

0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/42

10:00 a.m., March 21, 1988

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors

A. Abdallah
F. Cassell

C. H. Dallara

G. Grosche
J. E. Ismael

G. Ortiz
J. Ovi

G. A. Posthumus

G. Salehkhoul
A. K. Sengupta
K. Yamazaki
S. Zecchini

Alternate Executive Directors

E. T. El Kogali

Jiang H.

J. Prader
E. V. Feldman
A. M. Othman

J. E. Zeas, Temporary
D. McCormack
C. V. Santos
I. A. Al-Assaf

D. Marcel
G. P. J. Hogeweg
I. Sliper, Temporary

L. E. N. Fernando
S. Yoshikuni
N. Kyriazidis

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

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Also Present

Asian Department: P. R. Narvekar, Director; B. B. Aghevli, R. J. Corker, M. Ishihara, S. Ishii, D. A. Lipton, J. R. Márquez-Ruarte, H. L. Mendis, H. Vittas, S. Watanabe. European Department: M. Guitián, Deputy Director. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; P. A. Acquah. Fiscal Affairs Department: T. M. Ter-Minassian, Deputy Director; K.-Y. Chu. Legal Department: P. L. Francotte. Research Department: J. A. Frenkel, Economic Counsellor and Director; K. Ohno, M. A. Wattleworth. Secretary's Department: A. P. Bhagwat. Western Hemisphere Department: Y. Horiguchi. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: A. G. A. Faria, P. D. Péroz, M. Pétursson, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: N. Adachi, F. E. R. Alfiler, H. S. Binay, E. C. Demaestri, F. El Fiky, V. K. Fernández, B. Fuleihan, J. Gold, S. King, V. K. Malhotra, T. Morita, L. M. Piantini, S. Rebecchini, S. Rouai, C. C. A. van den Berg, E. L. Walker, R. Wenzel.

1. JAPAN - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultations with Japan (SM/88/44, 2/18/88). They also had before them a background paper on recent economic developments in Japan (SM/88/55, 3/7/88; Sup. 1, 3/9/88; and Sup. 2, 3/18/88).

Mr. Yamazaki made the following statement:

My authorities are grateful for the staff report and for the valuable discussions that took place when the staff team visited Tokyo in November and December 1987. Also, my authorities thank the Managing Director and the Director of the Research Department for participating in the final meetings, despite their tight schedules. Their cooperation added further substance to the consultations.

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

In 1987/88, the Japanese economy is expected to follow the favorable growth pattern that characterized the previous fiscal year, i.e., expansion centered on domestic demand, coupled with the decline in external demand that contributed to reducing the current account surplus. Furthermore, with the pace of expansion in residential and equipment investment accelerating and private consumption continuing its firm increasing trend, the growth rate of real domestic demand is expected to reach 5 percent, the highest rate since 1979/80. This, in turn, will lead to an overall real GNP growth rate of 3.7 percent, which is fairly higher than that recorded in the previous fiscal year.

In sum, the Japanese economy is entering a phase of full-scale expansion based on domestic demand. Several factors can be identified as contributing to this salient growth. In addition to the autonomous, cyclical upturn in inventory and equipment investment, the continued appreciation of the yen and the decline in crude oil prices, through their positive impact on price stability and corporate profit, contributed to restoring confidence in the household and corporate sectors.

As regards the concern about the effects of volatile stock and foreign exchange markets since autumn 1987, we are not in a position to make a final judgment at this stage. Nonetheless, it may seem reasonable to state that, on the whole, such volatility has not impeded the expansionary trend of the economy.

On top of the buoyant increase in plant and equipment investment by the nonmanufacturing sector and the small- and medium-sized enterprises already under way, there has been a

pickup in investment activity by the manufacturing sector and large enterprises, with a gradual increase in the share of investment for capacity expansion. A marked improvement in business sentiment, owing to the high level of corporate profits and the rapid increase in the capacity utilization rate, not only contributed to brisk investment activity, but also to a very favorable swing in the employment situation which, in turn, further ensured robust consumer spending. All this adds up to the emergence of an autonomous virtuous circle of domestic private sectors, with the strength of one enhancing the other.

