

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/70

10:00 a.m., June 7, 1989

R. D. Erb, Acting Chairman

Executive Directors

F. Cassell  
Dai Q.  
  
J. de Groote  
E. T. El Kogali  
  
E. V. Feldman  
L. Filardo  
N. Kyriazidis  
M. Finaish  
  
G. Grosche  
J. E. Ismael  
B. Jalan  
  
Mwakani Samba  
  
J. Ovi  
H. Ploix  
  
K. Yamazaki

Alternate Executive Directors

C. S. Warner  
J. Prader  
  
S.-W. Kwon  
R. J. Lombardo  
M. A. Fernández Ordóñez  
  
O. Kabbaj  
  
E. Kiriwat  
L. E. N. Fernando  
J. R. N. Almeida, Temporary  
  
I. A. Al-Assaf  
  
D. Marcel  
G. P. J. Hogeweg  
S. Yoshikuni

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

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Also Present

Asian Department: P. R. Narvekar, Director; D. A. Citrin, R. J. Corker, L. D. Dicks-Mireaux, J. R. Marquez-Ruarte, H. L. Mendis, S. Watanabe.  
European Department: M. Russo, Director; K. Saito. Exchange and Trade Relations Department: P. C. Acquah. External Relations Department: D. M. Cheney. Fiscal Affairs Department: V. Tanzi, Director; A. L. Bovenberg. Legal Department: J. V. Surr. Research Department: J. A. Frenkel, Economic Counsellor and Director; B. B. Aghevli, G. Calvo, Y. Harada, E. Hernández-Catá, F. Larsen, P. R. Masson, M. A. Wattleworth. Secretary's Department: C. Brachet, Deputy Secretary. Advisors to Executive Directors: N. Adachi, F. E. R. Alfiler, M. Al-Jasser, P. E. Archibong, J. Basiuk, M. B. Chatah, W. N. Engert, S. M. Hassan, J.-L. Menda, P. O. Montórfano, P. D. Péroz, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: B. A. Christiansen, E. C. Demaestri, S. K. Fayyad, M. E. Hansen, M. E. F. Jones, K. Kpetigo, C. Y. Legg, V. K. Malhotra, R. Marino, T. Morita, N. Morshed, J. K. Orleans-Lindsay, J.-P. Schoder, Yang J.

1. JAPAN - 1989 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1989 Article IV consultation with Japan (SM/89/75, 4/26/89; and Cor. 1, 6/6/89). They also had before them a background paper on recent economic developments in Japan (SM/89/84, 5/12/89; Sup. 1, 5/24/89; and Sup. 2, 6/5/89).

Mr. Yamazaki made the following statement:

I shall comment briefly on recent developments in the Japanese economy and on the main policy issues highlighted in the staff report.

In fiscal year 1988/89, the favorable growth pattern that characterized the economy since 1986/87, namely, the strong expansion of domestic demand that more than offset the decline in external demand, continued. Specifically, while the pace of expansion in residential investment decelerated following a sharp increase in the previous fiscal year, private plant and equipment investment and private consumption gained momentum, making the growth pattern of the economy more sustainable.

All in all, according to the official forecast, the growth rate of real domestic demand is estimated to have reached 6.6 percent, the highest level in the past 10 years. This growth in domestic demand will bring about an overall real GNP growth rate of 4.9 percent, almost equivalent to the rate recorded in the previous fiscal year.

The autonomous, virtuous cycle among domestic private sectors that emerged in the previous fiscal year was more conspicuous in 1988/89. With the continued increase in corporate profits, business confidence is growing further. Moreover, capacity utilization is at its previous peak, spurring a sharp increase in business investment as well as an expansion in employment. Under these circumstances, personal income is steadily increasing. This, coupled with continued price stability, is bringing about a steady increase in personal consumption.

Prices remain stable. Aided by such favorable factors as the decline in oil prices and the increase in the flow of low-priced imported goods, the wholesale price index declined by 0.7 percent, while the consumer price index rose slightly by 0.8 percent. On the external side, while imports continued to rise, reflecting the salient increase in imports of manufactured goods, the pace of the increase in overall imports has been somewhat tempered by the decline in oil prices. Meanwhile, exports rose steadily, supported by the rapid expansion of the overseas economy and by the increase in export prices. Consequently, the trade surplus in 1988/89 amounted to \$95.3 billion, slightly exceeding the previous fiscal year's level of \$94.0 billion.

exceeding the previous fiscal year's level of \$94.0 billion. Meanwhile, the invisible trade deficit rose sharply, owing to the large deficit in the travel balance. As a result, the external current account surplus for 1988/89 amounted to \$77.0 billion, which was considerably lower than the previous fiscal year's level of \$84.5 billion. The long-term capital balance, on the other hand, showed a net outflow of \$121.3 billion, equaling the net outflow recorded in the previous fiscal year--\$119.5 billion--primarily reflecting the buoyant overseas securities investment and direct investment by Japanese residents.

To maintain the steady expansion of the economy centered on domestic demand and to promote the external adjustment process, while at the same time putting an end to Japan's dependence on deficit financing bonds by 1990/91 with a view to restoring the adaptability of fiscal policy, the 1988/89 budget had two major objectives, namely, to maintain a high rate of increase in expenditure on general public works by drawing on the proceeds from the public sale of government-owned Nippon Telephone and Telegraph (NTT) stocks, and to curtail and rationalize expenditures, inter alia, to rein in operating expenses. In light of the strong economic growth driven by the private sector, due attention has been given to sustaining the expansion of domestic demand and the avoidance of overheating the economy in the implementation of the 1988/89 budget.

Turning to monetary policy, under generally relaxed monetary conditions, a cautious attitude was taken in order to maintain sustainable economic growth while ensuring stability in prices and in foreign exchange rates. The growth of the money supply, as measured by M2 and certificates of deposit, reached 12.1 percent in the first quarter of 1988, compared with the same period in the previous year, the highest growth rate since 1979. The rate gradually declined thereafter to 10.3 percent in the first quarter of 1989. Nonetheless, the growth rate is still considered to be on the high side relative to real economic activity. Meanwhile, in the area of corporate financing, monetary conditions were relaxed further.

In the coming fiscal year, the economy is expected to maintain the favorable growth pattern already mentioned--namely, continued price stability, sustainable growth of domestic demand, and reduction in the current account surplus, although the pace of the domestic demand growth will be somewhat slower than the brisk growth of the previous fiscal year. Consequently, the real GNP growth rate will be around 4 percent--of which the contribution of domestic demand is about 4.7 percent and that of external demand is minus 0.7 percent.

As regards domestic demand, a decline in housing investment will be inevitable, since a decrease in housing starts,

particularly in rental housing, has been observed since the latter half of the previous fiscal year after the strong growth recorded up to that period. Personal consumption, on the other hand, is expected to increase steadily, owing mainly to the steady increase in nominal household income resulting from the favorable trend in corporate profits as well as by the tightening of the labor market. As a result, with the continued price stability, real personal consumption will increase by about 4.6 percent, which will serve to underpin the growth of domestic demand. Furthermore, plant and equipment investment will continue to register buoyant growth. Despite the relatively high level of capital stock supported by the brisk investment activity maintained so far, indications are that the positive investment behavior for capacity expansion in the manufacturing sector, based on the high level of corporate profits and capacity utilization, will not lose momentum in the short run. In addition, investment by the nonmanufacturing sector will continue to be strong. On the whole, plant and equipment investment will increase by about 9.2 percent in real terms.

In the meantime, external demand will continue to decline with the continued increase in imports centered around manufactured goods.

Prices can reasonably be expected to remain stable, although there are uncertainties such as foreign exchange rates, oil prices, tightening of the supply and demand conditions of the labor market, and the high level of money supply. Meanwhile, the effect of the consumption tax on prices is considered to be within a reasonable range and of a temporary nature.

On the external side, while exports are expected to decelerate, particularly exports of capital goods, with the slowing down of the economic growth of the industrial countries, imports will continue to increase owing mainly to imports of manufactured goods. Furthermore, invisible trade will register a larger deficit reflecting the increase in expenditure on foreign travel by Japanese residents. Accordingly, my authorities expect a continued decline in the U.S. dollar-denominated current account surplus to about \$71 billion.

In light of these considerations on the current economic situation, in formulating the 1989/90 budget due consideration was given to the sustainable growth of domestic demand and the need to avoid overheating the economy. As a result, the general public works expenditure will be maintained at the high level recorded in the previous fiscal year by utilizing the proceeds from the public sale of NTT stocks. Meanwhile, with a view to eliminating the dependence on deficit financing bonds by 1990/91, continued efforts have been made to curtail and rationalize expenditures. Consequently, the amount of newly issued

government bonds will decline by ¥ 1.7 trillion, compared with the previous fiscal year, thereby reducing the share of bond financing to total expenditures to 11.8 percent, the lowest rate since 1975 when deficit financing bonds were issued for the first time.

In sum, the 1989/90 budget enables the authorities to proceed steadily toward the target of eliminating the issuance of deficit financing bonds by 1990/91, while paying due attention to the current economic situation. Nonetheless, it should be stressed that the outstanding issue of public debt as of the end of 1989/90 will amount to ¥ 162 trillion or 41.5 percent of GNP. Meanwhile, public bond-related expenses will still be high, at 19.3 percent of the overall general government expenditure, even after the suspension of the system of allocating a fixed ratio of public debt outstanding to the National Debt Consolidation Fund. In sum, the fiscal situation is still very severe. Accordingly, in order to cope with various social and economic changes, including the rapid aging of the population, further efforts should be made to promote fiscal reform vigorously by curtailing and rationalizing expenditures, including a critical review of the existing systems and procedures.

Regarding the tax system, in the absence of a comprehensive tax reform, reliance on direct taxes, particularly on wage earnings, increased, while the share of the consumption tax in overall tax receipts decreased, which not only brought about the negative perception by taxpayers that the tax burden was heavy and unfair, but also gave rise to the concern that such a perception would become more pronounced with the aging of the population. Furthermore, it was pointed out that the current tax system, if left unchecked despite the globalization of the world economy, would result in a hollowing out of the Japanese economy and intensified external friction.

In light of these considerations, to ensure fairness in income taxation, and more generally to maintain, in a practical sense, equity in the overall tax structure, a comprehensive reform of the tax system was approved by the Diet in December 1988 and is now being implemented. The principal features of this reform are: a reduction in personal income taxes through lowering tax rates and reducing the number of tax brackets; the introduction of a consumption tax on goods and services; and various measures aimed at an equitable burden of assets taxation.

Taken together, these measures amount to a net tax reduction of ¥ 2.6 trillion, which is expected to have a favorable effect on the economy, in view of the need to sustain domestic demand. In addition, the reform will contribute to stimulating the motivation to work by striking a balance among income, consumption,

and assets taxes within the entire tax structure, which, in turn, will increase the overall vigor of the economy.

Although the introduction of the consumption tax is expected to bring about a 1.2 percent increase in the consumer price index, this is a one-time increase and should not be interpreted as an inflationary price hike.

As evidenced by the high level of the money supply and easier corporate finance, the degree of monetary relaxation has been conspicuous. While there is no imminent risk of a slowdown of the economy, a rapid expansion of the economy would be likely to exert an upward pressure on prices through tightening supply and demand conditions in goods and labor markets. Furthermore, the exchange rate of the Japanese yen vis-à-vis the U.S. dollar is declining considerably, reflecting the strength of the U.S. dollar on the foreign exchange market. As regards the financial markets, interest rates, although remaining at historically low levels, are generally on the rise both on the short-term and the long-term markets.

The Bank of Japan had decided to raise the official discount rate from 2.5 percent to 3.25 percent effective from May 31. This measure was taken to bring the level of the official discount rate in line with rates prevailing in the market. The official discount rate had been fixed at an extremely low level since it was lowered in February 1987 to cope with the business slump caused by the appreciation of the yen. Also, the measure will contribute to the maintenance of domestic demand-led, non-inflationary economic growth, and it does not imply a change in the basic stance of the macroeconomic policies.

To further promote arbitrary transactions among short-term money markets, and with a view to enhancing the flexibility of the monetary control mechanism, the Bank of Japan has reviewed and altered its methods of monetary operations. Specifically, in November 1988 the Bank launched an operation targeted at commercial bills with shorter maturities--one to three weeks-- while at the same time encouraging the participants of the interbank market to diversify transactions. This new modus operandi in monetary control has contributed greatly to smoothening the arbitrary transactions between short-term money markets. Subsequently, the Bank launched an operation on the commercial paper market in May 1989.

The exchange rate for the yen, which started at a peak level of around ¥ 121 vis-à-vis the U.S. dollar at the beginning of 1988, after a sharp appreciation at the end of 1987, hovered around the ¥ 120-130 range up to the middle of the year. Thereafter, the yen depreciated until it reached around ¥ 137 per U.S. dollar at the beginning of September. It appreciated again to

post the peak rate of ¥ 121 per U.S. dollar at the end of November and hovered around the ¥ 120 level until the end of the year. All in all, the movement of the exchange rate for the yen in 1988 was, although with some fluctuations, the most stable after the Plaza Agreement. Meanwhile, the joint statement of the U.S. President and the Japanese Prime Minister in January 1988 confirmed that a further depreciation of the U.S. dollar would be counterproductive. In September the finance ministers and central bank governors of the seven major industrial countries met in Berlin and reconfirmed their commitment to pursue policies that will maintain exchange rate stability and to continue to cooperate closely on exchange markets. Since the beginning of 1989, against the backdrop of increasing U.S. interest rates and brighter prospects for the reduction of the U.S. fiscal deficit, the yen exchange rate has been generally weak.

The meetings of the Group of Seven held in February and April reconfirmed close cooperation on the exchange markets. The yen sharply depreciated together with the major European currencies toward the end of May. Since exchange rate stability is essential to sustainable noninflationary growth of the world economy, my authorities consider that the current policy of close coordination, particularly among major industrial countries, should be maintained.

