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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/41

3:00 p.m., March 6, 1987

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	J. M. Jones, Temporary
	Song G., Temporary
	D. C. Templeman, Temporary
	G. Seyler, Temporary
	E. Feldman
	M. Arif, Temporary
G. Grosche	
	J. Reddy
	J. R. N. Almeida, Temporary
	S. King, Temporary
	O. Isleifsson, Temporary
	D. McCormack
Mawakani Samba	
	L. P. Ebrill, Temporary
G. Ortiz	
H. Ploix	S. de Forges
	J. de Beaufort Wijnholds
C. R. Rye	
	B. Tamami, Temporary
	A. Vasudevan, Temporary
K. Yamazaki	M. Sugita
S. Zecchini	

L. Van Houtven, Secretary
S. J. Fennell, Assistant

Also Present

Asian Department: P. R. Narvekar, Director; A. Ariyoshi, U. Baumgartner, H. Mendis, J. Otani, S. M. Schadler, B. J. Smith, W. M. Tilakaratna. European Department: R. A. Feldman. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; J. T. Boorman, A. M. Jul, J. M. T. Paljarvi, C. M. Watson. Fiscal Affairs Department: K.-Y. Chu. IMF Institute: M. Nakao, Participant. Legal Department: J. M. Ogoola. Research Department: W. M. Corden, P. R. Fenton, S. Takagi. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. Bertuch-Samuels, G. Pineau. Assistants to Executive Directors: F. E. R. Alfiler, F. Di Mauro, V. J. Fernández, Hon C.-W., V. K. Malhotra, T. Morita, L. M. Piantini, S. Rebecchini, H. van der Burg.

1. JAPAN - 1986 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/87/40, 3/6/87) their consideration of the staff report for the 1986 Article IV consultation with Japan (SM/87/33, 2/6/87; and Cor. 1, 3/3/87). They also had before them a background paper on recent economic developments in Japan (SM/87/50, 3/23/87; and Sup. 1, 2/27/87).

Mr. Zecchini made the following statement:

Impressive achievements have characterized the economy of Japan in the mid-1980s, reflecting the high degree of success of its policies. More recently, however, some problems have emerged: growth has been slowing, the current account surplus has more than doubled over the last two years, the unemployment rate, although by far the lowest among industrial countries, has increased. Moreover, prospects for growth and the correction of the external imbalance in 1987 seem also somewhat disappointing. These elements are even more worrying if they are considered in the light of Japan's responsibility in fostering orderly economic growth and global adjustment.

In this respect, we commend the staff for focusing the consultation on the issue of how Japan can achieve an orderly reduction of its payments surplus and sustain economic growth. Undoubtedly, these are the major challenges facing Japan in the near future and the reconciliation of both objectives is indeed no easy task as this implies shifting the economy from an export-led growth model towards a more domestic-demand oriented one. To put things into perspective, it can be recalled that both these objectives have been at the center of the economic policy debate in Japan since the early 1970s. The process of opening up the economy to imports and of improving the role of domestic demand was, however, severely constrained if not reversed by the two oil price increases and the appreciation of the dollar. Today, Japan having successfully coped with these shocks, it is all the more important that such process be resumed in view of the magnitude of the imbalances involved and the increased impact on the world economy.

As we are in broad agreement with the thrust of the staff appraisal and the policy recommendations, we will focus on some of the difficulties that are due to structural and cyclical factors which are likely to hamper the process of correcting external imbalances and expanding domestic demand. We will also comment on demand, structural, and external policies.

In spite of the appreciation of the yen, the current account surplus in 1986 continued to grow and in 1987, with the J-curve effect disappearing, it is expected to decline to the level of about $70 billion, which remains above the level prevailing before the exchange rate adjustment process. Several factors can explain such a slow pace of adjustment of the current account. The correction of the existing large gap between the level of exports and the level of imports requires a very strong growth differential in favor of the latter if some significant progress has to be achieved. The income elasticity of Japanese exports is almost twice as high as the import elasticity. The inflow of net investment income will remain large as a result of the strong net external asset position of Japan. The commodity composition of external trade shows that a large share of imports is made up of oil and raw materials whose cost is not likely to increase significantly for the time being. Furthermore, losses of competitiveness which could derive from the nominal exchange rate appreciation have been largely offset by the pricing policy of Japanese exporters: as indicated in the report the nominal effective rate of the yen appreciated by 33 percent between the Plaza meeting and January 1987, while the real rate measured by export unit values only increased by 10 percent. Moreover, the same measure indicates that while competitiveness vis-à-vis the United States has deteriorated, significant improvements were achieved with respect to important European economies. This development is reflected in the rise of exports to Europe (62 percent in 1986) and the increasing trade surplus with this area.

As for the objective of expanding growth through domestic demand, several features point to the difficulties Japan is facing and will face in this task. In theory, domestic demand expansion should be brought about mainly by the income effect of the terms of trade changes. Nevertheless, as indicated by the staff report, the pass-through of the terms-of-trade gains has been reduced by the high propensity to save of consumers and the cautious attitude with respect to investments of the business sector. These factors reflect the relatively young age of the population and the uncertainty about growth prospects for the Japanese economy pending its reliance on external demand. Moreover, the downward rigidity of some regulated prices, such as food or transportation, further reduces the income effect of the higher yen. More in general it is not clear whether the established growth model of the Japanese economy has now reached the structural limits of its possibilities, given the slow growth of external demand and the appreciation of the yen. Perhaps the staff or Mr. Yamazaki could comment on this point.