Prices remain stable, with the wholesale price index declining by 1.7 percent, owing mainly to the strength of the yen and the decline in energy prices, while the consumer price index is expected to rise only slightly by 0.7 percent. Turning to the external scene, the long-awaited effects of exchange rate adjustments have finally begun to bring about a noticeable shift in nominal balance of payments statistics. Owing to a further adjustment in volume, the yen-denominated current account surplus is narrowing sharply. As a result, the current account surplus for the fiscal year is expected to amount to \$82 billion, compared with \$94 billion in the previous fiscal year, the first decline in the dollar-denominated surplus after a long interval. Meanwhile, the large outflow of long-term capital continued, mainly reflecting the high level of Japanese investments in foreign securities. As a result, the long-term capital balance registered a large deficit of \$137 billion, which gave rise to a deficit of \$50 billion in the basic balance, despite the huge current account surplus.

With a view to maintaining the steady expansion of the economy centering on domestic demand, and to promoting the external adjustment process, emergency economic measures were adopted in May 1987. The measures were aimed at bringing expenditure to a level of ¥ 6 trillion, which included the addition of ¥ 5 trillion to public works expenditure and the reduction in individual income tax. Specifically, such measures as extraordinary front-loading of public works contracts, augmentation of public works utilizing the proceeds from public sales of government-owned NTT stocks, and preferential treatment to facilitate residential and equipment investment were implemented. On the other hand, to accomplish sustainable economic growth based on price stability and to stabilize the foreign exchange market, a flexible stance was taken in implementing the management of monetary policy. The growth of the money supply as measured by M2 and certificates of deposit (CDs) further accelerated to 11.8 percent during the October-December period, the highest growth rate since the second quarter of 1979. Meanwhile, substantial relaxation of credit conditions is under way in the area of corporate financing.

In the coming fiscal year, the Japanese economy will maintain a desirable current growth pattern, i.e., autonomous economic expansion led by domestic demand, while enabling a steady improvement in external balances. As a result, the real GNP growth rate will be about 3.8 percent--of which the contribution of domestic demand is about 4.7 percent, and that of external demand is a negative 1 percent. The external demand will continue to exert a negative impact on the economy. In particular, the process of exchange rate adjustment is being further amplified by a new development, namely, a remarkable shift toward overseas production of Japanese goods and, moreover, imports of such goods by Japanese corporations.

Turning to domestic demand, residential investment is expected to remain at a high level owing to the low rate of interest on housing loans. On the other hand, personal consumption will continue to increase steadily by about 3.8 percent, owing to a gain in real income reflecting the favorable employment situation, and the beneficial effect of a reduction in personal taxes, against the background of steady consumer confidence based on price stability. We do not consider that the plunge in stock prices will have a major impact on overall consumer spending, barring any further instability in the market. In fact, the rate of the fall in Japanese stock prices and the rate of individual stock ownership are relatively low compared with those in other industrial countries.

Furthermore, the prospect for plant and equipment investment is even brighter. Capital investment in manufacturing, which showed a noticeable upturn in the current fiscal year is expected to gain further momentum, aided by a high rate of capacity utilization. This, coupled with the continuing strength in the investments of the nonmanufacturing industry, owing to steady consumer spending and to buoyant investment demand for office automation, will result in a double-digit increase in equipment investment.

Prices are expected to remain stable, although the declining trend that has dominated wholesale prices will disappear as the pass-through effect of yen appreciation runs its course and the pace of economic expansion accelerates. On the whole, the wholesale price index will increase only slightly by about 0.3 percent, while the consumer price index will increase by about 1.3 percent.

Although the external balance is difficult to predict since it hinges on many factors, particularly exchange rate developments, my authorities expect a continued decline in the U.S. dollar-denominated current account surplus by \$10 billion to \$72 billion in the official forecast.

