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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/71

3:00 p.m., June 7, 1989

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
F. Cassell	
Dai Q.	
	C. S. Warner
J. de Groote	
E. T. El Kogali	
	S.-W. Kwon
E. V. Feldman	R. J. Lombardo
L. Filardo	M. A. Fernández Ordóñez
	N. Kyriazidis
	S. K. Fayyad
	O. Kabbaj
G. Grosche	
J. E. Ismael	
B. Jalan	
	L. M. Piantini
	D. McCormack
Mawakani Samba	
	I. A. Al-Assaf
J. Ovi	
H. Ploix	J.-L. Menda, Temporary
	G. P. J. Hogeweg
K. Yamazaki	S. Yoshikuni

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

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, 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. <u>JAPAN - 1989 ARTICLE IV CONSULTATION</u>

The Executive Directors continued from the previous meeting (EBM/89/70, 6/7/89) their consideration of 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).

The Director of the Asian Department, recalling Mr. Cassell's observation that the supplement to the staff report, which carried the heading "contains confidential information," contained little information that was not already in the public domain, noted that, in Fund practice, a supplement to a staff report containing confidential information received the same security classification as the basic document.

On the broad question of the appropriate stance of financial policies, the question could be addressed without distinguishing between fiscal and monetary policies but rather viewing the issue in the context of general macroeconomic policy, the Director continued. While Mr. Warner had suggested that there was room for financial stimulus in the Japanese economy, several other Directors--including Mr. Grosche, Mr. Hogeweg, and Mr. McCormack--had expressed the view that the staff was too optimistic about the possibility of sustained growth without an acceleration of inflationary pressures. The staff's view lay somewhere between those two positions: namely, that at the present juncture financial policies should be neutral and that the present policy stance was broadly appropriate. In taking that position, the staff had preferred to err on the side of caution. The considerations underlying the staff's view included the fact that domestic demand and domestic output growth were strong and showed no sign of lagging in 1989; that there were pressures in the labor market; and that price movements, although not dramatically sharp, were moving in a direction that could be cause for some concern. At 2 percent, the projected rate of inflation for 1989 might seem low by international standards, but it was two or three times its level in recent years. In view of the overall domestic macroeconomic situation, Japan's record of controlling inflation, and the absence of inflationary expectations, the staff did not see the current inflation rate as a matter of concern but did consider it important to avoid financial policies that can possibly damage public confidence. The staff, however, agreed with Mr. Warner that if the growth of demand slowed, some stimulus would be needed, although there could be differences of opinion; for example, how much of a slowing of domestic demand expansion to tolerate before taking action.

When pursuing fiscal consolidation in the 1980s, the authorities had shown a good deal of flexibility in mitigating the sharpness of fiscal restraint to take account of the cyclical situation, the Director observed. Although there had been some difference of opinion between the staff and the authorities on the degree of fiscal restraint at particular moments of time, the staff had agreed that the authorities' medium-term objective was appropriate. It had taken the view that in striving to achieve the specific fiscal consolidation objectives that they had set, the authorities should also take into account the cyclical situation. The authorities had done just that, for example, in their 1987 stimulus package, by de-emphasizing the objective--now very much within reach--of eliminating deficit financing bonds.

On the exchange rate, Mr. Warner had remarked on the counterproductivity of a significant appreciation of the yen, which was also the view taken by the Japanese authorities, the Director commented. The staff, however, shared the view expressed on an earlier occasion by Mr. Grosche that the exchange rate should not be thrown out of the tool box of policy instruments. Of course, that raised the question of how to manage the exchange rate under a floating exchange rate system. Not only was that difficult to do, but might require the authorities to sacrifice the inflation objective to some degree. In the staff's view, if market forces led to a depreciation of the yen, it should be accepted, but not at the cost of domestic inflation.

The question of what constituted appropriate policies in the surplus countries should be dealt with in the consultation reports on those countries as well as in the reports on the world economic outlook, the Director considered. In general, the staff agreed with those Directors who had expressed the view that the burden of corrective policies should now be on the deficit countries. That did not mean that the surplus countries had no contribution to make; for example, the need for structural adjustment in those countries had been suggested by some Directors. It had also been suggested that if corrective measures were taken in other countries--for instance, if a sharp reduction in the U.S. budget deficit were to result in a slowing down of demand both in the United States and in Japan, the question of whether there was indeed scope for further stimulative action on Japan's part would have to be considered carefully. Similarly, if a tightening of the budget situation in the United States led to a reduction in interest rates, and an appreciation of the yen, that outcome should be accepted. Indeed, in those two respects, there was a need for the deficit and surplus countries to cooperate.