Regarding external adjustment, as noted earlier, the reduction in the trade surplus seems to have come to a standstill since the latter half of last year, largely owing to temporary or transitional factors such as the exports brought about by the strong expansion of the overseas economy, increased direct investment and overseas production by Japanese firms, and the decline in oil prices. Apart from these factors, it is reasonable to conclude that, in general, the adjustment of external imbalances continues at a steady pace. This adjustment is already evidenced by the structural changes reflecting the Japanese economy's transformation into one led by domestic demand; for example, the increase in the share of imports of manufactured goods, the higher import penetration ratios of various goods, and the expansion of overseas production by Japanese firms, including the import of goods from these overseas production bases.

Meanwhile, in light of the strong economic growth and the need for noninflationary sustainable growth, there is no room for expansionary fiscal and monetary policies. Because stability of the exchange rate is essential to rectify external imbalances, efforts should be continued to improve the access of nonresidents to Japanese markets and to proceed with structural reform. In this connection, cooperative efforts by the other major

industrial countries, including the United States, are equally important, and Japan should maintain close cooperation with these countries.

The liberalization and globalization of capital and financial markets contribute not only to the efficient development of the Japanese economy but also to the development of the world economy as a whole. Further progress has been made in this area since 1988. As for the liberalization of deposit interest rates, with the successive reduction in the minimum amount, the liberalization of interest rates on large denomination deposits will have been completed by this fall by reducing the minimum denomination of large time deposits with market-determined interest rates to ¥ 10 million. As regards small deposits, both the postal savings institutions and the commercial banks were allowed to issue small denomination money market certificates starting this June, paving the way for the liberalization of interest rates.

On the short-term money markets, together with the review of the monetary control mechanism by the Bank of Japan, transactions on the call and bill discount markets were further facilitated. On the long-term bond market, the auction system was introduced for part of the newly issued long-term government bonds, while access by foreign financial institutions to the government bonds market was improved by such measures as the increase in the share of foreign financial institutions in the underwriting syndicate for government bonds and the entry of foreign securities houses in the underwriting syndicate. Last, but not least, subsequent to the introduction of the futures transactions on stock indices in September 1988, in accordance with the Financial Futures Transaction Act approved in May 1988, the Tokyo International Financial Futures Exchange was established in April 1989, enabling Japanese residents to engage in full-scale financial futures transactions since the beginning of June.

To foster a harmonious external economic relationship, Japan has continued to extend external economic cooperation commensurate with its economic power. As regards official development assistance (ODA), a high growth rate of 7.8 percent--in terms of the Japanese yen--was allocated in the 1989/90 budget, in accordance with the previously announced Five-Year Plan to double the ODA. Furthermore, over 90 percent of the \$30 billion recycling program announced in 1987 has already been committed. In view of the important role of the Fund in the international monetary system and the debt strategy, Japan has supported the Fund's activities in many ways. Particularly noteworthy are activities since last year, including the contribution to the ESAF Account, the establishment of the administered account for the intensified collaborative approach, and the announcement of the intention of Japan's Export-Import Bank to provide parallel lending.

While my authorities are generally in agreement with the staff's analysis, they would like to raise the following points for comment by the staff.

With regard to the medium-term outlook, the "Economic Management with a Global Context"--the so-called Five-Year Economic Plan adopted in May 1988--presented the following outlook for the period 1988-92: a real economic growth rate of about 3 3/4 percent with a domestic demand contribution of about 4 1/4 percent; and a continuing decline in the ratio of the current account surplus to GNP to reach internationally harmonious levels by the end of the Plan. Therefore, compared with the staff, my authorities envisage somewhat lower economic growth and slightly faster external adjustment although the Plan covers a different time period. My authorities' forecast for the growth rate does not attach much importance to the high rates realized in 1987 and 1988.

My authorities believe that external adjustment will continue steadily for the following reasons: first, the growth rate of exports will decelerate owing to the slowdown of the economies of the industrial countries and an increase in overseas production of Japanese firms with a higher local contents ratio. Second, my authorities envisage a general increase in the import penetration ratio and a higher horizontal division of labor with overseas economies, such as newly industrializing economies, as a result of the ongoing structural reform. Third, the economy, led by domestic demand, will continue to grow steadily. Fourth, my authorities firmly believe that more attention needs to be paid to the increasing deficit in the invisible trade balance, particularly the travel balance.

At any rate, a forecast of the balance of payments should be viewed with appropriate latitude, since it is based upon many assumptions and only a small change in the assumptions would significantly alter the result. For example, beginning in the latter part of 1988, the actual price of oil was considerably below the assumption of the official forecast, which contributed to the higher trade surplus. However, recently the price of oil has recovered and will be reflected in the trade statistics in the coming months.

In the area of structural reform, the staff refers to the possibility of front-loading reforms, thereby improving the external adjustment process in the medium term. However, my authorities are vigorously implementing structural reforms in accordance with the Five-Year Plan, and it would be extremely difficult to envisage a further front-loading of such reforms. In this connection, the staff seems to recommend a high investment in social infrastructure. As the staff rightly notes in its report, however, at this stage it would not be advisable to speed

up public investment in the short term. Also, it should be stressed that the ratio of Japanese general government capital formation to GNP in 1987 was 5.3 percent, which was considerably higher than in other major industrial countries. For example, the ratio in the United States was 1.5 percent; in the United Kingdom, 2.0 percent; and in the Federal Republic of Germany, 2.3 percent.

The staff notes that the ratio of Japanese ODA to GNP will be maintained at its current level during 1988-92. However, the fourth midterm target for ODA aims at increasing Japan's share of ODA in line with its relative economic strength among the major creditor countries. This would imply a steady increase in the share of ODA in GNP. The staff also notes that, "As a prosperous nation with a large external surplus, Japan has a special responsibility to provide and facilitate the flow of financial resources to the developing countries." Although my authorities are undertaking to increase Japan's ODA in absolute terms, or in relation to GNP, it has also to be borne in mind that the external surplus is held by the private sector, while the public sector is still running a deficit. Therefore, they wonder whether the external surplus is a proper statistic on which to base the size of external economic cooperation by the public sector.

The Director of the Asian Department remarked that the staff was indeed forecasting higher rates of growth than the authorities, both in 1989 and in the medium term. In formulating those projections, the staff had taken account of the rate of growth in 1987 and 1988--an average of about 5 percent--as well as the strength of domestic investment and developments so far in 1989. The economy had been strong in the first quarter of 1989: a respected private forecaster had estimated GNP growth at about 9 percent. The staff's original forecast of 4.5 percent real GNP growth in 1989 was likely to be somewhat conservative. Moreover, with another year of investment-led growth at a rate of nearly 5 percent, the staff's projection of a 4.25 percent growth rate for the medium term did not appear to be optimistic.

Since the world economic outlook exercise in the summer of 1988, the staff had been suggesting that Japan's current account adjustment had begun to stall in 1989, the Director recalled. Mr. Yamazaki had listed a number of reasons why adjustment would continue; the staff had incorporated those factors in its analysis, although clearly not to the extent that the authorities would like. The staff was currently revising its projections in the forthcoming world economic outlook exercise. Although it was difficult to anticipate the exact magnitude of those revisions, the likely direction for 1989 and 1990 could be indicated now. Recent data pointed to an even stronger export volume growth in 1989 than the staff had been forecasting. Therefore, even with higher oil prices and weaker export prices because of the depreciation of the yen, the trade surplus for 1989 would have to be revised upward. By contrast, investment had been weaker than

expected, and projected investment income receipts would probably be revised downward. A significant revision in projections of the travel balance for 1989, which were close to those of the authorities, was not foreseen. On balance, the current account surplus for 1989 could be slightly lower than had been projected by the staff, but it was unlikely to be below the 1988 level. For 1990, however, the recent depreciation of the yen would lead to a sharp increase of the surplus to a higher level than that projected in the staff report. In any case, as had been fully acknowledged in the staff report, the projections were subject to uncertainties which emanate from both external and domestic sources.

On the question of the appropriate pace of structural reform, the staff certainly had not identified social infrastructure as the main candidate for front-loading, the Director observed. Indeed, as Mr. Yamazaki had recognized, the staff had specifically stated in its report that it would not be advisable to speed up public investment in social infrastructure at the present stage in view of the tightening capacity constraints in the economy. However, the staff did believe that there was room for vigorous action on other important aspects of structural reform, namely the distribution system, land management, agricultural protection, and the postal savings system. Such reforms would help remove distortions in the economy and would help improve the prospects for investment and growth.

The staff certainly did not intend to play down Japan's great role in overseas development assistance, the Director of the Asian Department remarked. Were Japan to achieve its medium-term target as described in the supplement to the background paper, the ratio of ODA to GDP would rise from 0.31 percent in 1987 to the Development Assistance Committee's average--now at 0.35 percent--by 1992. The staff would not propose the external surplus as a proper statistic on which to base the size of external economic cooperation in terms of ODA. It did believe, however, that in facilitating the flow of savings in appropriate directions, the larger surplus countries could play an important role, as Japan had been doing.

Mr. Ismael made the following statement:

I would like to commend the staff for its concise and clear account of the achievements of Japan's economy. I am in broad agreement with the staff's assessment.

The authorities are to be congratulated for their continued success in managing the economy in 1988. The achievement of the highest rate of GNP growth and the lowest rate of inflation among the OECD member countries, with a substantial further reduction in the current account surplus, is indeed remarkable. No doubt, this has to be attributed first and foremost to the pursuit of prudent but flexible medium-term macroeconomic policies and the implementation of appropriate structural reforms. It is also due to buoyancy of domestic demand and, in particular, consumption

and private investment, even if foreign trade also contributed positively to growth in the last part of the year.

Let me now directly examine the prospects of the economy in 1989 along the following lines: will strong economic growth continue; can domestic price stability be maintained; and, will the trade surplus continue to decline? I will then offer a view on the consequent desirable policy implications of those prospects.

There are signs that the economy has slowed from the exceptional rate of growth of 5.7 percent in 1988. Recent data show a two-thirds fall in the growth rate of the fourth quarter of 1988. Similarly, industrial production fell in February, and retail sales declined to under 6 percent in both January and February 1989, well below the 9 percent average for last year. These developments seem to confirm the staff's latest forecast of a growth rate of 4.5 percent for 1989.

Japan's trade surplus eased in March 1989 by 10 percent to \$6.7 billion, compared to March 1988, with total exports rising 16.9 percent to \$26.5 billion, while imports rose 29.8 percent to \$19.8 billion. This is the first decline in seven months and reflects a strengthening in consumer spending, which had weakened in January and February 1989. Oil imports also rose strongly in March 1989. The fall in the trade surplus, however, is unlikely to continue and will probably be reversed very shortly, particularly as export growth has shown little sign of declining significantly.

Inflationary pressures have risen, even though the rate of inflation remains low compared with that of Japan's major competitors. A recent study in the Nikkon Kensai Shimbun has anticipated that the imposition of a 3 percent sales tax in April 1989 will add about 1 percent to the consumer price index. On top of a "natural" rate of inflation of 1 percent forecast for 1989, this could bring the rise in consumer prices to almost 2 percent. Wholesale prices rose by 0.5 percent in the year to March 1989. Although this figure is not particularly high in itself, it is indicative of an upward trend. Furthermore, an increase in import prices owing to higher oil and commodity prices is also expected to pressure inflation.

In view of the above-mentioned economic performance and risks, I would, first of all, recommend that the present prudent, but flexible, medium-term macroeconomic policies be continued.

To contribute to a strong expansion of imports, market access, both in goods and services, has to be improved further. To this end, reforms in regulatory structures in the distribution

and other service sectors have to be expedited. While substantial progress has already been made in the financial sector, financial liberalization and internationalization should be continued further. Such measures are essential not only for price stability, but also for correcting the external imbalance and for maintaining the vitality of the Japanese economy.

Prudence should be maintained with respect to public expenditures, notwithstanding rising tax revenues, since market conditions are tightening against the background of continued economic expansion led by private demand. Such prudence will also serve in achieving a more efficient and sound fiscal position in the long run. While a major reform has recently been achieved to improve the tax system, further progress will have to be made in adjusting public revenue and expenditure structures, taking into account, among others, the prospective aging of the population. In addition, the removal of legal and other impediments to more efficient land use, as well as the review of taxation of land, should be expedited.

It is also important that monetary policy continues to be ready to act in a timely and appropriate manner to forestall an erosion of price stability. Such a stance is indispensable for ensuring the long-term domestic expansion of the economy, and is also the key to noninflationary, sustainable growth of the world economy. I can, therefore, sympathize with the Bank of Japan's cautious efforts in restricting the volume of the main commercial banks' lending to 3 percent during the first three months of 1989 in order to reduce liquidity, which is still considered too abundant, and the recent increase in the official discount rate from 2.5 percent to 3.25 percent.

In concluding, I would like to express my chair's deep appreciation for Japan's increasing aid to the developing world, for its lending to the Fund, and for its parallel financing arrangements to countries undertaking structural adjustment efforts. Official development assistance in 1988 has made Japan the world's foremost donor country when measured in U.S. dollar terms. Regrettably, ODA remains low in relation to GNP at 0.32 percent, and the grant share in total aid is less than 50 percent, which puts Japan last among the member countries of the Development Assistance Committee. It would be highly appreciated if these two latter features of Japan's aid could be improved.

Mr. Kyriazidis made the following statement:

The results achieved by the Japanese economy in 1988 were once again very impressive. The superior performance of the Japanese economy is effectively summarized by the rate of GNP

growth and the rate of inflation achieved in 1988, which were, respectively, the highest and the lowest among the major industrial economies.