My authorities wish to stress that in order to realize the favorable prospects mentioned above, we should continue to proceed with policy coordination among the major industrial countries aimed at stabilizing the exchange markets.

Against the background of a huge accumulation of public debt and persistently large fiscal deficits, there is little, if any, room for discretion in implementing fiscal policy. A steep increase in debt service payments has considerably weakened the adaptability of fiscal policy to the changing needs of the society and the economy. To cope with the inevitable rapid aging of the population, it is essential to continue proceeding with fiscal reform aimed at eliminating the dependence on deficit financing bonds by 1990/91.

Equally important is the need for realizing sustainable economic growth centered on domestic demand and for fostering harmonious external economic relationships. In this connection, it is necessary to further promote policy coordination among the major industrial countries.

Accordingly, while efforts continue to curtail and rationalize expenditures, particularly by reining in operating expenses in the 1988/89 budget, due consideration is given to the need for promoting domestic demand expansion, i.e., general public works expenditure will increase dramatically by 20 percent compared with the previous year's initial budget, with a view to fostering the accumulation of social capital by utilizing the proceeds from the public sale of government-owned NTT stocks. As a result, for the first time in six years, since the 1982/83 budget, general expenditure exceeds that of the previous fiscal year and overall expenditure is up 4.8 percent, compared with the initial budget of the preceding fiscal year.

Meanwhile, on the revenue side, tax receipts are expected to increase rapidly by 9.5 percent, reflecting the economy's steady expansion. Consequently, the amount of newly issued government bonds will decline by ¥ 1.7 trillion, thereby reducing the share of bond financing in total expenditures to 15.6 percent, compared with 19.4 percent in the previous fiscal year.

The 1988/89 budget enables the authorities to proceed steadily toward the aim of eliminating the issuance of deficit financing bonds by 1990/91, while ensuring the expansion of domestic demand. Also, we envisage declines in both the debt/GNP and debt service ratios which have been rising persistently. It should be noted, however, that these ratios--43.5 percent and 20.3 percent, respectively--are still very high and point to the need for further efforts to promote fiscal reform in order to maintain vitality in the Japanese economy.

Regarding the tax system, a comprehensive study is under way to come up with a tax structure that is well balanced among incomes, consumption, and assets, and aimed at ensuring the welfare of the society. In February 1987, a fundamental tax reform in line with the above considerations was proposed. Although the reform did not garner full support in the Diet, some parts of the plan were adopted for implementation, i.e., partial adjustment of the progressive tax structure amounting to a tax reduction of ¥ 1.5 trillion in 1987/88, and elimination of the preferential treatment on income from personal savings for the coming fiscal year. Also, taking account of the basic thrust of the reform and the public reaction thereto, study continues regarding the desirable tax structure in various forms of the tax base, namely, personal income, corporate income, asset value, and consumption.

As evidenced by the historically low interest rates and the rapid rise in monetary aggregates that exceed the increase in nominal demand, the level of monetary relaxation is adequate to support the expansionary trend of domestic demand. Although prices remain stable, with the beneficial effect of a strong yen diminishing, there is a possibility that such factors as acceleration in the pace of economic growth and tightening of the demand-supply relationship in the employment sector would exert upward pressure on prices. On the other hand, movements in the foreign exchange market continue to warrant due attention necessitating that the authorities further promote policy coordination agreed upon the G-7 statements and confirmed in the Japan/U.S. Joint Statement. With these considerations in mind, conduct of monetary policy for the moment should be aimed at maintaining present monetary conditions, giving due attention to overall economic developments such as the price situation as well as developments in the international financial markets, and being prepared to deal with a changing situation by appropriate and flexible management.