In view of the above-mentioned objectives and of the constraints faced by the Japanese economy, the authorities in 1986 actively utilized monetary policy to stimulate demand, in line with the views expressed by the Executive Directors during the previous Article IV consultation. The stance of monetary policy was thus appropriately relaxed.

Turning to exchange rate policy, while we recognize the significant adjustment undergone by the yen, we do not fully share the authorities' view that "the exchange rate adjustment since the Plaza meeting would, in time, contribute substantially to a reduction in Japan's external surplus." In this respect, we have already explained the reasons for our doubts on the adequacy of the impact of the exchange rate changes on the adjustment of the current account surplus.

As for fiscal policy, the general account budget in 1987/88 provides for a reduction of the deficit to 3.1 percent of GDP. Despite the efforts directed toward sustaining economic activity, this budget, according to staff estimates, would imply a negative stimulus to the economy of about 3/4 of one percent of GNP. This is a disappointing development in light of the sluggish growth prospects the economy is facing. In this respect, we fully share the staff's recommendation that it would be inappropriate for fiscal policy to contribute to a further weakening of economic activity in the coming fiscal year. Some room for maneuver to improve the fiscal stance might be found in the implementation of the tax reform by advancing, for instance, the tax cuts while maintaining the overall revenue neutrality of the package. We are glad to see in Mr. Yamazaki's interesting buff statement that his authorities are already proceeding in this direction. Nevertheless, an effort should also be made to maintain the 1986-87 levels of public expenditure, especially in the fields of housing and urban development.

As to wage policies we share the staff concern for the outcome of wage negotiations. If wage settlements turn out to be excessively low, disposable income of wage earners may not increase as required by the need to boost domestic demand, and/or business propensity to spend may not improve. Since the authorities have reiterated their unwillingness to play any role in wage negotiations, it becomes even more important that they take more responsibility for improving business expectations, and particularly fixed investment, through a more active policy to encourage private spending. The proposal of adopting a five-day working week is a step in the right direction. Deregulation measures and administrative reforms can also contribute to improving business expectations. In this respect, we commend the authorities' initiative to reorganize and privatize state-owned companies, to ease restrictions on land use, and we urge them to pursue the recently proposed tax reform.

We also welcome the progress in the trade liberalization process. Further steps should be taken to liberalize agricultural imports although we realize the political difficulties this might imply. Protectionism in this field is especially harmful to developing countries which depend on exports of primary products.

As for capital flows, two developments have emerged in 1986. First, there was a steep fall in long-term capital inflows in the second half of 1986. In spite of the liberalization effort to open up the Japanese financial market to foreign investors and expand capital inflows, after the improvement that occurred in 1985, longterm capital inflows dropped from $17 billion to less than $1 billion in 1986. Such reversal reflects, among other things, some structural weaknesses of the Japanese financial market pertaining to the liquidity of the secondary market and to the clearing system, which the authorities might want to address in order to stabilize such inflows and effectively increase the attractiveness of the domestic financial market for foreign investment. Second, long-term capital outflows from Japan rose in 1986 from $81 billion to $132 billion. This increase was financed to a large extent by a significant expansion of short-term capital inflows, especially by commercial banks, reaching $57 billion in 1986 up from $10 billion in 1985. A large proportion of the outflows was accounted for by the purchase of U.S. dollar-denominated securities even though long-term interest rate differentials in favor of the dollar declined and exchange rate losses were incurred by the Japanese investors. Part of these losses might have been cushioned by the increase in U.S. bond prices.

In the near future, however, it is unlikely that interest rate differentials or bond price changes are going to provide adequate incentives to Japaanese investors. In this environment, it is questionable whether a financial pattern, by which Japanese investors borrow short to purchase long-term U.S. debt, can be sustained for long, without giving life to a large risk of capital losses. The implications of a possible reversal of such flows or of a geographic shift away from the dollar should be carefully considered because of its implications on the economy of Japan as well as on the stability of the international monetary system.

Mr. Arif noted that developments in the world economy in the recent past had had a significant impact on the Japanese economy. The authorities' response, while cautious, had been wide ranging, and it would have to be sustained and strengthened in order to exploit the growth potential of the economy. External developments in 1986 had primarily affected the overall growth rate, which had declined to almost half the average level of the two preceding years, and the outlook for the current year was not very encouraging. The poor performance was also expected to adversely affect the fiscal outcome. He would therefore confine his remarks to issues broadly related to growth only.

Irrespective of developments in the external sector, a prolonged suppression of the growth rate would have adverse socioeconomic repercussions, Mr. Arif considered. As external stimulus was unlikely to be restored significantly, it should be adequately supplemented by an expansion in domestic demand in order to regain the growth momentum. In that connection, the role of the public sector, which already accounted for 35 percent of GNP, appeared to be limited, and the budgetary targets for 1987/88 would reduce the stimulus by the equivalent of 0.75 percent of GNP. That fiscal stance, if not appropriately modified, squarely placed the burden for providing the necessary impetus for growth and expansion on the private sector.