While achieving these results, the authorities also pursued successfully their effort to reorient Japan's economic growth more toward the domestic sector and managed to further reduce their external imbalances. The expansion of real domestic demand, driven by brisk investment activity--particularly in the business sector--once again outperformed the growth of output. The trade surplus was reduced owing to a substantial reduction of the real surplus, which was partially offset by changes in prices. The current account surplus declined even further as a result of the widening of the deficit in the invisibles account. The reduction of the external surplus since 1986--by about 1 1/2 percentage points in terms of GNP-- indicates the dimension of Japan's adjustment effort. While there is still room for the correction of the external imbalances--mainly through the implementation of structural reforms--it is fair to recognize that the possibilities for further unilateral action have clearly narrowed and that future reduction of the trade imbalance depends increasingly on coordinated adjustment efforts of the major deficit countries.

The authorities must be commended for all these remarkable results, which have been achieved by choosing and pursuing consistently a broadly appropriate policy mix. It will be no less challenging for the authorities to implement those economic policies which will keep the economy on the path of sustained expansion and minimal inflation, while at the same time improving the quality of economic growth. This would entail focusing mainly on structural measures while maintaining the strength of domestic demand.

Broadly speaking, I am in agreement with the analysis and conclusions of the staff appraisal. I will therefore focus my remarks on only a few main issues concerning fiscal, monetary, and structural policies.

Fiscal policy in 1988/89 was expected to continue to support the process of economic restructuring with only minor progress to be achieved in fiscal consolidation. However, the stronger than expected revenue performance, which accompanied cautious control of expenditures, resulted in further improvement in the general government surplus, which the staff now estimates to have grown by about 1/2 percentage point of GNP. This outcome perhaps dispelled some concerns about the effects of the introduction of the comprehensive tax reform at the end of 1988 which, undoubtedly, was the most important development of last year in the fiscal area. The reform is intended to remove several distortions from the system and to improve its fairness by

rationalizing indirect taxation and shifting part of the burden away from direct taxes. It is also expected to lower revenues while broadening the tax base.

In the coming year it will be appropriate for fiscal policy to maintain a broadly neutral stance while continuing to support the process of economic restructuring. The authorities foresee the need for continued fiscal restraint, particularly in view of their expectation of a substantial increase in social security costs owing to demographic factors. While my authorities share this point of view to a certain extent, there appears to be sufficient room for an acceleration of public investment in support of the structural reforms needed.

The stance of monetary policy in 1988 was adequate to strike a balance between promoting price stability and providing appropriate stimulus for domestic demand. More recently, following international developments that placed downward pressure on the yen, the authorities resolved to tighten monetary conditions by raising interest rates. Perhaps the staff would like to elaborate on how this development is expected to affect the outcome of the scenario envisaged in its appraisal and, in particular, on its likely effect on the speed of Japan's external adjustment. It would also be interesting to hear from Mr. Yamazaki whether the recent increase in the official discount rate signifies a change in his authorities' view about the nature of the downward pressure on the yen experienced in the past weeks.

The importance of structural policies and reforms is certainly already well recognized by the authorities, as evidenced by the Five-Year Economic Plan for 1988/89-1992/93, which endorsed the earlier recommendations contained in the Mayekawa Commission's report. However, while in some areas, such as tax and financial liberalization, positive developments were most evident, progress in the implementation of other structural policies remained behind.

Considering the strength of its economy, Japan is now in the uncommon position of being able to devote its energy to the quality of growth, by removing some weakness affecting certain areas. As shown by the alternative scenarios presented by the staff, this might be done at a faster pace, through increased public investment, without undermining the fiscal position. Moreover, most of these reforms would also help improve the external position.

One promising area, which received decreasing attention during the 1980s, is social infrastructure and housing. Investment in social overheads would be of great benefit to domestic welfare while contributing, at the same time, to the reduction of external imbalances.

Efforts should also be particularly concentrated on reforms in agriculture and agricultural trade, where the current system is inefficient and imposes high costs on Japanese consumers. The inefficiency of the system emerges clearly in the level of domestic prices, which is well in excess of international prices.

Another area where reforms are much needed and should be implemented at a faster pace is the market distribution system, which is dominated by small stores. Last, but not least, there is an urgent need to remove the several distortions affecting the use of land. This is a complex problem with difficult political implications, which nonetheless need to be addressed without further delays and in a comprehensive manner.

To conclude, 1988 was yet another extremely positive year for the Japanese economy. The strength of its economy offers Japan, more than ever, the opportunity to significantly improve domestic welfare by implementing necessary structural reforms, whose accomplishment would also help to reduce the external surplus. The achievement of both targets appears possible. It is interesting and encouraging to note that at the end of its appraisal, the staff recalled that 25 years ago, concerned about the large deficit in the invisibles account, it had recommended policies conducive to creating a trade surplus and had expressed the view that its achievement was "reasonably feasible." Today, it appears that the Japanese authorities did in fact trust that advice, that they followed that advice extremely well, and that the staff was more than reasonably right.

Mrs. Filardo made the following statement:

My authorities attach special importance to the discussion of the 1989 Article IV consultation with Japan. They are impressed by the excellent quality of the staff papers, particularly the supplementary background paper on structural policies. In addition, they consider that on the twenty-fifth anniversary of Japan's formal integration into the world economy, and specifically during 1988/89, the Japanese Government has made outstanding progress in managing its economy and great effort in maintaining international policy coordination among the group of industrial nations, for the enhancement of the world economy. It has also shown an important dedication to contributing new ideas and financial resources to developing countries through ODA, the World Bank, and the Fund's enhanced structural adjustment facility, and particularly in the last year, to improving the debt strategy through its parallel lending approach. My authorities are especially grateful for this contribution, which they hope will be consolidated in the near future on the basis of the authorities' main principle of providing additional resources to highly indebted countries to finance imports and economic growth.

In assessing Japan's economic development over the past 25 years, it becomes apparent that Japan has observed the fundamental principles of implementing sound economic policies and structural reforms: the Japanese miracle is an outstanding example of discipline and persistence that has been maintained over a long period of time. In view of Japan's past and its most recent experience, my authorities are confident that this excellent performance will continue and will be its best contribution to the improvement of the world economy.

Since my authorities are in broad agreement with the staff appraisal, they would emphasize only a few points. On the domestic front, the Government's achievement in 1988 of the most satisfactory results among the industrial nations in terms of growth and inflation as well as its implementation of sound demand and supply policies in the most dynamic manner in the circumstances is most impressive. The authorities' envisaged implementation of structural reforms as set out in the Five-Year Economic Management Plan, which the Government approved in May 1988, is also impressive. My authorities note with particular satisfaction the progress achieved in the areas of tax, financial, and trade reform. Nevertheless, fundamental aspects of the economy remain to be corrected, namely, the improvement of the distribution system, the enhancement of agricultural policy, and trade liberalization in certain areas of the economy. Moreover, the fiscal situation remains severe, and the authorities should be committed to continue with the implementation of fiscal reforms. Similarly, to ensure a more efficient allocation of resources in the economy, it is fundamentally important to continue to eliminate trade barriers, especially in the agricultural sector.

In view of the remaining external imbalances among the industrial nations as well as the recent depreciation of the yen vis-à-vis other currencies, particularly the U.S. dollar, and in the present circumstances where a level of the yen/dollar exchange rate seems to be agreed upon among the industrial nations, it is crucial that Japan continues to implement structural reforms not only to enhance the allocation of resources in its economy, but also to open its markets to other countries, especially to developing countries' agricultural products. Opening its markets to developing countries would not only complement those countries' adjustment efforts and trade reforms, it would also complement Japan's financial assistance to those nations. While the authorities' pursuit of self-sufficiency in food production for security reasons, even at high prices, is understandable, the rate of protection is the highest among the industrial countries and has increased substantially since 1955, which implies that domestic prices are well above international prices. This policy has resulted in a welfare loss for the Japanese economy as a whole, and its cost to the general public far exceeds the benefit received by producers. In my authorities' view, as

Japan has been fully integrated into the world economy, it should now be able to find ways to overcome these problems by designing a medium-term structural reform in the agricultural sector. Mr. Yamazaki's comments in this regard would be useful; in particular, were there any plans to solve this problem, or did the authorities still believe that for security reasons, they will have to continue to pursue an inefficient agricultural policy?

Finally, my authorities would encourage the Japanese authorities to continue the cooperative and coordinated approach that they have been following in recent years with the international community.

Mr. Warner made the following statement:

First, let me express the continuing admiration of my authorities for the overall economic performance of the Japanese economy over the past year. A rate of real GNP growth of 5 3/4 percent, an inflation rate of less than 1 percent, an unemployment rate of approximately 2 1/2 percent, and a current account surplus which fell from 3.6 percent of GNP in 1987 to 2.8 percent in 1988 are all highly commendable economic outcomes. In addition, there was good progress in a number of structural reform areas, notably tax reform and the expansion and modernization of financial markets. While most of my statement consists of comments and questions regarding the interaction of economic developments in Japan with those in other member countries, I certainly wish to acknowledge these important achievements.

If we were examining "country x," there would be little additional to say. But, Japan's growing role in the world economy places a special responsibility on its authorities to pursue policies that are not only good for Japan, but also good for the world economy. Japan's active participation in international economic policy coordination reflects that reality. An important part of this responsibility lies in efforts to reduce global external imbalances.

In fact, over the past year Japan has made a major contribution to the adjustment of these external imbalances. Domestic demand grew by about 7 3/4 percent, and the growth of imports in volume terms was nearly 17 percent, continuing the adjustment of the current balance in real terms for the third year in a row. Also, the current account surplus, in U.S. dollar terms, declined for the first time. But the latter decline was small, and the external adjustment process seems to be stalling. Indeed, there is a real danger that the external surplus could level off or even increase in 1989 and beyond.

There are only a few ways in which this surplus can be brought down further and the corresponding deficits in other countries reduced. Unfortunately, the staff seems to close the door to most options. In effect it says that Japan has little contribution to make, especially in the short run and in the macroeconomic field, to a further reduction in global imbalances. While the following excerpts from the staff paper are quoted out of context, their basic message is clear.

On page 10: "The authorities also ruled out the likelihood of a significant yen appreciation, which they viewed to be counterproductive, given the substantial appreciation of the yen since 1985."

On pages 5-6: "While economic policies must help sustain an adequate growth of domestic demand, efforts by Japan to reduce its surplus through expansionary financial policies, particularly fiscal stimulus, could be counterproductive...."

On page 20: "...there is no case in Japan at present for action in the macroeconomic area to promote external adjustment." Also, "The correction of the global external imbalances will ultimately require adjustments in financial policies of the major deficit countries. Unilateral action by Japan to reduce its surplus would not be desirable from an international perspective...."

Further, and in a different vein, on page 6, it is stated that, "By contrast, there is substantial scope for infusing new vigor into the implementation of structural policies."

My authorities agree with the last statement on the need for greater progress on structural reform. They also would not suggest that Japan follow imprudent fiscal or monetary policies in order to expand domestic demand. They entirely agree that the deficit countries, including the United States, have serious responsibilities for reducing global imbalances. No one is asking Japan for unilateral action. But, my authorities do not accept that there is virtually nothing that can be done at present by Japan to foster a pattern of relative demand in the major countries which is conducive to further reductions in external surpluses and deficits and that exchange rate adjustment should be excluded from the adjustment process.

The argument against any macroeconomic policy action seems to depend on the view that capacity utilization is high, that there is substantial potential for price increases this year, and that the fiscal adjustment should not be tampered with because of medium-term considerations.

With regard to capacity utilization, it would be interesting to know if capacity in the construction industry--and not just in the manufacturing industry--is also at a peak. This may be relevant, since residential construction is expected to fall by nearly 1 percentage point this year, compared with a growth rate in excess of 13 percent last year. At the same time, there is a need for building social infrastructure, which lags that in other industrial countries. The inflation rate could be somewhat higher than last year, as the effect of the decline in oil prices in 1988 wears off and owing to the rise in excise taxes and in the discount rate. But, a projected rate of inflation of 1 1/2 percent does not suggest major problems.

My authorities also note that public consumption is estimated to grow by only 1 percentage point, compared with an annual rate of 3-5 percent over the past three years. And, Japan's general government surplus is expected to continue growing, by an additional 1/2 percentage point this year. Previous efforts at fiscal stimulus in 1987 and 1988 did not generate inflationary pressures, which suggests that there may be, in fact, some room for maneuver this year in sustaining domestic demand somewhat more than is now expected, without damage to long-term fiscal adjustment objectives. Therefore, it is hoped that, should economic growth decelerate and the external surplus again increase, consideration will be given to some fiscal stimulus action.

Principal attention needs to be paid to the general government balance, and not just to that of the Central Government. After all, that balance has the main overall effect on the rest of the economy. Of course, it is still useful for analytical purposes to break out the disaggregated figures from the total, for example, the social security surpluses. As the staff points out, even including public enterprises in the broadest definition of the "public sector," there has been a major decline in that deficit. In that connection, it would be interesting to know why the public enterprises remain in deficit.

With regard to structural reforms, good progress has already been made in tax reform as well as in liberalizing, expanding, and modernizing the financial markets, although there is room for further improvement, notably with regard to further liberalization of interest rates and reform of the postal savings system. In particular, it is gratifying to note the authorities' successful efforts on tax reform--against considerable opposition--and the measures taken in financial and money markets over the past six months. But, in other areas, especially agriculture, land use, and the distribution system, not very much concrete has been done, despite the studies and plans which recognize the seriousness of these problems. A growing consensus appears to be emerging that the quality of life in Japan, notably with regard to

basic food and shelter, has lagged behind its overall economic growth. Perhaps this awareness will eventually overcome the political and cultural resistance to change.

Japan is not unique in encountering social and political resistance to change in its way of life when confronted with economic change and increasing integration of markets. I am old enough to remember when Americans bought their food from friendly, but inefficient, neighborhood grocery stores. There was serious political and social resistance when national chain stores began to appear and compete. More recently, many American communities, faced with the loss of jobs and the shutdown of factories in the face of foreign competition in automobiles and consumer electronics, have also had to face difficult problems of economic and social adjustment. And, American agriculture, when denied markets in Japan, continues to experience political and social adjustment problems. I do not wish to debate these particular issues, but cite them as evidence of the inevitable political and social problems that must be--and already have been--confronted by all member countries in the face of economic change and structural adjustment, as economies expand and become more closely integrated. It is no longer sufficient for countries' macroeconomic policies to be consistent with one another. Economic structures themselves must also become more compatible. Therefore, it is strongly hoped that the Japanese authorities will move promptly to address remaining structural adjustment problems, notably the land use and distribution system issues, going well beyond the preliminary steps referred to in the staff report.

