues that need to be resolved in connection with the adhesion:

First, there still needs to be clarification as to how the country will pay for its participation. Although the government's plans of a payment on a graduated schedule over a number of years seems to be a feasible solution, it is not clear if it is acceptable to the other member countries of the WAMU.

Second, information of the public by the government and the Central Bank of Guinea-Bissau on the WAMU and the adhesion process seems not to have been handled in an optimal manner, and there is a risk that a significant part of the population, especially in the rural areas, will not be able to meet the deadline for the exchange of the Peso in CFA francs (July 31, 1997). If no precautionary measures are taken, this would lead to an undesirable loss of savings and wealth of the groups concerned.

Finally, it should be pointed out that Guinea-Bissau's liquidity requirements change over time, and are largely dependent on the harvesting cycle of the cashew production. In the longer run, the banking sector will be able to address this situation by drawing on funds from the WAMU-area as a whole. But for the time being, the country seems to experience a serious money shortage, which is hampering the export sector.

Comments by the staff on these three issues would be appreciated.

Let me finally turn to the external sector. Exports remain highly concentrated in one area, namely cashew, which makes the external position of the country highly vulnerable. Perhaps staff could elaborate more on the strategy of the authorities to address this matter in the longer run and on what support is provided by the Fund and the Bank in this field.

The debt burden is certainly one of the most urgent problems Guinea-Bissau is confronted with. We fully support the staff's recommendation to address this problem by strengthening the debt management structure, pursuing an extremely prudent debt policy and continuing the negotiations with bilateral creditors to obtain debt relief on Paris Club terms. Moreover, we are looking forward to the presentation of the revised debt sustainability analysis which can provide the basis for an assessment of Guinea-Bissau's qualification for assistance under the HIPC Initiative.

With these remarks we support the authorities' request for the third annual arrangement as well as for the increase and extension of the three-year ESAF arrangement.

Mr. Loevinger made the following statement:

As the staff says in its assessment, Guinea-Bissau's overall record of implementation was somewhat mixed. I'd say their characterization is a bit generous. Last year, the current primary surplus was 1.5 percent of GDP less than programmed. This, along with an insufficiently tight monetary policy led to inflation that was over 50 percent more than targeted. And there were slippages in privatizing and restructuring public enterprises. While there were short periods of good performance, which perhaps not so coincidentally seemed to precede ESAF disbursements, the authorities seem unable to sustain sound policies for more than a few months.

It's a little troubling to see the staff's response to this record is to not only recommend that the Board proceed with the third year of the ESAF after such a short period of good behavior, but agree to augment the program. Particularly since only a week ago, many chairs, including this one, concluded during our discussion of the ESAF review that one of the reasons why many ESAF-supported programs failed to achieve their main objectives was because the staff and this Board were too tolerant of policy slippages. I fear that the staff's desire to proceed with the third year at this point may have less to do with the confidence that the authorities can sustain strong policies, but more with the desire to get them the resources they need to contribute to the West African central bank before they go off track again.

In fact, if it wasn't for very ambitious commitments for the third year, and in particular the proposed trade reform, this chair would have had difficulty supporting the a third year, let alone an augmentation. But the proposed trade reform is ambitious and important enough that we are willing to support the authorities' efforts in this area.

> But there must be a much more consistent and sustained track record of strong performance before any HIPC decision point. In particular, as Mr. Mori notes in his statement, membership in the West African Monetary Union will require a more consistently sound fiscal policy than the authorities have run in the past. The authorities must keep in mind that while membership in a monetary union makes it imperative to run a sound fiscal policy, membership in itself doesn't guarantee that this will be achieved. What is required is political will, which so far seems to be in short supply in Guinea-Bissau.

Mr. Barro Chambrier said that Directors should not underestimate the progress that had been made by Guinea-Bissau under very difficult circumstances. It was important to bear in mind that Guinea-Bissau had limited resources and limited administrative capacity; the level of salaries in the civil service was very low and the country faced a very heavy debt burden. Despite those factors, Guinea-Bissau had achieved a primary budget surplus in both 1995 and 1996, along with an acceleration of GDP growth.

Unfortunately, inflation remained a significant problem, Mr. Barro Chambrier noted. However, in the context of Guinea-Bissau's participation in the West African Monetary Union (WAMU), there was reason to believe that monetary discipline would go hand in hand with the fiscal discipline achieved, and, therefore, that rates of inflation would decline in the future. In addition, the progress toward regional integration would enhanced the country's capacity to put in place a viable economic adjustment and reform strategy.