The appropriate medium-term stance of fiscal policy as a country increasingly achieved the desired degree of consolidation was an important question, but one that was difficult to address analytically, the Director observed. For Japan, that question could be approached from the point of view of the government debt situation. Japan's gross debt/GNP ratio was one of the highest among the Group of Seven countries, the Director continued. That ratio had, however, stabilized owing to the fiscal consolidation achieved over the past several years. When the net debt ratio, taking into account financial assets also was considered, the performance of Japan was much better than that of other countries--the net debt ratio had also stabilized. From the perspective of the Government's net worth, Japan's performance was very good indeed; it was probably the only country of the Seven whose net worth had improved over the last several years so that it now approximated that of the Federal Republic of Germany. Thus, the basic element of a country's debt dynamics picture--

namely, a simple comparison of the growth rate and the real interest rate--did not suggest cause for concern in the Japanese case.

It was, nevertheless, questionable whether a much more relaxed view about the medium-term fiscal policy stance was appropriate for Japan, especially because the debt/net worth situation was expected to change owing to the likely commitments for social security and health care expenditures that the Government would have to bear in the future, the Director of the Asian Department remarked. A fundamental and important change in the coming years was the rapid aging of Japanese society: there was no other country in recent history where the aging of the population had taken place as rapidly as in Japan. The implications of that development for the public finances would therefore have to be assessed. The quantitative work that already had been done indicated that the debt ratios, which had been declining, would begin to rise again in the next several years. That situation could be avoided only by reducing social security benefits or by increasing charges or taxes, or by cutting other expenditures. In any event, the aging of Japanese society would have to be kept in mind when assessing the appropriateness of fiscal policy in the coming years.

The staff representative from the Research Department observed that some of the questions raised by Directors regarding Japan's comprehensive tax reform had been addressed in the supplementary background paper on recent economic developments. It was important to recall that the objective of the tax reform was to improve the efficiency of resource allocation as well as the horizontal equity of the tax system. The reform had not aimed at achieving macroeconomic goals, although there would be side effects on macroeconomic aggregates. The nature of the tax reform made the task of analyzing its impact on resource allocation and economic activity particularly difficult. Nevertheless, the staff had attempted to describe the partial effects of some elements of the reform in the supplementary paper.

The main effects of the tax reform would be to increase the efficiency of resource allocation while broadening and reducing the tax base, the staff representative explained. As regards the macroeconomic effects, the staff's analysis suggested that the reform would not have a major effect on the supply of labor or capital, but it was likely to affect the composition of private savings and the mix of financing for business investment. For example, the incentives for debt financing would be reduced because the reduction in the corporate tax rate would lower tax benefits accruing from the full deductibility of interest expenses. The reform, however, would not significantly affect the level of private savings and investment or the private savings/investment balance, and therefore the effects on the current account would be minimal. In the short run, the discretionary tax cut associated with the tax reform should add some stimulus to domestic demand. As for effects on income distribution, while the horizontal equity of the tax system had been enhanced, the cuts in tax rates designed to promote efficiency had reduced the progressivity of the tax system, primarily through changes in the personal income tax. Also, the consumption tax imposed a flat rate on necessities and luxuries alike, but some elements of the reform mitigated those effects, for example, the raising of bank exemptions and allowances. In addition, the removal of the tax exempt status of certain types of income, such as capital gains on security transactions, would affect mainly higher-income groups and enhance the progressivity of the tax system. Two remaining areas of tax reform required attention--namely, land taxation, which had been mentioned as a problem in the broader context of land management, and the consumption tax system, which could be further improved by abolishing some measures for small businesses and utilizing invoices to ensure a more accurate calculation of the amount of tax.