With regard to trade liberalization, my authorities welcome Japan's support for a successful Uruguay Round in the GATT, including the coverage of services. They also look forward to Japan's leadership in the agricultural area, where it can make a direct and substantial contribution.

Mr. Jalan made the following statement:

It is a particular pleasure to participate in this discussion on Japan. The countries of the Asian region take pride in the economic miracle that is Japan. In its report, the staff has done well to remind us of the economic transformation that has taken place in Japan within the relatively short period of 25 years. From a country having a stand-by arrangement with the Fund in 1964, Japan has become a large provider of resources to the Fund and has initiated major programs to help other countries through its parallel financing and cofinancing arrangements. The authorities are to be congratulated for these achievements. It is also gratifying that the relationship between the Fund and

Japan then and now has been close, and that the Fund's consultation reports through the years have been a source of available advice and comment.

The consultation reports on Japan over the last few years evidence a period of significant change in the world economy and in Japan's role in it. The high quality of, as well as the deep insights contained in, these reports is impressive.

With respect to macroeconomic policies, this year's staff report rightly gives high praise to the authorities. My authorities agree with this assessment. However, a couple of issues relating to the Japanese surplus deserve further comment.

*The staff's forecast of the current account surplus--\$84 billion in 1989--is much larger than the authorities' forecast of \$71 billion. Despite this difference in figures, both the authorities and the staff clearly expect current account surpluses to persist and to remain large. The staff report, however, seems to rule out the use of financial policies, particularly fiscal stimulus, as the right response to reduce the surplus. This stance is probably correct.*

The exchange rate has also appreciated substantially in the last two and a half years, and there does not seem to be much scope for using this instrument at the present juncture. The staff therefore has placed much greater emphasis on structural policies. However, it is not clear from the report which of these structural policies are likely to bring about the desired turnaround. Many of these policies, while desirable on other grounds, perhaps will not have much impact on the current account surplus, and decisions on some of these policies are related to social and economic priorities in Japan itself, and thus have little to do with the international economy. It would be interesting to hear some further staff comments on the priority it assigns to different kinds of structural policies and which of those policies have a direct impact on the current account surplus.

Some of the earlier consultation reports, for example, the staff report for the 1987 consultation with Japan, had pointed out that the correction of global payments imbalances required forcible action outside of Japan, and the burden in this respect may in fact be greater on countries other than Japan. There is not much discussion in the present report on what action has been taken outside of Japan and what is required from other countries. It would be useful if the staff could comment on this aspect.

As in so many other spheres, Japan has been successful in bringing about a major improvement in its fiscal position. Within a period of a decade, a deficit equivalent to 4.5 percent

of GNP has been converted into a surplus of 1.25 percent of GNP. Fiscal correction was necessary, and my authorities welcome the progress made in this respect. However, it will be interesting to know whether, from a medium-term perspective, the staff would wish Japan to continue with the surplus situation, and what are the implications of a continued budget surplus for the medium term.

Japan's official development assistance has increased, and Japan has become one of the larger donors to developing countries, particularly low-income countries, but its official development assistance is equivalent to only 0.3 percent of GNP. In view of Japan's current account surplus, it is hoped that Japan will find it possible to increase its ODA substantially and to attain the UN target over the medium term. It is also hoped that Japan will take further steps to immediately increase imports from developing countries.

Mr. Cassell made the following statement:

I join other speakers in congratulating the Japanese authorities for their handling of the economy over the past year. Japan has successfully sustained the economic adjustment initiated in 1987. There has been strong growth, led by domestic demand, as well as a further consolidation of the fiscal position.

Despite increased levels of capacity utilization and higher wage settlements, inflation had, until recently, not been a cause for concern. But recent events, including higher oil prices and the weakening of the yen, have increased the threat of developing inflation. It is of great importance that these pressures should be kept under control. The authorities have shown their recognition of this threat by raising the official discount rate. I would be interested to hear from the staff whether it sees this as an adequate response.

The present low yen/dollar rate is unhelpful in respect of the prospects both for inflation and for further reduction in Japan's current account surplus. The downward trend in the surplus since 1986 seems to have come to a halt even before the recent weakness of the yen. The terms of trade have played an important part in this stalling, but the adjustment process needs to be restarted.

I agree with Mr. Yamazaki that further measures along the lines of the 1987 initiatives would not be in the right direction. Expansionary policies at a time when domestic capacity utilization is so high would exacerbate the inflationary threat. However, I question the view attributed to the authorities by the

staff that a significant yen appreciation would be counterproductive. In the present context, it could help both in curbing domestic inflation and in improving international adjustment. So also would continuing efforts to open up Japan's domestic markets. This more liberal trade environment should extend to services, including the financial sector and the provision of air services.

Such liberalization should be part of a package of structural reforms. Agriculture is particularly heavily protected in Japan, despite some recent, limited, opening of the domestic market to foreign supplies. The staff has provided a full analysis of the inefficiencies created by this situation and has indicated the possible scale of the welfare losses incurred by the Japanese consumer. Opening up the domestic agricultural market would bring a large net benefit to Japan as well as to the world economy.

Another necessary reform, which the staff suggests has begun, is deregulation of the distribution sector. I note that progress has been limited, but also that the authorities are cognizant of the need to take this further. Greater competition here would benefit consumers and foreign suppliers alike, as distributors become less able to retain windfall profits when the currency rises and to pass on costs when it falls.

In other areas of structural reform the authorities have made greater progress, particularly, in liberalizing the domestic financial system and also in taking the first steps to improve the system of land use.

The importance of all these changes is illustrated by the staff analysis of the medium-term outlook, which shows that with only a moderate pace of reform, there would be sustained growth, but with accelerated reform, there would be not only faster growth but also, given likely responses in the economy, a reduction in the current account imbalance.

The staff projections assume that the authorities continue with their cautious fiscal and monetary policies. This seems a realistic and appropriate assumption. On the fiscal side, the comprehensive reform of the tax system has improved its neutrality and flexibility. Despite the implications of lower revenue in the longer term, strong growth in output and in asset trading activity have enabled the authorities to achieve further fiscal consolidation.

I appreciate the authorities' belief in the need for further fiscal consolidation, but they should not be overconcerned that the surplus on the general government balance is misleading because of future burdens on the social security funds. Expected

income growth can be set against these future burdens. I do recognize their concern about the deficit of the public enterprise sector; however, this should not be reflected in offsetting fiscal restraint but rather in eliminating that deficit through greater efficiency and financial control.

The authorities have introduced greater flexibility into their implementation of monetary policy and have relaxed rules relating to the maturity and size of bank deposits. The staff analysis suggests that financial liberalization has played a part in the recent marked increase in the demand for money, but less so than rising income and wealth. The authorities are naturally concerned about the potential inflationary impact if these money balances are run down. This underlines the need to ensure that inflationary expectations remain low. If they do, and if structural reforms, with their net positive influence on wealth, are vigorously pursued, this threat should not become a reality.

While external imbalances are certainly sustainable for considerable periods of time, it is hoped that the Japanese authorities will pay due regard in their policy deliberations to the external implications of their policies. Being the world's major creditor country imposes responsibilities. The question posed by the staff report, and elaborated in detail by Mr. Warner, is whether Japan measures up to these responsibilities. The various structural measures mentioned in the staff report are not only desirable in their own right, but should on balance help in reducing the current account surplus. But as the staff notes, the most important influence will be a closer match between domestic savings and investment. It is therefore hoped that when the present increase in inflationary pressure subsides, the authorities will follow the staff's suggestions about additions to social overhead capital, to the advantage of both the domestic economy and international economic harmony.

Mr. McCormack made the following statement:

As in 1987, the performance of the Japanese economy in 1988 was impressive. Strong real growth was led by robust domestic demand, the current account surplus declined, and prices remained stable. My authorities join the staff and previous speakers in commending this performance, and they are in broad agreement with the staff's appraisal. Thus, I would like to make only a few brief comments concerning some aspects of the report.

My authorities agree with the staff that in view of current supply constraints, it would not be advisable to consider stimulative policies to promote external adjustment. However, while Japan's inflation rate is low by international standards, and therefore not a cause for imminent concern, my authorities are

somewhat less optimistic than the staff concerning the inflation outlook. In this regard, a number of factors suggest a strengthening of inflationary pressures in the economy. First, there is the waning of price deflationary forces present in 1988, which resulted from the earlier appreciation of the yen and the decline in oil prices. In this connection, the recent depreciation of the yen and the increase in oil prices appear to have begun to be reflected in wholesale and consumer price movements in the first quarter of this year.

Second, unit labor costs, which have been falling since the first quarter of 1987, are expected to increase somewhat in 1989.

Third, most estimates suggest that the economy is already characterized by excess demand, and expected growth in the near term, above potential, is likely to fuel price pressures.

Fourth, broad money continues to grow strongly, at rates in excess of 10 percent. While the rapid growth of broad money in 1987 and 1988 has been attributed to a shift in the demand for money owing to financial deregulation and a strong growth of wealth, these factors appear to be stabilizing. For example, it seems unlikely that stock prices and Tokyo land prices will rise as dramatically as they did in 1987 and 1988. Therefore, the rate of money growth consistent with stable prices can be expected to be significantly lower than in the recent past.

In the light of these considerations, my authorities are not as convinced as the staff in their appraisal that the authorities' intention of maintaining a neutral stance of financial policies in the period ahead is entirely appropriate. Indeed, the considerations I have noted appear to be more consistent with the less optimistic statement earlier in the staff report that the underlying situation, with respect to prices, is becoming less favorable.

In this connection, the authorities currently enjoy an important measure of monetary policy credibility that could be jeopardized if an overly cautious, wait-and-see attitude toward developing inflationary momentum were adopted. A timely response to inflationary pressures would promote the achievement of price stability over the medium term. Moreover, to the extent that a tightening of monetary policy led to an appreciation of the yen, it would facilitate a continuation of the shift in Japanese consumption from domestic to foreign goods and, consequently, a reduction in the current surplus over time. In view of these considerations, my authorities fully support the Japanese authorities' decision to raise the discount rate by 75 basis points, effective from May 31.

My authorities welcome the recent implementation of tax reform in Japan and the continued progress in the deregulation of financial markets, both of which represent considerable achievements. To appreciate the extent of the achievement, one need only recall the considerable opposition that had to be overcome in the case of the tax reform. My authorities agree with the staff, however, that considerable scope for further structural reform remains, particularly in the areas of agriculture, land use, and the distribution system. In this connection, the staff has prepared some useful supplementary material that show the prospect of efficiency and welfare gains for the Japanese economy resulting from structural reform.

At the same time, an interesting aspect of the staff's analysis is that while structural reforms unambiguously have a positive impact on Japan's growth and welfare, the effect on the external position is less clear cut and depends on the specific nature of the reform envisaged. The staff's medium-term scenarios present one set of reforms which would indeed serve to reduce the external surplus, but other contributions may have more ambiguous results; moreover, a difficulty is that the relative pace of implementation of the different reforms cannot always be predicted. In this general connection, Chapter V of the supplementary background paper cites one study which indicates that agricultural trade liberalization, by increasing the efficiency of the Japanese economy, could lead to increases in Japan's manufacturing trade balance. Another chapter shows, as has earlier staff work, that Japan's high savings rate can be explained to a large extent by life cycle considerations, including wealth effects. Finally, as the last world economic outlook exercise demonstrated, a smooth resolution of the global imbalances problem is a function mainly of relative price on real exchange adjustment.

In sum, these considerations suggest that structural reform in Japan should be pursued not only insofar as it might help to mitigate the global imbalances problem--although that would clearly be welcome to the extent it was practicable--but mainly because of the positive effects that such reform would have on Japanese welfare and living standards.

Mr. Almeida made the following statement:

The performance of the Japanese economy in 1988 was impressive and, as in 1987, exceeded expectations. It reflects the resilience and flexibility of the economy to overcome challenges such as the real appreciation of the yen in recent years. It also reflects the authorities' policy actions, which have shown an increasingly willing acceptance of the country's international responsibilities.

The authorities have managed to pursue their medium-term objectives of fiscal consolidation with a positive response of the economy and without an exaggerated decrease in the current account surplus, which could have brought undesirable pressures in interest rates. In fact, the current account surplus declined by only 0.8 percentage points of GDP between 1987 and 1988, a moderate and healthy decline that was made possible only because the authorities were able to maintain low interest rates in the domestic market. Under these circumstances, it is difficult to understand why the Bank of Japan has recently decided to increase its discount rate, which had been kept constant since February 1987, by 0.75 percentage points.

Developing countries can absorb a substantial share of foreign investment and capital, particularly in conditions of low international interest rates. My authorities note, however, that Japan's direct investments are more concentrated than ever before in the United States and Europe. The share of direct investment flows to other parts of the world has declined from 60 percent to 28 percent in the last five fiscal years. It is particularly discouraging to see in the background paper that even in absolute terms the amount of investment to "other countries," which presumably includes all Latin American and African countries, has shown a persistent decline and reached only \$0.3 billion in 1987/88. By the same token, the share of developing countries in Japan's long-term net capital outflows has declined from 37 percent to 15 percent between 1983 and 1987.

The staff paper emphasizes several important structural policies adopted by the authorities to make the economy more efficient. My authorities attach great importance to the staff's recommendations to increase public investments in a medium-term context so as to raise the general standard of living with due regard to supply conditions. They also agree with the staff that the extraordinary increase in land prices might be largely the result of long years of agricultural protectionist policies, which have created an extraordinary differential between domestic and international agricultural prices. In this respect, it is gratifying to see that the authorities have begun to liberalize imports of tropical products and intend to continue to implement the structural measures outlined in the Mayekawa Report, particularly making agricultural tax rates on property more similar to those prevalent in urban areas.