Aggregate domestic demand had been sustained in 1986, largely owing to an increase in private consumption, Mr. Arif observed. During 1987/88, the proposed cuts in individual income tax, which would precede the imposition of tax on interest income, might also provide some stimulus to the economy. Nevertheless, the expected increase in private consumption, which was crucial in view of the constraints on private investment and which would be partly absorbed by increased imports, would be insufficient to generate a reasonable growth rate. Hence, the authorities should consider the feasibility of tax relief to encourage private consumption. He agreed with the staff on the role of wage policy, with due regard given to productivity, in stimulating growth. Furthermore, greater pass-through of the terms of trade gains to consumer prices was called for.

While the authorities did not play a direct role in wage negotiations, they should ensure that the beneficial effects of the terms of trade gains were disbursed more widely, Mr. Arif considered. Otherwise, manufacturers might use that gain to minimize the rise in export prices in foreign currency, and the staff's forecast of a net decline in the share of wages in the economy in 1987 might materialize. In order to facilitate adequate wage increases generally, the process of general wage setting should perhaps be insulated as far as possible from the influence of the traditional wage setting industries, which had been adversely affected by declining exports.

The need for sustaining and expanding private consumption was underscored by the falling trends in private investment in plant and equipment owing to the decline in external demand, which might also be ultimately offset to some extent as domestic consumption increased, Mr. Arif commented. However, the scope for a revival of private investment through tax incentives for export-oriented industries remained limited, as reflected by the subdued impact of a supportive monetary policy in 1986. The authorities had done well to facilitate the investment of part of the private sector's savings through privatization of the national railways and the participation of the private sector in large public sector infrastructural projects. That process should perhaps be expanded. Construction was another promising area, and the success of the steps taken by the authorities in 1986 to facilitate land use for construction purposes, including tax incentives and the provision of requisite financing, was reflected in the more than threefold increase in residential investment in 1986. That approach appeared to be a viable way to enhance domestic demand until such time as the manufacturing sector was able to adjust to the changing environment--a long and arduous process.

He could appreciate the authorities' concern about the adverse consequences of increased domestic demand, particularly the possible increases in prices and unemployment owing to higher wages, Mr. Arif stated. With respect to prices, the impact of the yen's appreciation had not been fully reflected in domestic prices, and the consumer price index had remained unchanged in 1986. The expected pressure on domestic prices emanating from enhanced demand would be neutralized to the extent that the terms of trade gains were allowed to be translated into increased real incomes. However, any increase in prices of exports owing to increased domestic demand, while welcome from the viewpoint of achieving the objective of reducing the external imbalance, might have a further dampening effect on those industries. Nevertheless, a small increase in the overall price level might be acceptable if a reasonable overall growth rate was assured.

The unemployment situation seemed to have slightly worsened, and the unemployment rate was reported to have risen to 3 percent in January 1987, Mr. Arif observed. Wage increases, which were expected to boost private consumption, had perhaps aggravated the situation. However, the unemployment situation in Japan was not serious by international standards. One might recall that the decline in the employment rate in 1986 had been arrested by an increase in nonmanufacturing activity, and a further expansion in those sectors might absorb wage increases and increase employment too. The increase in demand would then have a favorable impact on the manufacturing sector. He wished the Japanese authorities well at this crucial juncture in coping with the vastly altered economic environment.

Mr. Mawakani made the following statement:

> It is evident from the staff papers and Mr. Yamazaki's opening statement that economic and financial developments in Japan during 1986/87 have emphasized the policy dilemmas confronting the Japanese authorities. The impressive performance in terms of growth, employment, and relative price stability that has characterized the economy over the past three years has gradually given way to a slowdown in economic growth, which is low by historical standards and below the economy's potential. There has also been a rise in unemployment which, at about 3 percent, is high by Japanese standards. A shift in external demand has largely contributed to this economic weakness, and the outlook for the immediate future suggests that the external sector's contribution to economic expansion will continue to decline, while that of domestic demand will rise. Over the past three years, the external current account balance has been recording a sustained rate of growth. It could be argued that since the Japanese economy is somewhat overly outward oriented, the reversal that is taking place is a welcome development.
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> Underlying these overall developments, which have been in line with the expectations of the international community, was the sharp and rapid increase in the value of the yen and lower oil and

commodity prices. Although these factors have resulted in a turnaround in Japan's trade volumes, with a decline in exports and an increase in imports, the external current account has continued and even managed to register an increasing surplus. How this current account surplus can be reduced poses a problem for the international community. From this standpoint, I am pleased to note that the Japanese authorities are continuing to cooperate with the other major industrial countries in their efforts to establish more stability in the international monetary system for achieving the goal of sustainable noninflationary growth.

There is no doubt that the authorities have continued to manage their economy skillfully, and the staff paper has highlighted positive developments that have taken place, such as the boom in the construction sector, the strong growth in services, the strengthened recovery in residential investment owing to lower interest rates, and a general easing of monetary conditions. I shall not dwell on them since I am in broad agreement with the staff analysis and appraisal.