Mr. Fujii made the following statement:

> I am pleased that in 1996 economic growth was higher than expected and the current account improved more than was targeted. It is also commendable that the authorities achieved all of the benchmarks as of March 1997.
>
> I support Guinea-Bissau's entry into the WAMU. This will not only stimulate foreign investment and private activity, but also accelerate economic growth by implementing prudent monetary and exchange rate policy as well as promoting regional integration. In order to receive the beneficial effects from the entry into the WAMU, the authorities are expected to make continued progress in strengthening fiscal and structural adjustment.
>
> While the economic circumstances of Guinea-Bissau seem favorable, the country remains vulnerable to external shock because of its large reliance on the exports of cashew nuts, its heavy external debt, its significant dependence on external assistance to finance investment programs, and maintenance of balance of payments.
>
> On fiscal policy, I am concerned that budgetary performance in 1996 was somewhat weaker than expected. As the staff says, Guinea Bissau has achieved surplus in the current primary balance, however, the overall balance still shows a large deficit, which is the main factor in the current account deficit. As was noted in the discussion on the currency integration of the

European Union, reduction of budget deficits is necessary in order to join the monetary union.

Furthermore, when we look into the composition of both revenue and expenditure, we can see the vulnerability of the fiscal position. On the revenue side, the authorities depend largely on fishing licenses. They also need foreign grants, which approximately amount to total revenue. On the expenditure side, in addition to the ordinary outlays, the cost is high for the recapitalization of the central bank in 1997 and the capital share of the BCEAO will have to be paid for in the near future.

In these respects, it is fair to say that the fiscal position of Guinea Bissau remains vulnerable. The authorities should carry out fiscal consolidation. In order to improve the fiscal balance, it is important to implement comprehensive fiscal and structural adjustment, including improvement of the tax system and the tax administration, reduction of unnecessary outlays, civil service reform, and promotion of privatization. At the same time, in order to accelerate economic growth, the authorities need to attract foreign investment and stimulate private activity by maintaining prudent monetary and exchange rate policy under the WAMU. On the external debt, the authorities should increase creditors' confidence and maintain continued negotiations on debt relief by implementing prudent debt management. Assuming that the authorities make every effort in implementing these policies successfully, I support the proposed decision.

Finally, let me comment on the issue related to the HIPC Initiative. The staff indicates that Guinea-Bissau could arrive at a decision point after completion of this three-year ESAF program. However, it should be noted that the HIPC Initiative normally requires a three-year good track record before a decision is reached. I have strong doubts that completion of the third-year arrangement would automatically mean that Guinea-Bissau had arrived at a decision, because of the fact that the first-year arrangement went off track and that budgetary performance during the second year was weak.

With these remarks, I wish the authorities every success.

Mr. Fayolle made the following statement:

I agree with Mr. Barro Chambrier that Guinea-Bissau has made significant progress in the implementation of macroeconomic and structural reforms under the enhanced structural adjustment arrangement. Therefore, I have no problem supporting the proposed decision.

At the same time, there is no room for complacency and the international financial community should send a strong signal to the authorities to pursue this demanding path.

Like Mr. Fujii, I welcome Guinea-Bissau's participation in the CFA franc zone, which should raise the prospects for price stability and growth and enhance the credibility of its policies, particularly monetary policy. With respect to the arrangements for Guinea-Bissau's entry into the WAMU, the staff report indicates that the negative capital position of Guinea-Bissau's central bank at end-1996 and the associated recapitalization excluded provisions for separation indemnities to personnel still under negotiation. I wonder whether the staff could comment on the likely size of such separation indemnities and the way in which the negotiations on separation are expected to be conducted. Who will be responsible for the payment of these indemnities?

The Guinean authorities will have to follow very tight fiscal policies in the context of the monetary union. This will require determined fiscal efforts with respect to both revenue and expenditure. The poor revenue performance has to be improved with the tax reform and the strengthening of budgetary discipline. I welcome the indications contained in the staff report on the ongoing efforts to strengthen the budgetary process. Nevertheless, given the remaining weakness in Guinea-Bissau's administrative capacity, I look forward to the provision of timely technical assistance by the Fund.

As to the HIPC Initiative, the debt burden of Guinea-Bissau is unsustainable. Therefore, it will be crucial for Guinea-Bissau to successfully implement the current program, in order to reach the decision point for the HIPC Initiative recommended in the staff report.