The measurement of capacity utilization was generally difficult, and for Japan's construction sector it was even more difficult, the staff representative commented. Although the staff did not have any indices for the construction sector, it had observed that capacity utilization was at a very high level. Some recent figures supported that observation: residential investment had grown by 22 percent in 1987, by 13 percent in 1988, and by 10 percent in the first quarter of 1989; moreover, construction and manufacturing had risen by 40 percent in 1988, and had increased by a similar amount in the last few months. Clearly, construction could not continue at such rates, and the staff had projected that residential investment might be flat after a period of sharp increases.

The deficit of the public enterprise sector generally reflected the excess of investment over savings rather than an operating loss, although some enterprises had incurred operating losses, the staff representative remarked. In principle, public enterprises were required to be self-supporting, so the fact that they had a deficit was not necessarily problematic. It should also be noted that substantial spending on roads and on housing was included in the expenditures of that sector.

Some Directors had raised the issue of the effect of structural reforms on the current account, the staff representative recalled. The staff fully agreed that it was difficult to make a general statement that the effect would be positive or negative; clearly, it would depend on the specific nature of the reform. In that regard, the staff had tried to point out in its report how some structural reforms had in fact had opposing effects, but those were not easily quantifiable. According to the staff's scenario, many of the reforms tended to improve the environment for domestic investment and therefore were expected to have a beneficial effect on the current account in that they would reduce the surplus.

The staff agreed with those Directors who considered that it would be a mistake to focus on the effect of various structural reforms on the current account when setting priorities, the staff representative continued. Rather, the focus should be on their effect on economic efficiency and welfare. On that basis, the staff had highlighted in its report the major areas where further action was needed.

Trade relations with the newly industrializing economies--a point raised by Mr. de Groote--was discussed in the background paper, the staff representative observed. In general, a considerable portion of Japanese exports to those countries had been processed and rechanneled as exports to third countries. It was not easy, of course, to quantify the effect of such movements. A staff study of Japan's trade with the newly industrializing countries was under way and more information on that issue should soon be available to Directors. It should be noted, however, that trade figures had to be interpreted carefully. For instance, the volume of Japan's imports from the United States as well as from developing countries had changed a great deal owing largely to lower international oil prices.

The authorities' decision to raise the official discount rate underscored their concern that the weakening of the yen and the high degree of resources used may generate inflationary pressures, the staff representative remarked. Interest rates had been increasing in response to both the strength of domestic activity and market concerns about price stability. In the circumstances, the discount rate increase gave the right signal, namely, that the monetary authorities intended to combat inflationary pressures. The discount rate increase was partly an adjustment to market rates and to that extent, it may lead to further increases in market interest rates.

Directors had raised a number of important issues regarding the effects of monetary tightening on the current account; here, depending on Directors' assessment of the importance of various channels, there were different answers, the staff representative commented. As monetary policy was tightened, the resulting appreciation of the yen would shift resources to the nontraded sector and promote external adjustment. Of course, monetary tightening would also tend to dampen domestic demand and therefore could have a negative effect on output. On balance, it was not easy to tell which of those effects would dominate. The question was an empirical one and depended on the elasticities of various relationships in the economy.

Looking at some econometric models--MULTIMODE, for example, as well as a model used by Japan's Economic Planning Agency--monetary tightening led to a reduction in the current account surplus, the staff representative continued. That was partly because in these models domestic demand was not very interest sensitive; therefore, competitiveness losses emanating from exchange rate depreciation dominated developments in the trade balance. In addition, foreign investment income payments rose with higher domestic interest rates. Domestic demand was more interest sensitive in the Federal Reserve's multicountry model, where the fall in the current account was initially very small and was eventually reversed despite a large exchange rate appreciation.

On the whole, regardless of its direction, the quantitative effect of monetary tightening on the current account was not likely to be large, the staff representative noted. The staff therefore held the view that monetary policy would not be an effective instrument to correct the current account imbalances. The effect of the exchange rate on the current account would be very different if the exchange rate were to change not because of monetary policy but because of other forces operating in the market. In that regard, it was interesting to note that following the Plaza Agreement, the sharp appreciation of the yen had been accompanied by a decline in interest rates. Therefore, while the external adjustment effects of the exchange rate were taking place, the decline in interest rates helped to offset the adverse effects of that adjustment on domestic demand and growth. In the subsequent period, the Japanese economy recovered quickly, and at the same time, the real current account surplus declined sharply. However, if the change in the exchange rate was effected through monetary policy, the interest rate would move in the other direction and would offset most, or all, of the external adjustment, depending on the model that was used.