I share the view that the major policy issue confronting the Japanese authorities is how to sustain the economy's rate of growth, which should be led by stronger domestic demand, while reducing the large external account surplus. I am pleased to note in this context that the authorities have recognized the limited role and effectiveness of macroeconomic policies for achieving these goals in the short term and have therefore placed emphasis on structural policies. These measures include the privatization of public enterprises and other initiatives for enhancing the role of the private sector's participation in public works, as well as measures to stimulate housing construction where the potential is said to be very large. The policy initiatives already taken in this area are encouraging and I welcome the statement by Mr. Yamazaki that his authorities' fiscal policy stance for 1987/88 seeks to exercise strict expenditure restraint in order to give the highest priority to the expansion of domestic demand in the context of their medium-term fiscal consolidation efforts. I am also encouraged by the proposals underlying the reform of the tax system and its expected favorable impact on incentives and the revitalization of private economic activity so as to stimulate domestic demand. Another area of structural reform that is a step in the right direction is the restructuring of the industrial sector, a process that is being accelerated by the yen's appreciation.

On trade policy, Japan's recognition of the vital role that it has to play in preserving a free trading system and contributing to world economic growth augurs well for the global economy. I am pleased to note, therefore, that the implementation of the Action Program that was adopted in 1985 is proceeding well ahead of schedule and that concrete results have been achieved in reducing tariffs and removing barriers. Clearly, more needs to be done and

I urge the Japanese authorities to intensify their efforts to remove the remaining barriers, and to take significant action to encourage more imports. I welcome the recent expansion of imports from the newly industrializing countries of Asia and it is my hope that developing countries' access to Japanese markets will be further widened.

Regarding capital flows and financial liberalization, it is encouraging to note that further progress was made during 1986, and that foreign direct investment and other long-term and short-term capital outflows increased. However, I share the view that these outflows must be deployed to the greatest international benefit, especially for the developing countries, particularly as current developments affecting private lending to these countries have been somewhat adverse. I recognize the importance that the Japanese authorities attach to official development asistance (ODA). However, it is regrettable that the level of ODA declined to 0.29 percent of GNP in 1985, well below the UN target of 0.7 percent of GNP. In any event, I welcome the new target that the Japanese authorities have set for the 1986-92 period, and their efforts in this direction are appreciated.

The staff representative from the Asian Department stated that the objectives of the tax reform in Japan were to increase the equity, simplicity, and vitality of the tax system and to establish a reliable tax base that would have the understanding and trust of the Japanese population. The tax reform was, therefore, not directed only toward improving economic efficiency. While the tax reform would result in higher taxes on individuals and lower taxes on corporations, it should be borne in mind that corporate taxes in Japan were high and had been increasing in recent years. It was therefore understandable that the tax reform provided for an adjustment in the distribution of the direct tax burden in favor of the corporations. The net increase on personal taxes was derived from the elimination of the exemption from tax of interest on small savings--an attempt to remove a distortion in the tax system that was expected to have positive economic effects from both domestic and international viewpoints. The substitution of the value-added tax for income taxes within the personal tax structure would involve an increase in taxes on unincorporated businesses, which were substantial in number in Japan. Therefore, to some extent, the increase in taxes on the personal level was illusory. While a value-added tax might, on the face of it, be expected to reduce consumption and increase savings, it should be borne in mind that the value-added tax was being introduced in conjunction with offsetting increases in direct taxes. The staff had presented an analysis of the tax reform in the supplement to the paper on recent economic developments. That study indicated that the net effect of the two tax reform measures would be to bring about an income transfer from the retired population, who were drawing from their savings, to the working population, who were accumulating savings. Taking into account the elimination of the exemption of interest on small savings, it might be expected that the overall tax reform would tend to have a positive impact on consumption and a negative impact on overall savings. However, the effects were likely to be small.

He cautioned against trying to determine the full extent of the supplementary budget measures from the general account data provided in the background paper on recent economic developments, the staff representative stated. The largest part of the supplementary package of ¥ 3.6 trillion had already been accounted for, although about ¥ 0.6 trillion would roll over into the next fiscal year.

The reduction in revenues of ¥ 1.2 trillion resulting from the decline in economic growth in 1986/87 involved a corresponding reduction of ¥ 0.4 trillion in tax transfers to the local governments, the staff representative indicated. Consequently, there was a reduction in spending associated with the revenue shortfall. There were also other elements of lower spending that were nondiscretionary associated, inter alia, with lower interest rates and reduced oil prices, amounting to ¥ 0.3 trillion. However, there was a discretionary increase in spending of almost ¥ 1 trillion, or 0.3 percent of GNP, in the supplementary budget. In addition, there were substantial amounts of spending outside the general account budget by local governments on public works, amounting to about ¥ 1 trillion; by the Housing Loan Corporation to be funded through the Fiscal Investment and Loans Program (FILP), amounting to some ¥ 0.8 trillion; and under programs that would be funded by the private sector.

The difference in the estimates of the withdrawal of external stimulus in 1987/88 by the staff--0.9 percent of GNP--and by the authorities--0.5 percent of GNP--arose from different projections of the national accounts deflators, especially for service transactions, the staff representative commented. There was considerable difficulty in estimating the national accounts deflators for external transactions, and the staff had been unable to obtain the authorities' estimates of the deflators involved in their projections.