At the previous discussion on the review of ESAF-supported programs, the need to strengthen program monitoring, such as through quarterly reviews, was highlighted. Given the exceptional circumstances and challenges facing Guinea-Bissau at the present stage, it provides a good example of where stepped-up monitoring efforts might be warranted.

Ms. Mercusa made the following statement:

As this chair indicated at the previous discussion on Guinea-Bissau, it is surprising to note the staff's suggestion for a decision point as early mid-1998. This is all the more true, given Directors' comments at the recent review of ESAF-supported programs, which called for more careful assessments of performance and more care in coming to decisions on such programs.

As Mr. Loevinger and Mr. Fujii noted, Guinea-Bissau's track record does not appear to be consistent with taking a decision at this point. The staff should not send any signals to the authorities that could create false expectations. Moreover, debt relief should not be sought in order to implement the measures needed to place the economy on a more sustainable path. Rather, it should be sought only after most of the needed measures have been implemented.

Mr. Prader made the following statement:

I share a number of Mr. Loevinger's concerns about Guinea-Bissau's economic performance. At this stage I would like to make the following comments:

First, I was surprised to read that the civil service census that seems to have been so useful for rationalizing the public sector and setting up a more comprehensive payroll data base still does not include the Ministries of Defense and the Interior. Incidentally, Mr. Barro-Chambrier's statement expresses the view that the civil service census is complete. I am aware that these ministries are probably the most difficult and sensitive part of the whole exercise, but it has to be one sooner or later if the public sector wage bill is to be gotten under control. I therefore strongly support the staff's recommendations.

Second, I would like to learn from the staff about the progress of the effort to improve budgetary procedures. The staff already recommended such an effort on the occasion of the last review, and I would be keenly interested to know whether the budgetary procedures described in paragraph 26 are sufficient or will require further strengthening.

Third, in formal terms the staff is absolutely right to argue that the requested extension of the three-year commitment period conforms to the regulations of the ESAF Trust. At the same time, I recall that the original ESAF instrument was conceived as a one-time low-interest loan with no possibility of renewal or extension, precisely in order to focus the attention of the beneficiary country authorities on making the adjustment as strong as possible, and to overcome the reluctance of creditors to accept this new instrument. The decision to introduce more flexibility with respect to the length of the commitment period and the amount of financing may have been partly motivated by the slower than expected progress of adjustment and reform under ESAF-supported programs, but it could also be worthwhile to ask whether retaining the tighter budget constraints and deadlines originally envisaged would have been more effective in accelerating the pace of reform. Guinea-Bissau might derive more benefit if the establishment of budget constraints received more emphasis, and the provision of financing less, under its ESAF program.

These remarks should not detract from our recognition that in fact, Guinea-Bissau has made significant progress in reform and adjustment.

Mr. Lucenti made the following statement:

Given Guinea-Bissau's general framework, there has been important progress toward the achievement of balance in several areas. Real GDP growth has been favorable in the last several years, inflation was brought down on the second half of 1996, and continued to stay low during the first half of 1997, and there has been improvement in the current account. As other speakers have mentioned, I also welcome Guinea-Bissau's entry into the West African Monetary Union. Besides improving the regional integration, this step will contribute to the monetary and exchange rate stability. Regarding the adjustment program for the ESAF's third annual arrangement, I believe it to be quite ambitious, but necessary to address the weakness of several areas, in particular the fiscal policy. Therefore, this chair supports the proposed decision. However, I would like to express our concern on three issues: fiscal balance, debt management and privatization.

It is clear that to reduce the level of poverty, in a medium-term framework, more expenditure should be made on education and health. A review of the fiscal figures for 1997 will tell us that scheduled external interest payments represent 40 percent of current expenditure and 170 percent of central government wages and salaries, while expenditure on health and education may reach around 14 percent of current expenditure. The external debt stock at the end of 1996 is estimated to be 351 percent of GDP. With these figures I wonder whether any adjustment program, that the country may apply, has the likelihood of success, if the debt problem remains a serious constraint. It does not make any sense to have a primary fiscal surplus when expenditure on health and education is so low and the level of poverty so high. Therefore, one of the first priorities must be the solution of the debt problem. In this regard I welcome the forthcoming debt sustainability analysis which is being prepared in close cooperation with the World Bank staff and Guinea-Bissau's authorities through which an assessment may be made on whether Guinea-Bissau qualifies for assistance under the HIPC initiative.