Japan has made important and commendable contributions to official development assistance in recent years, but more remains to be done since its contribution is still below the average ODA/GNP ratio for the OECD countries. Japan's offer to provide additional finance for parallel lending to help strengthen the debt strategy is also commendable within its limits.

Mr. Al-Assaf made the following statement:

Like other Directors, I commend the Japanese authorities for the exceptional performance of their economy since the last Article IV consultation.

Japan is among the industrial countries whose dependence on the external environment is an important factor in its performance. But Japan's economic success last year can be attributed mainly to the policies pursued by its authorities. In this regard, I agree with the staff that prospects for a repeat of the results of 1988 in 1989 and beyond are, indeed, very favorable.

However, there is a major uncertainty related to the size and speed of further corrections in the external surplus, especially in view of recent exchange market developments. I have no difficulty in agreeing with the staff that at present, action in the macroeconomic area that aims at promoting external adjustment is not justified. In particular, fiscal stimulus is not a desirable option in the present circumstances, especially in view of the newly released data on economic activity.

The staff's alternative scenarios show, however, that structural reforms would have a significant and lasting impact on growth and the external balance. The staff report and the useful supplement to the background paper provide a comprehensive analysis of the main areas where structural reforms are warranted. I agree with the conclusions of the analysis, which along with the communiqué of the OECD Ministers, confirm the scope for action in the macroeconomic area in industrial countries.

As I agree with the thrust of the staff papers, I will only make a few comments on structural policy.

The case for structural reform has merit, not only in terms of the direct contribution that it could make to the external balance, but also in terms of its contribution to the expansion of trade between Japan and the developing countries. Imports from developing countries have been declining in recent years. A reversal of this trend is clearly desirable, particularly in the context of current efforts to solve the debt problem. This aspect perhaps deserved some elaboration in the staff paper.

The relevance of land reform, as part of a broad strategy of structural reform, should not be underestimated. I noted with interest the staff's argument that land policies could have certain undesirable effects on the external position, to the extent that lower real estate values could negatively affect import levels through reduced consumption. The argument has merit, but there is another side to this issue: the impact of the well-known high cost of living accommodations in Japan on savings

levels and consumption expenditures may have been minimized by the staff. Therefore, lower living accommodation costs could have a positive impact on the external sector, from an international perspective.

I also tend to share the view that the rules and established practices of distribution systems throughout Japan represent a significant obstacle to foreign products. In view of the size of Japan's domestic market and its expected growth in the years ahead, reform in this area would also be helpful in correcting external imbalances.

The role of Japan as a financial superpower is creating special responsibilities for the country. In making its financial resources available on a worldwide basis, Japan is rendering a major service to the international community. Because it is in the common interest that these resources are evenly distributed, it is of paramount importance that Japan's role as a provider of official development assistance grow in line with its financial and economic position.

Mrs. Ploix made the following statement:

My authorities are impressed by the remarkable results achieved by Japan in 1988. The figures in the staff papers clearly demonstrate that the Japanese authorities have largely succeeded in reorienting growth toward the domestic sector. The authorities should be commended for their efforts in implementing their commitment in the context of international policy coordination.

Indeed, we must look back to 1973 to find such exceptional results: in 1988, the growth rate still accelerated and was, for the second year, the highest among major industrial countries. Manufacturing production continued to recover, with a buoyant growth rate of 9.4 percent. Domestic demand, which largely outpaced GNP growth, was the main factor responsible for this performance: corporate investment, stimulated by high profits and strong internal demand increased at an exceptional rate-- 15.9 percent--and private consumption, by 5 percent. This outcome is all the more remarkable because it was achieved without generating inflation.

External adjustment continued in 1988 as evidenced by the decline in the current account surplus, mainly owing to the further decrease of the trade balance in terms of GNP. Nevertheless, the pace of adjustment clearly slowed, as the effects of the appreciation of the yen seem to have been partially offset by high productivity gains. Therefore, the authorities have to strike a delicate balance between sustaining internal activity

and, at the same time, avoiding a further depreciation of the yen and the resurgence of inflation. This aim will necessitate a combination of fine-tuned macroeconomic policies, and, in view of the relatively small room for maneuver in this area, the implementation of further structural reform.

The prospects for 1989 cast a clear light on the constraints on macroeconomic policies in Japan. Recent developments in the world economic situation seem to have introduced some changes that are not reflected in the staff's estimates. First, I wonder how long the Japanese economy will resist inflationary pressures already being experienced in other major industrial countries. The recent rise in oil prices and the depreciation of the yen have added to internal factors, namely, the tightening of labor market conditions and the greater rate of utilization of manufacturing capacity. The recent introduction of a value-added tax, although otherwise a welcome measure, could add to these inflationary pressures, in view of the rigidities in the distribution sector. Second, the latest developments in the exchange market are likely to reinforce the recent halt in the external adjustment process. In the circumstances, the authorities should continue to rely on fiscal and monetary policy in order to pursue the adjustment process in the inflation and exchange areas without, however, being too prudent.

In the fiscal area, the authorities succeeded in reaching a balance between medium-term consolidation and the short-term need to support domestic demand. More recently, fiscal policy has taken a more neutral stance, which seems appropriate in view of the buoyancy of domestic demand. But the general government surplus should be closely monitored, and the authorities should be ready to respond to any weakening in the economic activity.

The authorities are to be commended for the pragmatic way in which monetary policy has been implemented with the aim of sustaining internal growth: low interest rates and a high increase in money aggregates have played a favorable role. The recent reform of the interbank market should further enhance its efficiency. But the room for maneuver has diminished, as it is now clear that monetary policy will have to adapt to the recent depreciation of the yen. We welcome the authorities' recent response in this area and encourage them to take the necessary measures to prevent a further depreciation of the yen.

External adjustment should clearly be pursued by the authorities. It is cause for concern that the trade surplus has again started to grow since the third quarter and was higher in fiscal year 1988 than during the previous year; it is also worrisome that the apparent doubling in travel payments was the main reason behind the further decline of the current account surplus in U.S. dollar terms. Moreover, it is somewhat disappointing that the

information provided by the staff this morning does not match that provided by Mr. Yamazaki. Further comment on this important issue would be helpful.

Concerning capital flows, one major development was the increase in direct investment abroad, associated with the appreciation of the yen. With respect to the rise of direct investment in Europe, my authorities do not share the staff's view, which mentions the uncertainties over market access after 1992 as a factor for Japanese direct investment. In my authorities' view, this trend reflects instead the many opportunities that European countries offer for private investment.

Structural policies will again play an essential role in Japan's adjustment process. By enhancing the level of consumption they are indispensable to maintaining noninflationary growth, which is more oriented toward the domestic market. The comprehensive tax reform introduced this year is a welcome step, and the authorities should be commended for having resisted the strong opposition against it.

My authorities share the staff's view on the need for further steps in such areas as social infrastructure, land management and housing policies, the distribution system, and agricultural trade. They very much welcome the medium-term scenarios, which provide a most useful quantification of the impact of structural measures on the adjustment process, the results of which confirm their views: GNP would be higher, owing to increased efficiency in the economy, and the current account surplus would be lower as a consequence of the narrowing of the investment-savings gap.

Financial liberalization is another important goal that has been addressed by the authorities for a long time. I would appreciate some information on how long it will take to implement the further measures needed to fully achieve this reform, which should provide a better allocation of savings and also a greater openness of financial markets to foreign institutions.

Concerning trade policy, my authorities welcome the substantial progress already made in tariff reduction and other areas, as clearly evidenced by the strong growth of manufactured goods imports. Nevertheless, and in view of the present slowdown in the adjustment process, the authorities should proceed, as far as possible, in opening the economy, mainly in the area of commodity imports and the deregulation of the distribution system.

The Japanese authorities are to be commended for the recent increase in official development assistance. It is gratifying to note that the ratio of Japan's ODA increased to 0.31 percent of GNP in 1987. Nevertheless, it remains below the OECD average of

0.35 percent. My authorities have no doubt that the Japanese authorities will pursue their efforts to increase their assistance.

Mr. Feldman made the following statement:

Japan's economic performance continues to be impressive and worthy of great admiration. Real GNP increased last year at the highest rate in 15 years, and unemployment remained at a very low level. Moreover, this outcome has been achieved in a noninflationary domestic environment and despite a significant withdrawal of external demand. The economic expansion has prolonged the positive trend initiated in 1986 of domestic demand growing more rapidly than GNP. This high domestic absorption will contribute to correct significant external imbalances, which continue to exist in the Japanese economy.

My authorities concur with most elements and recommendations included in the staff appraisal. The staff is to be commended, particularly for the valuable work presented in the background papers on Japan. I will offer only a few comments on some specific issues, basically of technical nature, namely, the macroeconomic effects of the tax reform, the behavior of household savings and the demand for money, the liberalization of agricultural trade, and the role of Japan in providing financing to developing countries.

The tax reform approved in December 1988 has addressed a number of problems that had emerged under the previous tax system. By broadening the tax base, eliminating most selective taxes, and reducing the level and dispersion of tax rates, reform is expected to enhance the neutrality and the horizontal equity of the system, reduce evasion, and place less of the tax burden on middle-income salaried workers.

The macroeconomic consequences of the tax reform, however, are more difficult to assess, particularly the net fiscal stimulus or withdrawal, in the view of the propensities to consume of the private sector, vis-à-vis the public sector and also the different savings behavior in the private sector. Similarly, particular importance should be attached to the effects of the tax reform on the current account balance, domestic prices, and interest rates. In this regard, the background papers indicate that the modification in the indirect tax system is expected to raise consumer prices and that it is likely that this increase will, in turn, affect interest rates. Perhaps the staff would like to elaborate further on the expected effects of the tax reform on nominal and real interest rates.

With regard to savings and the demand for money, my authorities agree with the staff that the macroeconomic consequences of the tax reform are difficult to assess in the absence of a general equilibrium model. In order to analyze the potential effects of the tax reform on overall private savings, it is tempting, however, to look at the behavioral equation for the household savings rate, estimated in Chapter VI of the supplement to the background paper.

It appears--and perhaps the staff would like to comment on this--that an increase in the household savings ratio in the short run could be expected after the tax reform is put into effect. Considering that the savings rate would be positively correlated both with the rate of inflation and with unexpected or transitory changes in income, the tax reform might imply an increase in the savings ratio if, as it is expected, increases in inflation and transitory changes in income occur. It should be noted that, although this conclusion is in line with the staff's projection on national savings as a percentage of GDP for 1989, it is not compatible with the staff's expectation that the tax reform would induce a shift in the composition of savings but without generating a significant impact on the overall private savings ratio.

As for the behavior of the household savings rate, the staff papers show a declining trend since 1977, which seems mainly to reflect movements in the household net worth/income ratio as well as in inflation. In the analysis of the demand for money, however, it appears that the growth of wealth has been the predominant factor underlying the more rapid increase in broad money/GNP ratio. Considering that a significant component of the broad money definition may also be a significant component of the household saving definition, the relationship between the demand for broad money, household savings and wealth would deserve further analysis. The staff may like to comment on this apparent contradictory role of the recent strong increase in wealth, which has contributed both to a decline in the household savings rate and to a more rapid decline in money velocity. Perhaps there is a definitional problem here.

On trade liberalization, although the steps that have already been taken are in the right direction, import liberalization in the agricultural sector could be further strengthened. My authorities concur with the staff that agricultural liberalization may yield ambiguous results on the trade balance. But as has been also recognized, opening Japanese markets to agricultural and food products from developing countries would remove price and allocative distortions in the Japanese economy, while helping developing countries as well as improving Japan's role in the world economy.

My authorities concur with the staff that a lasting solution to the problem of global external imbalances lies in adjusting the financial policies of the major deficit and surplus countries in a simultaneous way. All of the major industrial countries need to work more closely together to eliminate imbalances and to coordinate policies. Unilateral efforts by Japan to reduce its surplus could cause world interest rates to rise or impede their reduction. From an international perspective, this might result in unfavorable economic conditions for both industrial and developing countries. My authorities appreciate Japan's contribution to the process of economic coordination.

The recycling of surplus savings should also be viewed as a way to enlarge the role of Japan in the world economy. The question is how to find proper ways to channel those funds. In this regard, the involvement of Japan and of Japanese banks in the debt strategy is certainly welcome. It is hoped that the Japanese external surplus will increasingly flow to developing countries which are embarked on strong, growth-oriented economic programs. In fact, the recycling of Japanese financial resources has already started, and this has been very much welcomed by developing nations. My authorities hope that, both through official assistance and by channeling funds through international capital markets, Japan will play a leading role in providing financing to developing countries, thereby making a decisive contribution to the resolution of the debt problem.

Mr. Finaish made the following statement:

Reflecting a more rapid than expected reorientation of the growth pattern in the economy in response to the sharp appreciation of the yen since 1985, Japan's recent growth performance is remarkable. The maintenance of the growth momentum in an environment of moderate inflation, while at the same time contributing significantly to a reduction in international imbalances, has indeed been a major achievement with substantial benefits both for Japan and for the rest of the world. However, with the effects of the yen's appreciation wearing thin, and in view of, on the one hand, the need to avoid jeopardizing the medium-term orientation of fiscal policy, and on the other hand, the current buoyancy of domestic demand, it is evident that the main challenge facing the authorities of preserving the conditions for sustained noninflationary growth at home while reinforcing the process of international adjustment can best be met by focusing mainly on furthering the process of structural reform.