The most recent data on corporate profits indicated little increase in the profits of wholesale and retail firms, the staff representative continued. Profit/sales ratios in the hotel and retail sector had increased only marginally in the first half of 1986. However, gains had been evident in the domestic demand-oriented sectors that used imports heavily. For example, the profit/sale ratio in the electric utility sector had risen from 13 percent in mid-1985 to 25 percent in mid-1986, and in gas utilities, from 2 percent to 20 percent. Those margins had been largely eliminated following the adjustment of utility rates in June 1986 and again earlier in 1987. Other domestic demand-oriented import intensive sectors, such as paper and pulp, had also shown some increase in profitability. Furthermore, agricultural profitability had risen. There was also some evidence that profits in the distribution sector, as defined to include household businesses, had also increased.

Wage restraint in Japan had had demonstrable benefits in increasing employment and investment in recent years, the staff representative commented. However, the staff did not consider that that experience was inconsistent with the staff's current advice that average wages should not grow at a rate that was less than would be warranted by productivity and terms of trade gains. In other words, the share of wages in the economy had fallen in 1986 and was in danger of declining further in 1987. The staff was proposing no more than that wage increases should match productivity.

A number of Directors had considered that it was not only or even primarily the existence of Japan's large external surplus that was a source of international tension, but especially the question of its disposition, the staff representative recalled. That view stemmed from the perception that efforts to reduce the surplus would almost inevitably lead to a slowdown of growth in Japan. While the staff shared that view to some extent, there were two points that should be mentioned. First, even if the surplus were deployed most effectively for international purposes, a surplus of the magnitude projected over the medium term would require additional adjustment, not least because of its threat to protectionism. Second, while a reduction in the surplus might involve some cost to growth in the short term, that would not necessarily be the case in the medium term. Indeed, there was a need for a restructuring of the economy toward reliance on domestic demand and away from reliance on exports. If effective policies such as those called for in the Mayekawa report were implemented, the cost in terms of growth was likely to be lower.

However, he was not denying the importance of deploying the surplus most effectively, the staff representative from the Asian Department stated. There was room for both external adjustment and deployment of the surplus in the way that would serve the needs of the international community. The authorities recognized that fact and had taken a number of steps in the right direction. They had provided SDR 3 billion to the Fund; they were discussing the possibility of additional lending in coordination with the World Bank; and the Export-Import Bank of Japan was also providing additional funding. The staff was considering what further action could be taken and it hoped that a study on that general issue would be completed by the end of the summer. Table 28 of the background paper on recent economic developments provided information on the direction and form of capital flows from Japan.

Mr. Grosche agreed with the staff that both external and internal adjustment was called for in Japan. However, he was opposed to any intermediation by multilateral institutions with respect to the distribution of Japanese savings. The operations of the capital markets should determine the direction of those flows.

Mr. Zecchini suggested that in its study, the staff should examine the responsibility of the multilateral institutions to provide an adequate framework for recycling Japan's surplus in a way that was consistent with the optimal functioning of the markets, while bearing in mind the welfare of the international community.

The Director of the Exchange and Trade Relations Department commented that the staff had not yet completed the study on the recycling of the Japanese surplus because of the complex nature of the subject. Furthermore, there were difficult political issues that arose from some suggestions that might be made. The staff would take into account the proposals put forward by Directors in the present discussion in progressing with that study.

Mr. Yamazaki made the following statement:

> Many Directors questioned the attainability of the Government's economic growth forecast and noted that the staff projection of real GNP growth of 2.8 percent was lower than the official forecast. I am of the firm view that the authorities' forecast is achievable. The economy is in a final stage of the minor inventory adjustment cycle, and after completing the adjustment in early 1987/88, a moderate acceleration of inventory accumulation will provide momentum to domestic demand growth. Income gains arising from the currency appreciation and record low interest rates will also continue to sustain the demand expansion. Net external demand will work as a negative factor as far as the growth projection is concerned, but the staff may have overestimated the effect of this factor. Quick examination of each demand component underscores my confidence.
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> First, while capacity-expanding capital investment by the manufacturing sector is expected to decline owing to exchange rate adjustment, business investment by the private sector as a whole will remain firm, underpinned by investment by the nonmanufacturing sector, which accounts for nearly 60 percent of total private plant and equipment investment. The strength of nonmanufacturing investment partly reflects a shift in demand from the external sector to the domestic sector and partly reflects the investment by public utilities, which have benefited from both the currency appreciation and a fall in imported energy prices. Even in the manufacturing sector, investment demand for high technology and research and for replacement is expected to support the investment level.
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> Second, private consumption has been on a rising trend since the beginning of 1986 and will continue to receive impetus from an increase in real income deriving from price stability associated with the exchange rate appreciation.
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> Third, residential construction by the private sector has been particularly buoyant with the growth rate reaching 15-17 percent in the third and fourth quarters of 1986 over the previous year. The strength of housing investment will be maintained in 1987, aided by stable construction prices, lower interest rates, and supportive policy measures.

On our basic policy direction, there is broad agreement between the staff and my authorities. However, the staff and some Directors expressed the view that a withdrawal of demand stimulus would be inappropriate when there is a downside risk in the economy, and they suggested flexibility in our fiscal management.