Mr. Yamazaki remarked that he would convey Executive Directors' helpful and constructive comments to his authorities, who were grateful for the excellent staff papers, including the supplementary paper on the latest policy developments. Since most of the questions raised by Directors had been answered by the staff, he would touch briefly on those areas of special interest to his authorities.

Some Directors had questioned whether the economic growth forecast for 1989/90 could be attained, especially in view of the decision to raise the official discount rate, Mr. Yamazaki recalled. It should be noted that that decision was intended to maintain noninflationary, sustainable growth led by domestic demand; it did not imply a basic change in the authorities' macroeconomic policies. If the decision had been delayed until inflation was already pronounced, it would have led to higher interest rates and a slowing down of economic activity. Therefore, at the present stage, his authorities saw no need to change the official forecast for 1989/90. Rather, they believed that the recent action would help realize the scenario. Moreover, they saw no need for a further increase in the discount rate at present.

As regards the staff's forecast for the current fiscal year, his authorities were concerned that it was on the high side, Mr. Yamazaki commented. In particular, they expected an inevitable decline in residential investment as the adjustment process continued after the sharp increase recorded up to 1986/87. They also expected that the negative impact of external demand would be greater than had been forecast by the staff.

There were some differences of view between his authorities and the staff concerning the medium-term outlook, particularly with respect to growth and external adjustment, Mr. Yamazaki continued. He would not elaborate on that point, but wished to stress that in view of the unpredictability of domestic and international developments, the medium-term scenario should be seen as rough estimates with considerable leeway on either side. For that reason, his authorities had no intention of sticking to the figure envisaged in the Five-Year Plan in any given year.

In his authorities' view, there was no need to revise the projected average medium-term growth rate, because the high rate of domestic demand growth between 1987 and 1989 was largely due to the decline in international oil prices, the effect of the depreciation of the yen, and the effect of emergency measures that were taken in the middle of 1987, Mr. Yamazaki remarked. His authorities did not consider that such a high rate of growth could be maintained in the medium term.

Some Directors had suggested the possibility of fiscal restraint to forestall inflation, while others had suggested the need for an expansionary fiscal policy, Mr. Yamazaki recalled. As he had noted at the outset, the decision to raise the official discount rate did not alter the basic stance of macroeconomic policies, namely, to pursue noninflationary sustainable growth led by domestic demand. At the present stage, his authorities were not considering contractionary measures on the fiscal front in view of the price stability maintained so far. For similar reasons, a more expansionary policy was not being considered in the present circumstances. Regarding the implementation of the budget for 1989/90, his authorities would continue to follow the stance taken in the previous fiscal year: they would not set a specific target for the pace of public works contracted for the first half of the fiscal year. Of course, they were prepared to take appropriate measures to cope with the changing economic situation, paying close attention to prices, and the relationship of supply and demand in the construction sector.

On the measurement of the fiscal balance, his chair had repeatedly stressed the Japanese authorities' reservations about using the general government balance as an indicator of the fiscal position, and he did not wish to elaborate on that point at the present meeting, Mr. Yamazaki remarked. Nevertheless, his authorities very much welcomed the staff's analysis of the fiscal position, taking account of the social security fund and public enterprises, which was included in this year's staff paper. His authorities had requested that the staff should pay increasing attention to various statistics in order to correctly judge Japan's actual fiscal situation.

Many Directors had expressed concern about the recent standstill in the external adjustment process, Mr. Yamazaki noted. In that connection, there was a divergence between the staff's forecast and the official forecast with respect to the current account surplus for fiscal year 1989. As he had stressed in his opening statement, the forecast of the balance of payments should be viewed with an appropriate latitude, since it was based upon many assumptions and only a small change in those assumptions would significantly alter the forecast. He would add that the outlook for the current account depended upon the extent to which structural changes in the Japanese economy were incorporated. While he understood that the staff's model could not take account of structural change, such change was progressing. The process of rapid structural change helped to explain his authorities' position on external adjustment. Moreover, the importance of maintaining stable exchange rates had been confirmed not only at ministerial meetings of the Group of Seven, but also at OECD meetings. His authorities were, of course, prepared to continue to cooperate closely with other countries, including the Group of Seven, in order to maintain stable exchange rates.