While it may be true, as indicated by the staff's alternative medium-term scenario, that a faster implementation of structural reforms could not be expected to yield substantial reductions in the current account surplus, particularly over the

coming two years, it should be kept in mind that no surplus reductions at all are envisaged under the baseline scenario. Furthermore, aside from improving welfare at home, pushing ahead with structural reforms should also improve the environment for international policy coordination. Having said this, I should add that economic policy formulation in Japan will inevitably, over the foreseeable future, continue to be constrained by the policy environment in deficit countries. While it may be justified on the basis of domestic considerations, the recent increase in the discount rate of the Bank of Japan could be seen in that light. Of course, a bolder pursuit of corrective financial policies in the major deficit countries should reduce the need for, and hence the risks that may be associated with, the implementation by Japan of measures aimed at easing the tensions arising from exchange market developments and from the persistence of large global imbalances.

The importance attached to structural reforms under the current Five-Year Economic Plan is welcome. The staff has provided, both in the report as well as in the supplement to the background paper, an extensive coverage of important structural issues, which makes it amply clear that while substantial progress has already been achieved toward improving economic efficiency in a number of areas, notably tax reform and financial liberalization, there is still considerable scope for a greater effort in other areas, particularly in agriculture, but also in the areas of land management and the distribution system. In the agricultural sector, it is particularly noteworthy that, in spite of the sharp decline in comparative advantage, especially in the production of cereals, almost three fourths of food consumed in Japan is still produced domestically. While much of the pressure for a broad reform of agricultural policies has in recent years been associated with Japan's substantial trade surplus, it is to be noted that the domestic welfare gains to consumers associated with agricultural reforms are estimated to be substantial and to exceed by far the losses to producers. And with the Japanese farm sector currently dominated by small-scale and high-cost producers for whom off-farm earnings account for a substantial portion of income, it appears that the scope for greater efficiency through structural reforms and a lowering of trade barriers in the farm sector is indeed considerable.

The Japanese economy has indeed come a long way over the past 25 years. With the rise to economic eminence, there came an increase in global responsibilities, which the authorities have not been reluctant to shoulder, particularly in the area of providing, and facilitating the flow of, financial resources to the developing countries.

Mr. Grosche made the following statement:

I broadly share the staff's analysis and can endorse its recommendations. I will therefore be brief and will concentrate my remarks on those policy areas where action might be warranted in order to maintain Japan's impressive performance and to reinvigorate the external adjustment process.

With regard to price developments, I am somewhat skeptical about the staff's statement that inflation does not pose an immediate threat despite the tightening that can be witnessed in the goods and labor markets. The recent weakening of the yen against the U.S. dollar, coupled with a continuing high growth of broad money, seems to create a potential for rising prices, which needs to be watched carefully. Moreover, the introduction of the value-added tax on April 1 might be taken as an excuse for raising prices in excess of what the new tax is suggesting.

Against this background, I welcome the recent rise of the official discount rate. While this move would not appear to unduly constrain domestic demand, it might help to contain somewhat the demand for money and to prevent a further weakening of the yen. The recent strength of the dollar is puzzling: the fundamentals clearly point in the other direction. The yen can be expected to strengthen again in the not-too-distant future and relieve pressures from the import side. But the authorities should not rest on this expectation. Like several previous speakers, particularly Mr. Cassell and Mr. McCormack, I believe that the authorities should keep monetary developments under close review and act promptly before signs of inflation emerge. In this regard, I am heartened by the authorities' statement that price stability will continue to be the primary objective of monetary policy.

A stronger yen is, of course, all the more important in view of the need for further external adjustment. Toward the end of 1988, the surplus stopped declining. On the basis of the results for the first four months of 1989, the staff has an even stronger case for the validity of its projection of a surplus, which is expected to rise in 1989 in U.S. dollar terms but to remain stable in relation to GNP.

This prospect is a matter of concern and underscores the need for the authorities to continue to contribute their share to the international adjustment process. Until now, the authorities did what they had been asked to do, and the results in terms of domestic demand growth exceeded by far what had been expected. Clearly, the imbalances cannot be tackled by the surplus countries alone. The staff is absolutely right when stating that the

correction of the global external imbalances will ultimately require adjustments in the financial policies of the major deficit countries.

In this context, I am concerned that the U.S. Trade Representative identified Japan as a "priority country" under the "Super 301" provisions of the 1988 Trade Act. The intention of this action seems to be to launch bilateral negotiations that would aim at eliminating certain trade practices. In my view, this approach runs counter to GATT principles and, more important, distracts from the need to reduce domestic and external imbalances through appropriate macroeconomic measures.

This is not to say that the authorities have exhausted their potential for action. The staff rightly points to several areas, particularly trade and the distribution system, where more can be done. To be sure, these are politically sensitive areas. But the authorities have demonstrated in the past that they are able and willing to act. They have come a long way in reforming the economy, and they are to be particularly commended for the comprehensive tax reform and the many steps toward financial liberalization. The success of their policies should encourage them to persevere and to continue with structural reform. In this regard, I would stress the reform of the postal savings system, of the regulations governing the taxation and use of land, and of the retail system. The reforms should also encompass the agricultural sector. Some welcome steps have been taken, but agricultural policy in Japan is still largely characterized by import quotas and administered prices. As the supplementary background paper shows, the average nominal rate of protection in 1984 was almost five times as high as that in Europe.

In conclusion, I continue to be impressed by the strength of the Japanese economy, and I am confident that the authorities will continue with reforms that aim at improving welfare and living standards in Japan as well as promoting external adjustment.

Mr. El-Kogali made the following statement:

The prudent manner in which the Japanese authorities continue to manage their economy leaves little room for others to advise, and there is much to learn from the outstanding performance of the Japanese economy which, as the staff states, "has once again confounded even the most optimistic of forecasters." All economic indicators reflect an impressive performance. In particular, domestic demand compensated for the further withdrawal of external stimulus, resulting in a 15-year record real GNP growth rate without creating inflationary pressures.

The progressive improvement in the fiscal position has been associated with a continuous rise in the revenue/GNP ratio, which reflects buoyancy of the tax system. The comprehensive reform of the tax system approved recently is expected to increase the Government's ability to generate additional resources needed to maintain fiscal consolidation. The sound position of government finances and the absence of inflationary pressure has freed fiscal policy to promote economic restructuring. I note the authorities' view that the current comfortable budgetary balance is a reflection of transitory factors and that the underlying fiscal position will remain under considerable strain with a continued need for fiscal restraint over the medium term. While the authorities' cautious stance may be appropriate under the prevailing circumstances where domestic demand does not need further stimulus, it might need to be reconsidered if developments indicate substantial weakness in domestic private sector demand. In particular, investment in social overhead capital, as emphasized in the Five-Year Economic Plan, may call for increased public investment.

In 1988 the external sector registered a further adjustment, with the trade surplus showing further decline and the deficit in invisibles widening sharply, thereby contributing to the international adjustment process. The authorities are encouraged to make further efforts to reduce global imbalances, and I endorse the staff's view that the correction of global external imbalances would require sustained effort by all industrial countries to adjust their financial policies to support such objectives. Unilateral action by Japan, without coordinated effort by other industrial countries, may not succeed in achieving a significant reduction in the global imbalances and is likely to have some adverse implications for the international economy.

My last point concerns the flow of financial resources to the developing countries and, in particular, concessional flows to low-income countries. The Japanese authorities are to be commended for the significant increase in the volume of ODA in recent years and the effort to improve its quality. Japan's contribution to the Fund's enhanced structural adjustment facility and the World Bank's special facility is greatly appreciated. Nonetheless, in view of its international position and prosperity, Japan has a special responsibility to assist the low-income economies, and we would urge the authorities to increase their ODA and step up their assistance to the low-income countries.

Mr. Kwon made the following statement:

First of all, I would like to join other Directors in commending the authorities for yet another impressive year of robust and stable growth of the Japanese economy. It is beginning to be

a rite of spring for the staff to admit that they have underestimated the potential of the Japanese economy to rise to the challenge of sustaining growth amid significant structural adjustments.

Over the last two years Directors have periodically expressed concerns that the shift in the main origin of growth from external to domestic demand, as well as the perceived weakness in Japan's manufacturing sector, would result in downturns in the short run. In the event, it must be acknowledged that, owing mainly to prudent macroeconomic policies and an increase in efficiency through important structural changes, the authorities have been able to maintain real GNP growth at rates higher than those of the other major industrial countries while keeping inflation at the lowest rate among them.

I agree with the staff's assessment that there is no immediate reason for the authorities to go beyond the range of their present macroeconomic policy. Indeed, while the staff is right to play down any imminent inflationary concerns, it is clear that in considering the scope for further fiscal or monetary policy stimulus, the authorities need to keep a wary eye on the nascent inflationary risks contained in rising oil prices and emerging domestic supply constraints as well as the potential impact of the new consumption tax on inflationary expectations. A point to emerge during the Board's recent discussion on exchange rate developments (Informal Session 89/13, 5/15/89) was the need to ensure that the correction of existing external imbalances did not involve a ratcheting up of national inflation rates to the highest common denominator.

My authorities certainly would not see any scope for further easing of monetary policy, which already appears relatively loose. It is intriguing that, notwithstanding the recent increase in the official discount rate, the short-term interest differential between Japan and the Federal Republic of Germany has continued to widen in favor of the latter, potentially fueling destabilizing speculation that the current exchange rate relationship may not be sustainable. Of course, the differential with U.S. dollar rates has narrowed in recent months as the dollar has continued to strengthen. There is clearly a balance to be struck, in the setting of monetary policy, between preserving domestic price stability and currency stability. For their part, my authorities would be inclined to give primary emphasis to domestic price stability, but I would be grateful for any insight Mr. Yamazaki could provide into the current thinking of his authorities.

There are, however, some worrying trends in the latest figures. In particular, it would appear that net exports re-emerged as a positive contributor to growth in the second half of 1988.

The extent to which continuing strong growth in investment is concentrated in the manufacturing sector might also lead one to question how far the necessary transfer of resources from the traded sector to the nontraded sector has progressed. As yet, trends are not clear. But I am inclined to wonder about the extent to which the reduction achieved over recent years in the external surplus has in fact reflected fundamental adjustment in the underlying structure of the Japanese economy.

I agree with the staff that unilateral action by Japan to reduce its surplus would not be desirable from an international perspective: correction of the global external imbalances will ultimately require policy adjustments in the major deficit countries. But Japan clearly has a responsibility to contribute to reducing external imbalances in view of its size and importance in the world economy.

In this context, Mr. Yamazaki's indication that his authorities expect somewhat faster external adjustment over the next few years than has been suggested by the staff is reassuring. I would be grateful for any further elaboration he could provide on the factors underpinning this difference of opinion, particularly with regard to the likely current account outcome for 1989. In any event, the outlook now implies a far more moderate pace of adjustment than the authorities and other commentators had suggested 12 months ago.

If, indeed, the opportunity for significant restructuring provided by the earlier appreciation of the yen has not been fully taken advantage of, the answer would seem to lie--as the staff rightly suggests--in the area of microeconomic reform. The staff correctly identifies the key elements for the authorities to address in their structural reform agenda, and I agree with its appraisal that there is considerable scope to accelerate the pace of reform in all these areas.

It is popular wisdom that such structural reform would itself go a long way to reducing Japan's external surplus. Certainly, there are a number of obvious areas, such as trade policy, where unilateral liberalization would be in keeping with Japan's emerging leadership role in the global economy. As is evident from the background papers, however, the likely direct impact of various structural reform measures on the savings-investment gap and the current account surplus remains problematic. The alternative medium-term scenario, which assumes a faster implementation of structural reforms, is encouraging in this regard, although I wonder whether the impact on the external position will be as clear-cut as implied by staff. Japan's remaining huge external surplus and relatively comfortable macroeconomic position, however, should provide the authorities with flexibility to explore alternative policy action within the

medium-term objectives of their Five-Year Development Plan, and I would hope that the authorities would seriously consider all the implications of this alternative scenario.

What is clearly true, however, is that such reform promises considerable potential welfare gains for the Japanese economy itself, together with a significant improvement in the efficiency and flexibility of the economy, and hence its ability to absorb external shocks and respond positively to relative price changes.

It is imperative that recent political difficulties in Japan not undermine commitment to this broad agenda of structural reform. My authorities are somewhat worried, therefore, by recent reports of "policy paralysis" and, in particular, speculation that some elements of recent structural policy initiatives may be watered down or reversed.

Let me comment briefly on some of the specific areas of structural reform raised in the staff report.

I would not want to underestimate the significance of the recently approved package of tax reforms. However, while the staff is correct in highlighting the direction of the changes, my authorities feel that the staff overstates the extent to which the problems have been solved. They would urge the Japanese authorities to view this as only a first step on what is likely to be a long and difficult path. Major deficiencies in the tax system remain to be addressed, and there is clearly considerable scope to further enhance administrative simplicity, equity, and efficiency and to minimize evasion and avoidance. I would note, for example, that the consumption tax exemption for businesses with annual sales less than ¥ 30 million, and concessional treatment for those with sales up to ¥ 500 million, is likely to benefit almost 95 percent of all enterprises. Similarly, the decision to base the consumption tax on company book entries rather than invoices seems to reflect the concerns of small and medium-term businesses that an invoice system would allow their income tax compliance to be checked. Meanwhile, the effective nominal corporate tax rate of 49.98 percent--based on estimates of the Ministry of Finance--remains high by international standards.

My authorities will also be keen to see whether this, and subsequent, tax reform will effectively address, for example, the distortions arising from land taxation, and whether it will provide the necessary resources for greater investment in social infrastructure and other outlays associated with the aging of Japan's population. As Mr. Yamazaki has stated, the aim must be to increase the overall vigor of the Japanese economy.

Land policies remain one of the most difficult political and economic issues facing Japan. My own authorities are particularly interested to monitor progress in this area, as Korea is facing similar, if not the same, problems. The staff identifies a number of regulations and taxes which impinge on the utilization of land. There is a strong prima facie case that removal of these regulations and taxes would improve resource allocation. Nevertheless, the system is so complicated that it is difficult to judge the size or nature of these efficiency gains; this area might justify further study by the staff.