The exchange rate for the yen, which started at about the ¥ 150 level at the beginning of 1987, sharply appreciated in the early part of the year to exceed ¥ 140 level in late April. After that the yen rate on the whole hovered around the ¥ 140 level. Toward the end of the year, however, the rate again appreciated sharply to reach ¥ 122 at the end of December, resulting in a year-on-year increase of 31 percent compared with 25 percent in the previous year. Meanwhile, Finance Ministers and Central Bank Governors of the seven major industrial countries met in Paris in February and agreed to cooperate closely to foster stability of exchange rates around the then prevailing levels. Also, in December, a statement was published that reconfirmed the resolution in the G-7 statements. It is worth noting that, as the determination of the monetary authorities was publicized in G-7 statements, and, furthermore, was evidenced

by actual measures, including cooperative intervention in the market, indications arose showing that the sentiment of the market is changing for the better. It is essential to encourage such a favorable tendency to restore stability in the foreign exchange market, thereby securing stability in international financial and capital markets. To that end, we consider that the current close policy coordination should be maintained and intensified.

As noted earlier, with the exchange rate adjustments beginning to work through to nominal payment flows, the current account has seen a sharp contraction in its yen-denominated surpluses, which have fallen short of the previous year's level since April of 1987. This, in turn, has begun to translate into a reduction in U.S. dollar-denominated surpluses. On the other hand, G-7 statements stressed that further substantial exchange rate shifts could be counterproductive for the world economy. Hence, the adjustment of the external balance should be conducted through comprehensive measures such as the expansion of domestic demand, further opening of the market, and changes in industrial structure. So far, the expansion of domestic demand is already under way as a result of policy measures hitherto employed. As regards the structural adjustment, we should continue to execute the various proposals presented in the Mayekawa Report.

Further progress was made toward liberalization and globalization of the capital and financial markets in 1987. First, with regard to the liberalization of deposit interest rates, further progress was made, including the reduction in the minimum amount for certificates of deposit and money market certificates. Second, in the short-term money market, a domestic commercial paper market was launched in November 1987 which provided nonbank corporations with an effective device to raise and invest short-term funds. Also, the transactional character of treasury bills and finance bills was improved and the noncollateralized call money transaction was facilitated. Third, participation of Japanese financial institutions in overseas futures markets was liberalized in May 1987, and in June the Osaka stock exchange launched futures transactions on stock indices. Triggered by these developments, progress was made toward enabling full-fledged futures transactions, including the potential establishment of a domestic financial futures market. Last, but not least, access of foreign financial institutions to the Tokyo market was further improved as evidenced by granting membership in the Tokyo Stock Exchange to 16 foreign securities companies. Meanwhile, the size of the Japan offshore market established at the end of 1986 increased to a remarkable level of \$200 billion.

The year 1987 should be noted for the marked increase in Japan's contribution to external economic cooperation. First, as regards official development assistance (ODA), the Government

decided, as part of the emergency economic measures announced in May, to advance the target year for doubling ODA, announced in 1985, by at least two years. Furthermore, the measures included a program aimed at recycling financial resources to developing countries by \$20 billion in three years, in addition to the \$10 billion recycling program which has been implemented since 1986. Consequently, Japan has committed more than \$300 billion in this area. Finally, as you are well aware, we have already committed large amounts of funds to the enhanced structural adjustment facility, which was approved in December 1987, on the condition of approval by the Diet.

Mr. Grosche made the following statement:

The year 1987 was in many respects a challenging, but successful year. Domestic demand has fully replaced exports as the main engine for growth, and it is expanding at a satisfactory rate. Unemployment has returned to its usually low level. By all accounts, the authorities are moving in the right direction.

However, the current account surplus remains large, at least in nominal terms, and protectionist tendencies continue to cloud a brighter future. The need to make further adjustments in the external balance, without endangering domestic price stability and growth, continues to be the major challenge for policymakers in the years ahead.