Any solution given to the debt problem may allow a reallocation of fiscal resources to social expenditures. This, however, does not mean that nothing should be done structurally to modify what has originated the buildup of foreign debt. On the contrary, every effort should be made to achieve fiscal sustainability with a manageable debt size.

On the privatization front, while there has been some progress, more is needed. The authorities should accelerate this process in order to strengthen the role of the private sector and attract the foreign investment to support higher and sustained growth. This goal may be facilitated by Guinea-Bissau's entry into the WAMU.

With these remarks I wish the authorities success in their future endeavor.

Mr. Rouai said that he could support Guinea-Bissau's request for a third annual arrangement under the Enhanced Structural Adjustment Facility. As the staff paper on estimated costs and burden-sharing approaches for the HIPC Initiative (EBS/97/127, 7/1/97) noted, an 80 percent net present value reduction from bilateral creditors and 100 percent forgiveness by multilateral creditors would only allow Guinea-Bissau to reach a net present value of debt/exports ratio of 257 percent. The authorities should be encouraged to reinforce and deepen their adjustment strategies, and the international community should provide Guinea-Bissau appropriate financial support to alleviate the burden of external debt.

Mr. Heinbuecher made the following statement:

We broadly agree with the staff's analysis and recommendations. Our support for the proposed decisions, however, is based on the strong expectation that the authorities will strengthen their policy performance. The recent slippages under ESAF programs in various countries in the past years clearly have demonstrated, that an easy going approach will not improve the overall economic conditions and the debt situation in the respective country.

In contrast to the staff's assessment of the performance under the second annual arrangement we would rather prefer the term "mixed" instead of "broadly satisfactory" (p. 5, para. 1). It is very worrisome and disappointing that the authorities have allowed sizable fiscal slippages—like the overrun of current expenditure by almost 25 percent—and that the inflation rate has turned out to be about twice of the size of the program target shortly before joining the monetary union. As a member of a currency union the authorities can no longer use exchange rate or monetary policies in order to address imbalances. The remaining policy instruments—fiscal and structural policies—have to be used much more vigorously under such circumstances.

In this respect we wonder whether the envisaged strengthening of revenues in 1997 is sufficiently ambitious compared to last years targets and to what extend an increase in current expenditures of almost 70 percent over its programmed level for 1996 is in line with the necessary ambitious fiscal consolidation. We would also appreciate the staff's comments on how exactly the expenditure increase for wages and salaries by about 50 percent compared to the programmed level for 1996 and the projected further sizable increases in the years thereafter fit together with the envisaged reduction of the civil service.

Finally on the timing of the decision point for a possible participation of Guinea-Bissau in the HIPC-initiative. We share the views expressed by Ms. Mercusa, Mr. Loevinger and Mr. Fuji that the staff's envisaged decision point "in the second half of 1998" (p. 17, paragraph 37) seems too optimistic and hardly in line with the mixed track record of the country so far.

Mr. Morais made the following statement:

Guinea-Bissau's program not only remains on track, but also its economy is responding well to the reform process. Growth performance is likely to remain strong over the medium term in an atmosphere of relatively low inflation. This is essential for development and poverty alleviation.

Entry into the WAMU should be beneficial. However, as the authorities realize, this goal will require improved fiscal management and greater efforts on the revenue front. I welcome the steps taken to reform the tax system and improve tax administration.

I encourage the authorities to monitor expenditures carefully. I fully agree with the emphasis that is being placed on education, health, and basic infrastructure. Investment in these areas is the cornerstone for development and should be supported by the international community.

I support Mr. Barro Chambrier's comments on the need for timely and substantial debt relief for Guinea-Bissau as a means of helping the authorities sustain their adjustment efforts. I fully support the proposed decision.

Ms. Heinonen said that she could associate herself with the comments put forward by other Directors. Although participation in the HIPC Initiative would greatly enhance

Guinea-Bissau's efforts to return to external viability, caution should be used to avoid raising the expectations of individual countries by projecting possible decision points in staff papers.

The staff representative from the African Department noted that negotiations on the payment of Guinea-Bissau's capital share in the BCEAO, equal to one-seventh of the net capital of the institution, were still under way. Those negotiations were not expected to be completed before the end of 1997. However, there was an understanding that the burden associated with the payment of Guinea-Bissau's capital share would be kept reasonable and within its capacity to pay. The negotiations would focus not only on the modalities for graduated payments, but also on the possibility for offsetting payments with dividends receivable over the medium term.