As I explained, my authorities are of the view that moderate economic growth will be sustained in 1987/88 along the path projected by the Government. Moreover, my authorities do not necessarily share the staff assessment of the fiscal stance that is embodied in the 1987/88 budget. According to the definition by the staff, "fiscal neutrality" is obtained when government revenue increases at the actual rate of GNP growth and government expenditures grow at the rate of potential GNP growth.

In my view, the staff overestimates the restraining effect of government revenue by underestimating actual growth. On the expenditure side, overrating of potential growth may have led the staff to a rather negative assessment of the fiscal stimulus as well. Indeed, the economy is presently undergoing a substantial transformation of industrial structure in response to a change in relative prices. As a result, part of existing equipment, for example, in shipbuilding and steel industries, may no longer constitute an active productive capacity of the economy. Under those circumstances, there is a high probability that the potential growth rate will fall temporarily, implying that the staff estimates of the restraining effect on the revenue side may have been excessive.

Overall, we cannot go along with the staff projection which indicates that fiscal activity will result in a withdrawal of stimulus equivalent to about 0.75 percent of GNP in 1987/88. Furthermore, the methodology adopted by the staff fails to capture the economic effect of each component of expenditures. Thus, the efforts by the authorities remain largely unrecognized. Maximum efforts have been made in compiling the 1987/88 budget to increase public works, which have high multiplier effects, within the constraint of medium-term fiscal consolidation. The Fiscal Investment and Loans Program (FILP) for public works will increase by 14.8 percent over last year. With the encouragement of the Central Government, construction works by local government will also be expanded at a rate higher than that of the previous year. Participation by the private sector in public works will be continued. Reflecting these efforts by the authorities, the public sector as a whole will make a positive contribution to domestic demand in 1987/88.

Fiscal consolidation has to be implemented steadily in view of the present fiscal conditions. In this connection, Mr. Dallara pointed out that the surplus of social security funds has contributed to a reduction in the budget deficit at the general government level. The surplus of social security funds is a valid point, but this reflects only the relative immaturity of the funds, and the financial position of these funds is expected to deteriorate rapidly owing to demographic changes. That is the very reason why we emphasize the need to look closely at the underlying trend of the fiscal position, excluding social security funds, which requires closer attention to the central government fiscal position rather than to that of General Government.

I would like to refer to the statement issued by the Finance Ministers of the Group of Six on February 22, where my authorities stated their intention to prepare a comprehensive economic program after the approval of the 1987/88 budget by the Diet, so as to stimulate domestic demand, with the prevailing economic situation duly taken into account.

External adjustment is under way in terms of changes in the volume of exports and imports in response to exchange rate changes that have occurred since the 1986 Plaza Agreement. The adjustment is not painless. In a country where lifetime employment has been considered a norm, labor shedding has already started and is now spreading from such industries as shipbuilding and steel to auto manufacturing. While the current account surplus in U.S. dollar terms still remains at a high level owing to J-curve effects, in 1987 a point will be reached where the current account surplus even in dollar terms will start to decline.

Relative price changes that have been caused by exchange rate changes have already triggered large scale responses from enterprises, which will eventually lead to a transformation of industrial structure and a reduction in external surpluses. Most notable among the responses is the initiative by manufacturing industries to shift their production abroad. Take, for example, the auto industry. Car production in the United States by Japanese automakers, which was no more than 140,000 units in 1984 and 410,000 units in 1985, is expected to rise to 1.5 million units by 1988. This compares with the limit of 2.3 million units under the voluntary export restraint program presently in effect with the United States. A recent survey conducted by an association of machinery exporters of Japan indicated that more than 70 percent of manufacturers of electrical and office machineries are now considering moving at least part of their production capacity abroad. On the import side, steel imports increased by 24 percent in volume in 1986, from such countries and regions as Korea, Taiwan, Brazil, and Spain. As an illustration of ensuing adjustment, I might mention the reconstruction plan recently announced by the Nippon Steel Corporation, the largest steel maker in Japan, which is going to close 5 of its 13 furnaces by 1989, reduce employment by 19,000 from 52,000 by 1990, and diversify its business so that the share of steel in total sales is reduced to 50 percent by 1995.

Directors will recall how Japanese industries responded to the increases in imported oil prices in the 1970s and transformed their structure to save energy. I am therefore confident that the transformation of the Japanese industrial structure in response to recent changes in relative prices will be carried out swiftly and that this will soon be reflected in external balances. The restructuring of the economy will also be supported by institutional and policy changes, the need for which is well recognized by the authorities. Proposals in this direction are included in an "Outline of Procedures for the Promotion of Economic Structural Adjustment," which was announced in May 1986, based on the so-called Mayekawa report. Some of the measures in this Outline have already been implemented.

External adjustment has to be carried out by way of increased trade, not through trade restrictions. Indeed, the liberal trade system is the cornerstone for the growth of the world economy and for global welfare. For our part, the "Action Program," which was announced in 1985 to assure more liberal access to Japanese markets, has been implemented steadily, and some of the measures included in that program were even carried out ahead of schedule.