I welcome the substantial progress made in the area of financial liberalization, including the new measures taken during the past year. But I would urge the authorities to push forward, by removing the boundaries between different types of banks, the Post Office savings system, and the securities houses. In particular, it is clear that the Post Office savings system continues to be a major barrier to fully deregulating domestic interest rates.

Another area where significant progress can be made is in social infrastructure. Investments in social overhead capital will provide an excellent vehicle for attaining important dual objectives, namely, improving the quality of life and reducing the external surplus over the medium term. The authorities' concern over the budgetary implications of such investment in the midst of implementing far-reaching measures to reduce the central government deficit is understandable. Nevertheless, my authorities are inclined to agree with the staff's assessment that there should be ample room for improving the provision of public goods over the medium term without undermining the fiscal position.

Significant benefits might also be derived from minimizing the bureaucratic red tape that complicates the economy's distribution system. Reform in this area would not only help reduce the cost of domestic goods but would also contribute to the improvement of the general welfare of the population, and thus support the authorities' objective of improving the quality of life.

Trade liberalization is one of the more important areas where the authorities should consider taking a leading role. My authorities attach special importance to agricultural support mechanisms. While we all recognize that reform in this area is often difficult, Japan is probably in a better position than many other countries to take vigorous action on this front in view of its strong external position. Moreover, the domestic welfare benefits to the Japanese economy would be significant.

It is encouraging to note that the authorities have recognized the need to align domestic prices of agricultural

commodities with international prices and are gradually abolishing import quotas on a number of agricultural products. But the domestic price of rice remains, for example, nine times greater than the world price, while other agricultural products are on average three times greater than the world price. It has been estimated that the continued effect of higher food and related land prices results in domestic purchasing power some 30 percent below that of the U.S. consumer, notwithstanding the higher level of Japanese per capita incomes. Perhaps the most serious indictment of these policies is the estimate by the Australian Bureau of Agricultural and Resource Economics that it costs the Japanese taxpayer and consumer \$1.44 for each \$1 of income transferred to the farm sector and that this only marginally benefits those 70 percent of Japanese farmers who produce less than 10 percent of agricultural output.

Another area of trade liberalization that needs attention is the treatment of manufactured goods. It is regrettable to note a recent bilateral trade arrangement under which Korean exports of knitwear have become subject to voluntary export restraints. Although my authorities recognize that the arrangement has been worked out by the respective Japanese and Korean industries, they nevertheless share the concerns expressed by the staff that arrangements of this type, however exceptional, would mar the Japanese record, and could provoke charges that exports to Japan are subject to informal barriers. This perception would be particularly pronounced if historical trade figures between the two countries, which have always been in Japan's favor, are considered.

I would like to take this opportunity to express the appreciation of my constituency for the impressive efforts of the Japanese authorities to ensure an adequate flow of financial resources to developing countries. It is encouraging to note that disbursements of ODA are projected to amount to \$50 billion in 1988-92, with improved financial terms.

My authorities also acknowledge Japan's effort to contribute significantly to finding solutions to the international debt problem through its financial support of multilateral institutions' programs designed to assist the structural adjustment efforts of highly indebted countries. I trust that the Japanese authorities will continue in these efforts.

Mr. Ovi made the following statement:

In 1988 the Japanese economy performed extremely well for the second consecutive year. The high rate of growth, combined with stable price developments, fiscal consolidation, and a

substantial decline in the current account surplus, can to an important extent be attributed to the economic policies pursued by the authorities.

Looking to the future, it is expected that the growth rate of production and domestic demand will remain strong, and that the rate of inflation will remain at a low level relative to other industrial countries. However, owing primarily to the dissipation of the effects of the earlier yen appreciation, the pace of the external adjustment is expected to slow down, or even come to a halt. Seen in a global context, such a development is a matter for serious concern. Like Mr. Warner and others, I shall concentrate my remarks on the issue of external adjustment.

With regard to the short term, I agree with the staff's assessment that the scope for macroeconomic policies to contribute to further external adjustment is constrained by high capacity utilization and the emerging bottlenecks in the production and distribution sectors.

However, fears of a deterioration in the fiscal position as well as in inflation prospects should not be exaggerated and lead to a fiscal policy that is too restrictive. One must keep in mind the favorable starting position. The high level of savings, combined with the large need for additional public investment, should leave room for selective measures. A reduction in supply constraints by continued expansion in investments should generate an increase in production potential as well as imports.

Besides keeping domestic price developments under strict control, the main objective of monetary policies in the present circumstances should be to promote a continued external adjustment, primarily by avoiding a further depreciation of the yen. Despite the reduction in the differentials between interest rates in the United States and those in Japan since April, the yen has been under significant downward pressure with the risk that the ongoing transfer of resources from the export sector to the domestic sector will cease or even be reversed. My authorities welcome the recent increase in the discount rate in this context. Indeed, like others, I have difficulties with the staff's statement that a further yen appreciation could be counterproductive. Of course, the correction of global external imbalances ultimately requires adjustments in the policies of deficit as well as surplus countries. Thus, the Nordic countries hope that improved international coordination will soon lead to the adoption of necessary adjustment measures in several major countries and not only Japan. Otherwise, the relative stability in foreign exchange markets and the continued high rate of growth in the world economy might well be threatened.

Looking to the medium term, the main challenge for the authorities is how to continue the adjustment process by increasing domestic demand and imports without risking a surge in inflation. To this end, I agree with the staff's recommendations regarding further structural reforms, and I was pleased to read in the staff report that structural policies are a focal point of the Government's recent Five-Year Economic Plan.

I have particularly noted the recognition by the authorities that radical changes are needed in a number of crucial areas, such as social infrastructure, land use patterns, agricultural protection, and market access. As the medium-term scenarios show, the possibility of sustaining the growth process in an environment of price stability and reinforced external adjustment would be enhanced by the implementation of sound policies in these areas. In our view, emphasis should be put on those structural measures that will have an important bearing on the external surplus. Like Mr. Jalan, I should like to hear more from the staff on this issue.

Regarding Japan's contribution of financial resource flows to the developing countries, the Government has to be strongly commended for its efforts to contribute to finding a solution to the international debt problem; for instance, through arrangements to provide parallel financing in connection with Fund-supported programs. Japan's official development assistance, however, continues to be lower than the average for all OECD countries. Taking into account the strength of the Japanese economy, the Nordic countries believe that there should be scope for increasing Japan's ODA contribution substantially beyond the present level of 0.3 percent of GDP. As part of such efforts, Japan could make an important contribution also to the working of this institution by taking an active part in solving the problems of countries with overdue obligations.

Mr. Hogeweg made the following statement:

Today again, as last year, the staff's appraisal of Japan's policies and results is highly favorable. Japan's achievements in 1988 have been remarkable indeed. Especially welcome is the fact that real GNP growth was higher due to unexpectedly higher real domestic demand. It is, however, somewhat disappointing that the current account surplus as a percent of GNP has not diminished as much as last year's projections assumed.

Of course, many variables influence the outcome of the current account, but I read with great interest the discussion between the staff and the authorities on whether import demand is especially income elastic or elastic to relative prices. I support the staff's view that imports are unlikely to continue to

grow at the pace of recent years without further relative price or structural changes, and the shock of the yen appreciation since 1985 seems to have been already absorbed completely by the export sector. Of course, the external adjustment in Japan will also depend on policies in deficit countries. I agree fully with the staff that expansionary financial policies, particularly fiscal stimulus, could be counterproductive, but that there is substantial scope for more vigorous implementation of structural policy intentions. The better the structural adjustment, the less will be the need for adjustment in relative prices, that is, the exchange rate. Consequently, my authorities support the continuation of a neutral fiscal policy stance, realizing that demographic developments are bound to put pressure on the fiscal accounts. It is cause for concern that capacity constraints may make themselves felt, which could fuel inflationary pressures. Also, the recent yen depreciation has pushed up import prices to over 10 percent on an annual basis in the first quarter of 1989.

The recent increase in the discount rate is welcome, but I note from Mr. Yamazaki's statement that it does not represent a change in the basic stance of macroeconomic policy. I wonder whether, in view of the high growth rates of monetary aggregates, apparent capacity constraints, as well as exchange rate developments, it would not be advisable to further tighten monetary policy. More generally, interest rate policy could be made more flexible. Consequently, I am inclined to go much further than the staff statement that there is no room for monetary relaxation.

The extensive coverage of structural policies in the staff report as well as the ample attention given to it in the staff appraisal is especially welcome. I agree that structural adjustment should in the first place be aimed at improving external adjustment. Emphasis on investment in social infrastructure--necessary for increasing economic welfare in Japan--is certainly desirable also from the perspective of external adjustment. But in general, I found it difficult to judge how the different measures work out in terms of the private sector savings ratio.

On external adjustment, although the invisibles account is still in deficit, I wonder what is the contribution of income from Japan's net foreign assets to the current surplus. This item does not receive separate attention in the staff report but is clearly illustrated in the background paper. Just as deficits become more difficult to correct the longer they are left unadjusted because of interest obligations, surpluses may also become more intractable with the passage of time. And the rising stock of Japanese assets abroad may give rise to tensions insofar as it leads to resistance to foreign ownership in the countries concerned. These considerations further reinforce the need to invigorate the adjustment of global imbalances. As noted

earlier, Japan's contribution in this regard should take the form of vigorous implementation of structural reforms.

Finally, although Japan's ODA is large in absolute amounts, its ratio to GNP will, over the coming years, not increase much from its current level, which is still far removed from the UN's target of 0.7 percent. In response to Mr. Yamazaki, I think that this target was meant to be independent of the distribution of financial balances within the donor country and of a surplus or deficit position in the current account. However, a current surplus in general allows a transfer of real resources financed from the donor country's own savings. The situation prevailing in Japan, namely, that the Government is in deficit while the private sector accounts for the external surplus, also exists in the Netherlands. Of course, Japan's intentions, as a surplus country, to provide funds in parallel with Fund lending and also for debt reduction operations in the context of the strengthened debt strategy is most welcome.

Mr. Mawakani made the following statement:

I join other speakers in commending the Japanese authorities for their prudent policies, which have produced another year of impressive results. These achievements have been highlighted by Mr. Yamazaki and touched upon by previous speakers. It is worth mentioning that noninflationary growth was sustained and strengthened in 1988, when the highest growth rate in 15 years was recorded. This performance reflects the remarkable strength of domestic demand, which rose by 7 3/4 percent in 1988, and more than compensated for the effects of the sustained withdrawal of external stimulus. It also reflects the authorities' efforts in external adjustment.

I agree with the staff that the demanding task confronting the authorities in the immediate future is to guard carefully the conditions for sustained growth while building on these macro-economic achievements through the continued pursuit of structural reforms.

Following the successful fiscal consolidation in recent years, the authorities have initiated a comprehensive reform of the tax system, which has substantially improved the horizontal equity of the system. However, in view of the favorable short-term prospects for strengthening private domestic demand and the need for continued fiscal restraint in the medium term, the authorities intend to maintain a broadly neutral fiscal stance in 1989/90. With both current and capital expenditures budgeted to increase within reasonable limits but to fall slightly in terms

of GNP, and with revenue expected to grow broadly in line with GNP expansion, the authorities' policy stance is broadly appropriate.

In an environment of relative price stability, overall monetary policy has aimed at supporting domestic demand and stabilizing the external value of the yen by keeping domestic interest rates at relatively low levels. As the staff has rightly pointed out, the tightening of monetary policy in some major industrial countries in recent months has put downward pressure on the yen. In view of the re-emergence of inflationary pressures and the need to stabilize the external value of the yen, I welcome the authorities' recent decision to increase the official discount rate--for the first time in more than nine years--from 2.5 percent to 3.25 percent. This timely action is appropriate, and I would encourage the authorities to continue to focus on price stability as the primary objective of monetary policy.

It is now generally recognized that industrial countries' scope for strengthening macroeconomic policies in the international adjustment process can be significantly widened through structural reforms. In Japan, such reforms have already been initiated in the fiscal area in the context of a medium-term economic plan. I welcome the substantial progress that has been made in the areas of tax and financial reforms, as elaborated in the latest supplement to the background paper. However, one area of financial liberalization that shows limited progress is the postal savings system, which enjoys several privileges over private banks. I would therefore encourage the authorities to accelerate the additional reforms required in financial liberalization. Further structural changes are also needed to remove legal and other impediments to the more efficient use of land and to eliminate the rigidities in the domestic distribution system. The implementation of the required structural changes will contribute significantly to sustain growth and to achieve the authorities' external adjustment objectives. In this context, I would also encourage the authorities to consider adopting the staff's alternative medium-term scenario, which assumes a faster implementation of structural reforms.

Finally, I wish to express the appreciation of my authorities for Japan's commitment to shoulder its international responsibilities through its program of recycling financial resources to developing countries and to multilateral financial institutions as well as through official development assistance.

Mr. de Groote made the following statement:

The staff correctly notes in its appraisal that "the Japanese economy has, once again, confounded even the most

optimistic of forecasters." Indeed, it is hard to see which variable has not, in the recent past, moved in the right direction, both from the domestic and from the international point of view. Japan has experienced an impressive and historically high rate of growth without endangering the stability of its domestic price and wage levels; the unemployment rate has been further reduced to its apparently incompressible level; the general government balance has shifted to a substantial surplus; and, the external sector adjustment has continued.

At the same time, the huge task of structural reform has been vigorously endorsed in Japan's Five-Year Economic Plan. Substantial progress has already been made in the areas of tax reform and financial liberalization, thus providing reasonable hope for future structural adjustment measures in other identified fields and especially in the trade and distribution systems. Those measures should lead to an effective opening of Japan's economy. Colleagues have already touched upon the details of these reforms, and I can associate myself with most of their comments. On the comprehensive reform of the tax system, which enhanced the neutrality and the horizontal equity of the system, I have merely one comment concerning one of the apparent purposes of the reform, namely, its contribution to stimulating the motivation to work. While I have much sympathy for this purpose, I am nonetheless surprised that the obsession with productivity and overtime was accepted as the determinant motive; for others, an increase in total consumption would have been a more evident purpose. But I am sure Mr. Yamazaki will wish to comment on this topic.