Terms of trade gains and low commodity prices have helped to keep domestic prices down and have allowed monetary policy to be fairly accommodative, supporting domestic demand expansion. Fears about the monetary stance being too lax and reigniting inflationary tendencies subsided after the October 1987 stock market decline. The current stance of monetary policy seems to be broadly appropriate, but developments in the monetary field will have to be monitored closely, especially as the terms of trade effects are tapering off and capacity constraints are emerging.

There is agreement among major industrial countries that excessive fluctuation of exchange rates, a further decline in the value of the dollar, or an appreciation in the dollar to an extent that becomes destabilizing to the adjustment process could be counterproductive by damaging growth prospects in the world economy.

I fully agree with Mr. Yamazaki that cooperation among the G-7 countries has had a positive influence on the markets, and that the favorable tendency toward more stability has to be encouraged by maintaining and intensifying close policy coordination.

Fiscal policy is one of the main policy areas fostering the underlying conditions for more stability. The fiscal packages implemented in Japan in 1987 have supported domestic demand substantially. The authorities intelligently used the margin of maneuver offered by the decline in overall economic activity to support a strong increase in the public works program. The area for action was well chosen, since the central and local governments' public facilities are still below average compared with those of other mature economies.

However, the already huge public debt sets a clear limit for an overly expansionary fiscal policy. The authorities should continue to adhere to the objective of fiscal consolidation over the medium term. Clearly, it is not easy for a country with a strong external position to find the appropriate balance between the medium-term goal of strengthening the fiscal balance on the one hand, and the objective of supporting domestic demand growth and promoting external adjustment on the other.

After the expansionary fiscal stance in the 1987/88 budget, the coming 1988/89 budget seems to aim at taking a broadly neutral stance. While I agree with the staff that such a fiscal stance appears appropriate at this time, I also agree that it is not easy to accurately assess budgetary policy in Japan, because the budgetary process of local governments is still under way. For example, it would be interesting to know how the figures for the 1988/89 budget compare with the 1987/88 budget, including the higher level of general public works expenditure reached with the July 1987 supplementary appropriations.

With respect to taxes, I fully agree with the authorities that a major overhaul of the tax system appears to be necessary. The present system contributes to the savings/spending imbalance. The measures taken in 1987 are welcome. The recent attempts to further reduce the personal and corporate tax burden and to introduce a broad-based indirect tax seem to have again encountered strong parliamentary opposition. I am glad to note, from Mr. Yamazaki's opening statement, that the authorities are continuing with their reform efforts. I wonder whether Mr. Yamazaki's statement that a comprehensive study is under way, suggests that the plan to introduce a tax bill to the Diet later in 1988 has been postponed. The staff should comment in more detail on the Government's plan.

Private domestic demand is growing at a satisfactory rate, but structural impediments are becoming even more visible. For example, the increase in housing prices underlines the need for reforms in land use regulations. Although commendable progress has been made in this area, there seems to be a need--and room--for further credit and interest rate deregulation to broaden the range of financial instruments available to the consumer.

All of these issues have been taken up by the Mayekawa Report and by subsequent reports. I fully agree with the staff that the proposals put forward are appropriate and should be implemented as far and as quickly as possible. In this respect, I would be interested in additional information from Mr. Yamazaki on the structural measures contemplated under the new five-year plan.

The structural reform process is certainly difficult and often painful, because structural changes frequently mean that some vested interest groups have to be hurt; this is particularly true in trade. As the staff noted, a clear and comprehensive assessment of Japan's import policy is difficult because of the complexities and regulations involved with respect to the qualitative barriers to trade. More progress is needed. The Economic Council of Japan has proposed several measures which could be helpful to further import liberalization: a relaxation of the system of import standards and certification, and a review of licensing and other regulations in the retail industry. More generally, it is the monopolistic distribution system that helps keep retail prices high and counters consumer preferences for foreign goods. It seems that government controls and regulations are a major factor in shaping that system.

The authorities are to be commended for their successful policies during 1987. They are committed to the international coordination process, and I am convinced that this cooperation will benefit not only Japan, but also the world economy in general.