With respect to the emphasis placed by the staff and some Directors on the need to open Japan's markets to industrial goods, I would like to point out that the level of tariff rates is already the lowest among industrial countries, with no tariffs being applied to semiconductors, color televisions, and automobiles.

Thus, the policy framework for external adjustment is now in place, and there has already been some progress in this adjustment. But in order to foster and promote further progress, it is essential that a stable climate for business investment be maintained. This will be required to enable a restructuring of the economy while maintaining an adequate rate of growth. It is in this context that we attach particular importance to exchange rate stability. We welcome the recent Paris agreement by Ministers and Central Bank Governors and strongly hope that this will lead to the stability of exchange rates among major currencies. For our part, we committed ourselves to follow monetary and fiscal policies that will help to expand domestic demand and thereby contribute to reducing the external surplus; to get the 1987/88 budget approved by the Diet so that its early implementation can be ensured; and to prepare a comprehensive economic program after the approval of the 1987/88 budget by the Diet, so as to stimulate domestic demand, with the prevailing economic situation duly taken into account.

Incidentally, my authorities do not take the view that, compared with a certain level, some appreciation or depreciation of the currency is desirable. Similarly, my authorities do not commit themselves to a particular exchange rate or to a narrow band. Furthermore, I can confirm that the agreement in Paris does not mean a move toward target zones. With respect to the effect of a reduction in interest rates, my authorities believe that the lower interest rates will contribute to an expansion of domestic demand.

The staff and some Directors suggested that the tax reductions should be implemented prior to the tax increases as a means of maintaining fiscal stimulus and sustaining domestic demand. In this connection, I would like to emphasize the fact that the main objectives of the tax reform were to correct distortions and imbalances in the system and to establish a reliable revenue structure, rather than to increase or reduce overall tax revenue. Moreover, we believe that the economy will continue to grow at a pace consistent with the government projections and do not see the need to activate tax policies for stabilization purposes. We also believe that large fluctuations in the tax burden from year to year and a temporary shift in tax policies will do more harm than good to the confidence of taxpayers. With respect to the total effect of the tax reform on demand, according to the estimates based on the macroeconomic model of the Economic Planning Agency, the reform is expected to push up the real GNP growth rate by 0.1 percent on average annually during 1987-90.

Reference was made by the staff and some Directors to the role the authorities could play in private wage negotiations that are going to take place in the spring. The authorities recognize the importance of an appropriate distribution of income not only for the welfare of workers but also for an expansion of domestic demand, but it is the employers and the workers that decide wage levels in free bargaining in the light of prevailing conditions of enterprises and industries. The Government's role will be limited to creating an environment conducive to appropriate macrodistribution of income, for example, through sustaining demand expansion. A reduction in work hours is another way of distributing the fruits of economic growth, and in this connection, the Government will make further efforts to expand the adoption of a five-day work week by enterprises.

Many Directors emphasized the need for appropriate recycling of Japan's current account surplus to developing countries, and I particularly note the strong emphasis placed on this issue by Mr. Sengupta. In this connection, however, it is important to recognize that a large part of our current account surplus originates in the private sector. It is therefore of utmost importance that an environment be created that is conducive to the flow of private funds through market mechanisms.

The Tokyo capital market plays a particularly important role in channeling funds to developing countries by assuring liberal access by the World Bank and developing countries. This function is being reinforced by further liberalization and internationalization of the capital and money markets in Japan. We also attach importance to the establishment of the Multilateral Investment Guarantee Agency, which will contribute to the promotion of direct investment by the private sector.

On the part of the Government, a medium-term target of providing $40 billion of ODA during the seven years from 1986 to 1992 was established in 1985 and this policy has been implemented steadily. The authorities have also announced a plan to recycle public and private funds equivalent to $2 billion through the World Bank and are prepared to provide a maximum contribution of $2.6 billion to IDA. An offer to provide SDR 3 billion to the Fund has already been accepted by the Executive Board in December 1986.

Finally, let me remind the Board of one important point. I understand that views expressed at the Board today in respect of fiscal policy relate to the management of policy over the fiscal year 1987/88 as a whole. At this stage, however, the initial budget is on the agenda of the Diet and it has not yet been formally approved. If the present discussion by the Board leaks to the press, Directors' suggestions could be misinterpreted as being related to the initial budget rather than to the fiscal management over the entire fiscal year and could unduly delay the approval by the Diet of the initial budget, a development that will be most counterproductive and could result in consequences that are opposite to the views of many Directors. My authorities would therefore appreciate discretion by Executive Directors in this regard.

The Chairman made the following summing up:

Executive Directors commended the authorities on the performance of the Japanese economy, which continued to be very favorable in many respects last year.

Directors generally agreed that the central policy issue facing the authorities was to strengthen domestic demand and to avoid an undesirable economic downturn, while progressing with orderly external adjustment. However, commenting on the economic outlook, Directors expressed doubt that growth would rebound strongly in 1987/88. There were risks that the current weakness of the manufacturing sector might spread to other sectors of the economy, accentuating general economic weakness. On the external side, Directors noted that medium-term projections based on the assumptions of relatively strong world demand and unchanged real exchange rates indicated that Japan's current account surplus would decline only slowly. Even so, the sustained withdrawal of external demand implied that domestic demand would have to expand rapidly for growth to accelerate toward the economy's potential. Directors emphasized that achieving the objectives of growth and adjustment would require carefully balanced policy choices by Japan. At the same time, other countries also needed to take appropriate action. In this context, Directors welcomed the undertakings given at the recent Paris meeting of six industrial countries.