Under the currency conversion operation, the population of Guinea-Bissau was expected to change most of the currency, at a rate of PG 65 to the CFA franc, by July 31, 1997, the staff representative said. Information recently received from Guinea-Bissau indicated that the currency conversion operation was taking place expeditiously, with more than 90 percent of the conversion having been completed. The conversion operations had essentially been completed in the capital city, and the new currency had been widely accepted in the markets. The operation was also nearing completion in the rural areas. There were no indications to suggest that exports were being hindered by monetary shortages.

As to the question of monetary overhang, recent information showed that at least one of the two banks was relatively liquid, the staff representative continued. That bank would have plenty of opportunity to invest its liquidity in the regional money market, which was fairly sophisticated by international standards.

The staff considered that the fiscal program for 1997 was sufficiently ambitious, the staff representative stated. In terms of GDP, both the wage bill and overall current expenditures were targeted to decline. However, there was a need to improve the composition of expenditure. The level of unit wages was low, especially for teachers and health workers. Thus, there was a need to have savings in certain budget items in order to ensure that wages could be increased to more reasonable levels, especially for the most highly skilled personnel.

The revenue efforts envisaged under the budget, which were expected to result in a revenue increase of more than 1 percent of GDP, were also ambitious, the staff representative added.

Although Guinea-Bissau's current primary surplus, of about 3.3 percent of GDP excluding interest charges and foreign financed investment, was among the largest among the countries of western Africa, that surplus was needed to repay external debt, the staff representative commented. As noted by many Directors, the external debt burden, even after debt relief, was high as a percentage of GDP. Thus, it would be essential for Guinea-Bissau to maintain a large primary surplus at least for the foreseeable future in order to ensure its capacity to make timely repayments of external debt. Of course, the present situation could change under the HIPC Initiative. Also, efforts by a number of donors were under way to create a multilateral debt fund to provide external assistance to help Guinea-Bissau finance its debt-service payments to multilateral organizations, which were relatively large. It was hoped that such a fund could be put in place soon.

As the staff paper indicated, the costs associated with separation indemnities for personnel of the former central bank had not been included in the costs of the recapitalization, of about $33 million, the staff representative noted. Those additional costs, currently estimated at about $1–2 million, were expected to be paid over the next two to three years through the revenue generated by restructuring public enterprises and with external assistance, including from the World Bank. Most of the personnel of the merged central bank had been taken over by the BCEAO. The new central bank did not want to assume the costs of severance pay and other indemnities for the remaining personnel of the former central bank. However, those costs were not immediate, as the payments were to be made over time.

With respect to Mr. Loevinger's comments on Guinea-Bissau's track record, the performance to date could be interpreted in different ways, the staff representative said. The country was clearly vulnerable to spurts of inflation. As the staff analysis showed, the increase in inflation in that latter part of 1996 was largely attributable to uncertainties about how entry into the WAMU might impact the exchange rate, rather than to slippages in budgetary discipline. In the period leading up to WAMU, expectations that the entry would entail conversion of the currency at depreciated exchange rates had affected the behavior of trading companies and led to the jump in inflation, particularly in July and August 1996. The authorities had responded to the developments in the exchange rate and inflation promptly by tightening monetary policy. As a result of that corrective action, inflation rates had been brought under control. Recent data showed that the monthly rate of inflation had leveled off at about 1 percent during the first quarter of 1997, compared with the average monthly rate of 5.5 percent in 1996.

Fiscal developments, in particular with respect to expenditures, were disappointing in 1996, the staff representative stated. Nevertheless, the staff was confident that the package of fiscal measures being put in place by the authorities would significantly strengthen expenditure control. In particular, the measures requiring each of the ministries to obtain prior authorization by the Ministry of Finance for all expenditure commitments should go a long way to prevent the kind of overruns that had occurred in the past, when the Minister of Finance had not been in a position to prevent such overruns in terms of commitments. Those measures, which had been in effect since June 1997, currently applied to five key ministries, and they would be extended to cover the remaining ministries over the next few months.

As to the overall fiscal stance, it should be noted that the current expenditure/GDP ratio was expected to continue to decline in 1997, while the primary surplus was targeted to increase, the staff representative from the African Department commented. The budget constraint would be determined to a large extent by the external debt. The measures aimed at reforming the tax system and strengthening budgetary control, once in place, would allow for further strengthening the budget in the period ahead.