His authorities were grateful for the staff's positive assessment of the tax reform, Mr. Yamazaki stated. It was also gratifying to note Directors' positive and encouraging words on the direction of tax reform. His authorities were continuing to review the tax system with a view to maintaining its fairness and transparency.

The comments on structural reform were also appreciated, and in that regard he would stress only one point, Mr. Yamazaki remarked. With regard to front-loading of structural adjustment, his authorities' main concern--which had been supported by many Directors--was the impact of front-loading in certain areas, such as social overhead, capital improvements, and public investment, on overall economic trends. There was no intention to imply a negative response toward adjustment in those areas, but rather a preference to proceed first in other areas that would not have a negative impact on the value of the yen.

Many constructive comments had been made on official developme- - assistance (ODA), Mr. Yamazaki noted. As he had indicated in his opening statement, an external surplus did not always imply a surplus of the public sector. Thus, in considering the current account surplus and its relationship to ODA, careful consideration had to be given to the size of the deficit of the government sector. For Japan, even though there was a surplus in the current account, there was substantial deficiency in the fiscal position. Nevertheless, within the limits of fiscal restraint, Japan had responded positively in its ODA. The authorities' medium-term ODA target aimed at increasing Japan's share of ODA in line with its relative economic strength among the major creditor countries.

It should be stressed that his authorities were committed to increasing external economic cooperation commensurate with Japan's economic position, Mr. Yamazaki continued. In that regard, he had been very much impressed by the staff's survey of Japan's progress on the 25th anniversary of its acceptance of Article VIII status. Twenty-five years previously, he had been in the office of the Vice Minister for International Affairs, where his main responsibility had been to borrow in the government sector from foreign countries, including the United States and Germany, to supplement Japan's short foreign exchange reserves. At that time, no one believed that Japan's deteriorating balance of payments situation could be reversed. Japan had indeed come a long way, supported immensely by the international financial community. Japan therefore felt that it was its duty to explore every possible avenue to be supportive of the Fund as well as developing countries. He appreciated the warm words of many of his colleagues regarding the need to maintain policies that contribute to the international community as well as the position that Japan should occupy in the international society--a point that he hoped Directors would not forget to mention during the forthcoming discussion on Fund quotas.

The Acting Chairman made the following summing up:

Executive Directors noted the impressive performance of the Japanese economy in recent years. Japan achieved substantial external adjustment in 1987-88, while still recording high rates of output growth and stable prices; overall the best performance among the industrial countries. These accomplishments owed much to the authorities' sound financial policies, which Directors widely commended.

Directors also observed that, whereas the outlook for continued noninflationary growth was encouraging, the prospects for further external adjustment had worsened. A number of Directors thought that there was serious risk that adjustment could be reversed in the near term, and many Directors expressed concern that the recent movements in exchange rates could hinder the process of international adjustment. Directors generally acknowledged that the scope for unilateral financial action by Japan to reduce its surplus was limited, and they recognized that stronger adjustment--and a more appropriate configuration of exchange rates--would require policy adaptations in both deficit and surplus countries. Efforts to maintain a high rate of expansion of domestic demand in order to further the reduction of external imbalances should not compromise the objective of price stability. In that regard, several Directors were less sanguine than the staff about the maintenance of noninflationary growth. They cited the high rate of capacity utilization, the likely impact of the recent introduction of the value-added tax, and the continued rapid growth of broad monetary aggregates. They urged the authorities to respond promptly to avoid any emergence of inflation. Directors encouraged structural reform of the domestic economy that would promote domestic economic efficiency and welfare and promote external adjustment.

Directors praised the conduct of the fiscal policy in fiscal year 1988/89. The favorable revenue performance had allowed the authorities to make significant progress toward their fiscal consolidation objectives without dampening private domestic demand. Directors also welcomed a comprehensive tax reform, which was expected to improve the fairness and neutrality of the tax system while enhancing the Government's ability to raise any necessary revenue in the future. For 1989/90, most Directors supported the cautious and broadly neutral stance implied by the budget, given the anticipated strength of domestic demand and the high degree of resource utilization. Some Directors believed there might be room for more fiscal stimulus, if there were any signs of economic weakness.