Directors observed that translating the recent terms of trade gains into strongly growing domestic demand would be important if growth were to recover. In this connection, they expressed concern about the slow pace of the pass-through of the yen appreciation and oil price decline and stressed the need to strengthen the responsiveness of prices to external developments. The pronounced weakness in some industries might affect wage settlements also in those sectors that had not been hurt by the yen appreciation, Directors noted. This would sap the strength of domestic demand and, if sustained, would impede external adjustment. Real wages in sectors not adversely affected by the yen appreciation should not be compressed, as this would hinder the pass-through of terms of trade gains. It was suggested by some Directors that the Government might be able to provide appropriate signals without prejudicing its tradition of avoiding direct involvement in private sector wage determination. However, other Directors pointed to the possibility that larger wage increases might involve costs in terms of investment and employment.

While supporting the longer-run objective of fiscal consolidation, most Directors stressed that fiscal policy in 1987/88 should be implemented in a way that took account of the weakness of the economy. They commended the authorities for the flexibility shown in fiscal policy in 1986/87 and urged them to maintain flexibility in 1987/88. Directors observed that the proposed central government budget for 1987/88 provided for a further reduction in the deficit and that, taken overall, the budgets for 1987/88, based on the staff's calculations, with which Mr. Yamazaki did not agree, implied a sizable withdrawal of fiscal stimulus. Directors stressed that fiscal policy should not add to the economic weakness, and they urged the authorities to adopt additional fiscal measures that would at least avoid a withdrawal of fiscal stimulus in 1987/88. In this connection, Directors welcomed the undertaking given by Japan at the Paris meeting to prepare a comprehensive economic program to stimulate domestic demand after approval by the Diet of the 1987/88 budget, with the prevailing economic situation duly taken into account.

Concerning tax policy, Directors welcomed the tax reform proposals now under consideration. They noted in particular the proposed elimination of the exemption of most interest income from taxes, and the positive incentive effects of the changes. Some

Directors expressed the view that tax reform might be implemented in a manner so as to impart a stimulus to the economy. On monetary policy, the prevailing view was that the pace of monetary expansion did not pose a threat to price stability in the present situation.

Directors agreed that, in present circumstances, stability of exchange rates around current levels was desirable, and noted the intention expressed at the Paris meeting to cooperate closely to foster such stability. In this context, they noted the need to restore confidence in industry in Japan and to encourage the restructuring of industry that has been held back by exchange rate uncertainty. It was also observed that the feasibility of achieving exchange rate stability through deployment of monetary policy was limited if strong and persistent market pressures were to arise and that flexibility would then be needed. Over a longer time horizon, it was desirable that exchange rate developments should be consistent with both the maintenance of strong growth as well as sustained external adjustment. While policies in Japan should be directed toward this objective, it would be essential also that appropriate policies be pursued outside Japan.

Executive Directors stressed the importance of structural policies. In this context, they warmly welcomed the wide-ranging recommendations of the Mayekawa report. They noted the scope for action to ease land use regulations, and remarked that this would stimulate residential investment and urban development. Directors commended the authorities on the progress in liberalizing the financial system in recent years and stressed the need for the continuation of this process. In this connection they referred, in particular, to the need to press ahead with reform of the postal savings system.

Directors emphasized Japan's responsibilities in the promotion of free trade and commended the authorities for the leading role they had played in multilateral trade negotiations. They noted that, despite significant recent liberalization steps, important barriers remained in Japan's markets. These barriers were most visible in the area of agriculture, and Directors urged the authorities to act to bring about a substantial lowering of agricultural protection in the near future. There was also a need to persevere with the efforts to open fully Japan's markets for manufactured goods and to ensure free market access by industrial and developing countries alike. Directors urged the authorities to be vigilant in resisting demands for protection by import-competing industries that would likely follow in the wake of the yen appreciation.

Directors expressed the hope that financial flows from Japan to developing countries would grow rapidly in coming years. They welcomed the discussion now going on in both official and private circles in Japan concerning ways in which the large capital outflows from Japan could best contribute to promoting world growth and development. They commended Japan on the recent increase in the flow of funds through public agencies and encouraged the authorities to develop appropriate mechanisms for ensuring larger flows to developing countries. Directors also noted the vital importance of Japanese banks' support in dealing with the problem of the indebtedness of developing countries.

Directors expressed disappointment about the decline of ODA in percent of GNP in 1985 and urged the authorities to increase ODA substantially. Some Directors expressed the hope that the authorities would aim to exceed the official target of doubling the dollar value of aid flows over seven years.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/87/40 (3/6/87) and EBM/87/41 (3/6/87).

2. BOLIVIA - TECHNICAL ASSISTANCE

In response to a request from the authorities of the Central Bank of Bolivia for technical assistance in the financial sector, the Executive Board approves the proposal set forth in EBD/87/67 (3/3/87).

Adopted March 6, 1987

APPROVED: October 6, 1987

LEO VAN HOUTVEN
Secretary