Mr. Barro Chambrier thanked Executive Directors for their support for Guinea-Bissau's request for a third annual enhanced structural adjustment arrangement. He would convey the comments and concerns put forward by Directors for the current discussion to his Guinean authorities.

As the staff had provided detailed answers to the questions raised by Directors for the current discussion, he could confine his comments to a few points that merited emphasis, Mr. Barro Chambrier commented.

Guinea-Bissau had begun its implementation of the adjustment program supported by the Bretton Woods institutions and other creditors, Mr. Barro Chambrier noted. It had also begun to reap the benefits of reforms in both the macroeconomic and structural areas. Nevertheless, as the authorities were well aware, several problems remained, including the heavy external debt burden, which continued to constrain progress toward the achievement of higher levels of sustainable growth.

The limited administrative capacity of Guinea-Bissau was another serious cause for concern, Mr. Barro Chambrier considered. Therefore, continued technical assistance from the international community and, in particular, from the Fund would be essential in the period ahead.

The Guinean authorities were aware of the need to improve the country's track record as part of the eligibility requirement for the HIPC Initiative, Mr. Barro Chambrier noted. They were fully committed to the forceful implementation of the economic adjustment and reform program supported by the ESAF. In that connection, the authorities had made significant strides toward comprehensive structural reform, despite the small size of the country and its limited administrative capacity. It was to be hoped that, within the context of its participation in WAMU, Guinea-Bissau would be able to make similar progress toward fiscal consolidation over the period ahead. The fiscal targets under the proposed program were clearly ambitious, in particular given the urgent need for increased social expenditure. It should be borne in mind that the achievement of those targets would require not only significant efforts on the part of the Guinean authorities, but also sacrifices on the part of the people.

The Executive Board took the following decision:

1. The government of Guinea-Bissau has requested:

(a) the third annual arrangement under the Enhanced Structural Adjustment Facility (ESAF);

(b) an increase in the amount of the three-year ESAF arrangement (EBS/94/247, Sup. 1), and the third annual arrangement thereunder of SDR 1.05 million (10 percent of quota), to meet the external obligations associated with the entry into the West African Monetary Union; and

(c) an extension of the commitment period of the three-year arrangement to March 31, 1998.

2. The Fund has appraised the progress of Guinea-Bissau in implementing economic policies and achieving the objectives of the program supported by the second annual arrangement, and notes the updated policy framework paper set forth in EBD/97/82.

3. The Fund extends the commitment period of the three-year ESAF arrangement for Guinea-Bissau to March 31, 1998 and approves the third annual arrangement set forth in EBS/97/129.

Decision No. 11548-(97/77), adopted
July 25, 1997

4. RELATIONS WITH WORLD TRADE ORGANIZATION—INVITATION TO ATTEND EXECUTIVE BOARD MEETING

The Executive Directors agreed to invite the Director-General of the World Trade Organization to send an observer to attend the upcoming discussion on capital movements under an Amendment of the Articles, tentatively scheduled for Tuesday, August 26, 1997.

5. CENTRAL AFRICAN REPUBLIC—OVERDUE FINANCIAL OBLIGATIONS—STATUS REPORT

The Executive Directors agreed to a proposal by the First Deputy Managing Director to postpone for one week the issuance of a communication to Fund Governors on the Central African Republic's overdue financial obligations to the Fund.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/97/76 (7/23/97) and EBM/97/77 (7/25/97).

6. BRAZIL—INQUIRY UNDER ARTICLE VIII, SECTION 2(B)

The General Counsel is authorized to transmit the letter contained as Attachment B to EBD/97/88.

Decision No. 11549-(97/77), adopted
July 23, 1997

7. OFFICE SPACE—PHASE III—FITOUT BUDGET—PART THREE

1. Appropriations for the construction of Part Three of the Phase III fitout work, including the new workspace standards as described in EBAP/97/72 (7/21/97), are approved in the total amount of $17.0 million. This amount will increase the current Phase III Fitout Budget of $22.1 million to $39.1 million.

2. No commitment will be made that causes the revised Phase III Fitout Budget of $39.1 million to be exceeded without prior approval by the Executive Board.

Adopted July 24, 1997

8. EXECUTIVE BOARD TRAVEL

Travel by an Assistant to Executive Director as set forth in EBAM/97/120 (7/18/97) is approved.

APPROVAL: May 12, 1998

REINHARD H. MUNZBERG
Secretary