The authorities deserved credit for their skillful management of monetary policy, which had preserved price stability while supporting economic growth. Directors differed in their view of the effectiveness of monetary policy for external adjustment, depending on their assessment of the relative importance of the exchange rate and interest rate effects. Nevertheless, most speakers thought that the recent increase in Japan's official discount rate, which had followed interest rate increases in domestic money markets, had been appropriate in light of the weakening of the yen and the need to prevent the emergence of inflationary pressures.

Directors strongly supported the authorities' intentions to implement needed structural reform as laid out in the Five-Year Economic Plan, but there were questions as to how much and how speedily such reform would contribute to external adjustment. Substantial progress had already been made, notably in the areas of financial and tax reform, but much remained to be done. Directors urged the authorities to accelerate the pace of structural reform, particularly in priority areas, including land management policy, the agricultural sector, the distribution system, and postal savings. The scope for such reforms to improve public welfare and raise living standards was emphasized by many speakers. Directors also saw scope for improving welfare through public investment in social overhead capital. Such investment need not jeopardize the fiscal position and could also promote the process of external adjustment.

Japan had a special role to play in promoting free trade, many Directors stressed. In this respect, Directors welcomed the stance taken by Japan at the Uruguay Round of the GATT negotiations to promote multilateral reductions in trade barriers. Directors urged the Japanese authorities to make further efforts to improve market access for imported goods. The recent decision to gradually abolish quotas on imports of beef and oranges was a welcome fresh step in freeing imports of agricultural goods, but more comprehensive agricultural reforms were required.

Japanese savings had played an important role in alleviating upward pressures on world interest rates and had helped finance productive investment in other countries. Directors praised the initiatives by the Japanese authorities to encourage a greater flow of Japanese capital to developing countries and observed that significant progress had been made in allocating the substantial resources committed under the 1987 recycling plan. Japan's leadership and support for a strengthening of the international debt strategy were welcomed, particularly through initiatives that involved the Fund. While noting Japan's leading role in official development assistance, Directors urged Japan to raise both the level and concessional character of such assistance.

The next Article IV consultation will be on a standard 12-month basis.

Extending his remarks, the Acting Chairman observed that some issues that had been raised by Directors could be taken up in the broader context of the Board's regular informal discussion on exchange rate developments and seminar on key issues in the functioning of the international monetary system, which were scheduled for June 26 (Informal Session 89/14; Executive Board Seminar 89/3). In particular, Mr. Warner had expressed the view, supported in varying degrees also by Mr. Ismael, Mr. Ovi, and Mrs. Ploix, that as inflation was not a major problem in Japan at present, there might be room for fiscal stimulus in Japan, particularly if there were any signs of economic weakness. Concern had also been expressed about the rise in interest rates, both with respect to the impact of domestic growth and the negative impact on external adjustment.

In contrast, Mr. Cassell, among others, had expressed the view that inflation remained a concern and should be a matter of priority for the monetary authorities in the period ahead, and that there was no room for fiscal stimulus, the Acting Chairman continued. Along with Mr. Al-Assaf, Mr. Grosche, Mr. Hogeweg, and Mr. McCormack, those speakers had also expressed support for the interest rate increase, which, in their view, was consistent with an improvement in the external position through its effect on the exchange rate. In supporting that view, Mr. Kwon had introduced another dimension, namely, cross-rates--both exchange and interest rates--between the yen, the deutsche mark, and the U.S. dollar.

Other speakers, including Mr. Feldman, Mr. Finaish, and Mr. Kyriazidis, had stressed that the appropriate policy choice would depend largely on what other industrial countries were doing, the Acting Chairman remarked.

He wondered to what extent the concerns expressed by Directors among the major industrial countries about inflation or interest rates in Japan reflected their concern about what would be happening in that respect in their own economies, the Acting Chairman commented. Those developments would also have a significant impact on the adjustment of external imbalances. In sum, while Directors shared the objective of promoting continued adjustment in the external accounts of the major industrial countries, there was a difference of views about the appropriate set of policies to achieve that adjustment. It might be useful to explore some of those views in a multilateral context on June 26.

APPROVED: December 28, 1989

LEO VAN HOUTVEN
Secretary