A discussion of the Japanese economy must necessarily integrate the international component, which is a major influence for Japan and which Japan influences in a major way. In recent years, substantial policy modifications have clearly demonstrated the Japanese authorities' willingness to assume their role and responsibility in the world. Undeniably, the Japanese economy has become more domestically centered, with domestic demand playing a larger role in the growth dynamic, and has become more internationally integrated, with imports and especially manufactured imports increasing their share in the Japanese production and consumption processes. I wonder, however, if the bare figures showing the rise of imports and the fall of exports as a share of GDP do not give a rosy picture of these developments. The export ratio dropped over the last years at least partly as a result of the direct plant investment effort of Japanese companies in their export market; the automobile sector is a good example in this context. Conversely, I would be interested in the staff's comments on the role of Japanese production units operating in the newly industrializing economies of Asia; in particular, what is their impact on the increase of the import

to GDP ratio, especially for manufactured products imported as inputs for the domestic Japanese production process?

While the internationalization of Japanese companies is itself a welcome development, the shifts in Japan's import and export ratios have not eliminated its current account surplus. Here also, the Japanese economy has surprised more than one. On the basis of different assumptions, the staff and the authorities see the prospects for future current account surplus resorption in a different light. If the staff expects the current account to increase in nominal terms in 1989, the authorities--who prefer to refer to fiscal rather than calendar years, which does not facilitate comparisons--expect that surplus to diminish further. On the basis of the first four months' experience in 1989, the truth seems to lie somewhere in between: as reported in the recent supplement to the background paper, the current account surplus was unchanged from the previous four-month period. In any event, the current account surplus will remain high in nominal terms.

The staff's analysis of changes in the price and income elasticities of Japanese exports and imports over the last two years is most interesting in this context. Imports--and especially manufactured imports--have become considerably more sensitive to relative prices; in contrast, the relative price elasticities for Japanese exports have decreased, whereas the income elasticities have increased. In addition to the interpretation given by the staff, these movements also mean that imports substitute for domestic products in the production process and that the composition of exports changes in favor of high-technology equipment products for which Japanese exporters have gained a commanding position. These two movements could explain Japan's external sector performance despite substantial real effective exchange rate changes. With price movements due to exchange rate changes being passed through more for import products and less for export products, the appreciation of Japan's terms of trade will become a dominant feature. These developments could also explain the recovery in the profit position of the manufacturing sector: profits almost doubled during the last two years and provided the necessary financial support for the substantial increase of investments in plant and equipment, which will reinforce further the structural changes in the export sector. A so-called structural component in the surplus of the export sector has thus appeared over the last years, which will be more resistant to the classic exchange rate cure applied in the past.

Because the Japanese economy is now faced with a high utilization of productive capacity, I agree with the staff that the way to continue the international adjustment process will largely depend on an acceleration of structural reforms in Japan's economy and society, leading to a stronger penetration of foreign

imports and higher domestic absorption. Clearly, these are actions of a medium-term nature. In the meantime, the staff seems to accept as given the high growth/low adjustment model, which implies a continuous high financing by Japan and other surplus countries of the major deficit countries. Although I can agree with the staff that, in view of the dominant size of these countries, their internal adjustment is a prerequisite for a global absorption of disequilibria, I wonder whether complementary measures are not called for. These cannot, of course, be unilateral, but must be concerted actions taken by Japan together with its major trading partners. The recent exchange rate developments are clearly inappropriate. The recent interest rate changes in Japan and, to a lesser extent, in the United States are therefore welcome. Concerted action should now be centered on at least stabilizing, or even reversing, the dollar/yen exchange rate and on further adjusting the yen exchange rate vis-à-vis European currencies. The exchange rates of the EC countries have been adjusted only marginally vis-à-vis the yen in recent years, and Japan's competitive position seems still to be very strong with these countries. Indeed, the share of Japan's surplus with the European Communities in Japan's overall surplus, with some fluctuation over the recent years, is practically unchanged when 1984 and 1988 figures are compared, whereas, on the same basis, Japan's surplus with the United States has fallen substantially. Another indicator of Japan's continued strong competitive position vis-à-vis the European Communities can be found in Japan's flow of direct investment with Europe: compared with other regions, that flow has remained sluggish, especially for the most relevant manufacturing sector.

The desirable exchange rate changes could best be achieved by further gradual increases in Japan's interest rates. By reinforcing the wealth effects and by containing inflationary pressures, the depressing effects of such increases on domestic consumption should be marginal, as is shown by the staff's analysis of the behavior of the household savings rate. A complementary and short-term policy along these lines would thus leave domestic demand in Japan largely unaffected while operating principally through demand-shift effects. Their impact on global growth and resorption of external disequilibria should accordingly be positive.

It is a welcome fact that increases in Japan's official development assistance have paralleled increases in its GDP; the amounts are high, as are its output as the world's second industrial power and its surplus. It is also commendable that Japan has provided substantial support to the Fund and to the World Bank, a fact that should be reflected in a revision of the country's relative position in the Bretton Woods family. The arrangements for parallel financing for countries undertaking structural adjustment should be regarded as a model for other

surplus countries. In relative terms, with ODA equivalent to 0.31 percent of GDP, Japan still lags behind the average of other OECD countries. I am confident that the Japanese authorities will consider that an upward adjustment of this percentage becomes a country that has acquired a unique leadership in the world.

Mr. Kabbaj made the following statement:

I join previous speakers in commending the Japanese authorities for having made their country, in less than 25 years, one of the biggest success stories in recent history and for the impressive performance of the economy in 1988. I am in broad agreement with the staff appraisal, which is derived from a set of high-quality papers.

It is indeed heartening to note that the outcome for 1988 was much better than the Board and the international financial community had expected; for the second consecutive year, Japan has achieved the highest rate of GNP growth and the lowest rate of inflation among the major industrial countries. It is also important to note that Japan has contributed significantly to the international adjustment process. Its current account surplus was reduced from 4 percent of GNP in 1985-86 to 2.8 percent in 1988. Real domestic demand picked up strongly from 4 percent of GNP in 1985-86 to 7.7 percent in 1988. The contribution of net exports to GNP growth was reduced by 2 percentage points in 1988 following a reduction by 2 percentage points in the two previous years.

All this was accomplished in a well-mastered environment. The GNP deflator increased by a mere 0.5 percent after being negative in 1987, while residential investment increased by 13 percent and industrial production by 9.5 percent.

Without hesitation, my authorities agree with the staff that there is no case in Japan at present for action in the macroeconomic area to promote external adjustment. The logical conclusion is that the correction of the global imbalances will ultimately require adjustments in financial policies of the major deficit countries, and that unilateral action by Japan would not be desirable from an international perspective and could, in fact, worsen economic conditions in industrial and developing countries alike through inducing an increase in international interest rates.

Apart from the question of the acceleration of the pace of structural reforms in Japan, to which I will return, the question remains whether the deficit countries will be able to play their roles. I am afraid that in view of the rigidities and

constraints facing these countries, the international adjustment process could stall, as was clearly suggested during the Board's recent informal discussion on exchange rate developments. In this regard, I note that Mr. Yamazaki has taken a more optimistic view, since his authorities do not fully agree with the staff on the medium-term prospects of the Japanese economy. Nevertheless, and in view of the fact that the staff's position is underpinned by the generally reliable work on the world economic outlook, I wonder what steps could be taken by the Fund to avoid such an unwelcome development.

I am in general agreement with the staff's views on the appropriateness of the authorities' budgetary and monetary policies.

With respect to structural policies, my authorities welcome the adoption of the Five-Year Economic Plan for the period 1988-93 and the Plan's endorsement of the recommendations of the Mayekawa and other commissions. It is gratifying to note the progress in the implementation of these recommendations in the areas of tax and financial reform as well as the staff's favorable assessment in this regard. My authorities encourage the Japanese authorities to move boldly in other areas of structural reform. In that regard, one area that merits prompt attention is land management.

Another area to which my authorities accord the highest importance, especially in view of its consequences for developing countries, is trade. They are concerned about Japan's use of nontariff barriers for a broad range of products, particularly agricultural commodities and textiles. While they recognize that Japan is not the only country that has recourse to such protectionist policies--which are definitely detrimental to all parties--in view of its prominent position in the world economy and its comfortable external position for the foreseeable future, Japan is rightly expected to play a crucial role in fostering free trade, which is of paramount importance in promoting international cooperation and development. In this connection, my authorities fully concur with the staff's suggestions regarding the relaxation of government regulations.

My authorities wish to encourage the Japanese authorities to augment the flow of financial resources to the developing countries. In this regard, Mr. Yamazaki's statement that the external surplus is held by the private sector while the public sector is still running a deficit, is deeply disturbing. My authorities consider that Japan's official development assistance as a share of GNP is unduly low when compared with the UN target of 0.7 percent of GNP and even with the average of 0.35 percent of GNP for the OECD countries.

My authorities welcome Japan's contribution to finding a solution to the debt problem and commend the Japanese authorities for their contribution to the enhanced structural adjustment facility and to the World Bank's special facility for sub-Saharan Africa as well as for their support for countries' structural adjustment efforts through parallel financing. In this respect, some details regarding funds committed under the \$30 billion recycling plan introduced in May 1987 would be welcome, particularly with respect to the status of actual disbursements. Also, what are the prospects for the use of the SDR 3 billion lent to the Fund?

Mr. Dai made the following statement:

The overall achievements of the Japanese authorities in transforming their largely export-oriented economy into one led by domestic demand are certainly impressive and commendable. In the past year, the economy again maintained a strong growth momentum following a significant acceleration in 1987. The contributing factor to this strong growth was not external demand--which in the past had usually been the major stimulus to buoyant economic activity in Japan--but rather an acceleration in domestic demand led by sharp increases in investment in plants and equipment as well as personal consumption. It appears that the negative effects of the appreciation of the yen, which withdrew the external stimulus from the rate of output growth, have been more than offset by the positive effects, which, together with weak international oil and commodity prices, have strengthened domestic demand.

Favorable terms of trade helped the economy to achieve gains in growth and employment without inducing inflationary pressure. Meanwhile, monetary and fiscal policies also effectively reinforced the noninflationary growth of domestic demand. It is particularly worth mentioning that, while monetary and fiscal policies helped to sustain an adequate growth in domestic demand and were at the same time constrained by considerations to keep other goals on track, structural reforms currently under way are an appropriate complement to help alleviate such a dilemma.

The challenge facing the authorities is to preserve the present growth pattern, while pursuing structural reforms that will help maintain the economy on its noninflationary growth path. In this respect, I would like to make some observations regarding the impact of the reform of the tax system, the increase in the official discount rate, and the strengthening of the U.S. dollar in recent months.

Concerning the impact of the tax reform, these measures, directed at income taxation, consumption taxation, and assets taxation, would all have a favorable effect on the economy insofar as they improve the allocation of private savings while providing incentives to the economy. However, I would like the staff to clarify a few questions in this regard.

First, in view of the persistently higher savings rate, I have the impression that the propensity to consume in Japan has been relatively low compared with that of other major industrial countries. A contributing factor in this regard could be the tax system's undue reliance on direct taxation, which in past decades has depressed consumption demand. I wonder whether a reduction in personal income taxes through lower tax rates would increase the inclination to consume among the middle-income segments of the population.

Second, according to the staff, the tax reform was not expected to lead to any significant movement in the overall private savings-investment balance but was expected to change the composition of savings and the form of financing for business investment. In the past, owing to relatively low taxation on capital gains, people were inclined to put their savings in the form of securities. Therefore, business investment relied much more on security financing. After the tax reform, the composition of savings would probably change with a part of the savings shifting to more liquid assets such as bank deposits. I wonder whether such changes would have an impact on the monetary policy. I would appreciate some explanation from the staff on this point.

Concerning the increase in the official discount rate, which took place after the consultation papers were issued, I wonder whether the staff has analyzed its impact. Since prices remain stable and the inflation differential between Japan and other industrial countries favors the yen, I do not see any compelling reason for the authorities to tighten monetary policy. However, I would be interested in the staff's comments on this point.

With regard to the impact of the recent strengthening of the U.S. dollar, I agree with the staff's analysis. In view of the large external imbalances among major industrial countries and the favorable inflation performance of Japan, upward pressures on the yen could re-emerge. Japan has made great efforts to smooth out the large external imbalances among major industrial countries. Table 1 in the staff report shows a continuous reduction in Japan's current account imbalances as a percent of GNP since 1985. However, the table also shows a slowdown in the adjustment in 1989/90. I am sympathetic with the authorities' views relating to this projection. Since many assumptions are based on exogenous factors such as oil prices, exchange rate

movements, and the degree of penetration of newly industrializing economies, this projection could be vulnerable. However, I would emphasize that continuous structural reforms, especially in the trade area, should sustain the adjustment path. Further liberalization of trade should be encouraged.

Finally, I would like to commend the Japanese authorities on their significant contribution to ODA and their active involvement in debt financing. It is hoped that the authorities would continue to enhance their contributions in line with their growing economic strength. These contributions would certainly help the low- and middle-income countries out of their present economic difficulties. As neighboring countries, Japan and China have cooperated closely in the areas of trade, investment, and economic aid in recent years. My authorities value these cooperative relations built up through many years of common efforts.

The Executive Directors agreed to resume their discussion in the afternoon.

#### DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/89/69 (6/2/89) and EBM/89/70 (6/7/89).

2. PEOPLE'S REPUBLIC OF CHINA - TECHNICAL ASSISTANCE

In response to a request from the Chinese authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/89/160 (5/30/89).

Adopted June 2, 1989

3. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/89/141 (5/31/89).

Adopted June 5, 1989

4. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/89/143 (6/2/89) is approved.

5. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/89/144 (6/6/89) is approved.

APPROVED: December 28, 1989

LEO VAN HOUTVEN  
Secretary