Mr. Ortiz made the following statement:

The performance of the economy during 1987 was impressive and certainly exceeded expectations. As the staff mentioned, this performance reflects the underlying resilience and flexibility of the economy to overcome significant challenges, like the recent sharp appreciation of the yen; it is also a reflection of the policy actions of the monetary authorities, which have responded in a positive way to calls for international cooperation, and have been increasingly willing to accept Japan's growing international responsibilities.

The moderately expansionary emphasis of Japan's financial policies aimed at stimulating domestic demand succeeded in restoring economic growth and in helping to reduce real imbalances while maintaining price stability. The authorities even managed to continue pursuing their medium-term objectives of fiscal consolidation, and the response of the economy has been quite remarkable. This is good news for Japan and for the rest of the world, especially in that this responsiveness should instill

more confidence in the potential magnitude of Japan's contributions. Mr. Yamazaki's indications that his authorities intend to continue implementing the same mix of macroeconomic policies and to strengthen structural reforms to lend further support to the adjustment of the large imbalances still existing among major industrial countries are encouraging, as is the much needed recycling of resources to developing countries.

The Government decided to implement a set of fiscal measures to stimulate domestic demand in May 1987. At that time, it was clear that continuous fiscal consolidation was a medium-term target that the authorities wanted to preserve. The outcome of the fiscal policy stance was broadly satisfactory, and the authorities, in addition to increasing public investment expenditures to support an expansion in domestic demand, made significant progress in strengthening the financial position of the Government by reducing current expenditures and increasing tax revenues.

Capital spending should be maintained at high levels, as the authorities intend. However, a close link should be established between the medium-term rationality of this policy, the long-needed structural reforms in agricultural trade, and the related problems of land price and utilization. I agree with the authorities and the staff on the steps that should be taken in the field of tax reform; specifically, rate reductions on income, corporate, and inheritance taxes ought to be combined with the introduction of a broad-based indirect tax.

Monetary policy has played an important role in the promotion of domestic demand-based growth and in the search for the exchange rate objectives of the authorities. As in other industrial countries, it has become difficult to gauge the Japanese monetary policy stance by just referring to monetary aggregate indicators. However, I agree with the staff that the observed strong declines in income velocity have provided the authorities with a larger margin to implement an accommodative monetary policy aimed at reducing interest rates. In addition to domestic demand objectives, low interest rates have been required to reduce tensions in the foreign exchange market.

I agree with the staff that the monetary policy stance seems to be appropriate since inflationary expectations remain low. In addition, I agree with the authorities that exchange rate stability among major currencies will be mainly achieved through balanced macroeconomic policies. Putting too much emphasis on stabilizing exchange rates, exclusively by means of interest rate policy and foreign exchange market intervention, may be an adequate short-term policy response, but it is unsustainable in the medium term. International coordination of

macroeconomic policies is essential. In this regard, we tend to support the opinion that further appreciation of the yen would be increasingly difficult for the Japanese economy to assimilate.

The large real trade surplus observed since 1981 was almost balanced in the last two quarters of 1987. This indicates that the realignment in the value of the yen, in conjunction with fiscal and monetary policies, has allowed the expected adjustments in trade volumes to take place. It is now even more important that industrial countries intensify efforts to eliminate the persistent macroeconomic imbalances. As mentioned by the staff, in the event that the saving/investment gap in these countries remains large, a reduction in Japan's current account surplus would only intensify upward pressure on world interest rates. This is why the perspective of a significant reduction in the net surplus financial position of Japan, without a parallel reduction in the foreign financing needs of other developed countries, may be a worrisome development.

On structural measures, I have already mentioned that further changes in the tax system seem to be necessary to improve the quality of domestic demand management policies, to maintain the Government's financial position, and to make the tax system more efficient in the allocation of resources. Financial liberalization has continued in a very satisfactory manner, although some further steps may be needed in this area. Following the successful financial liberalization, the position of Tokyo as one of the most important financial centers has been consolidated.

However, much remains to be done in other key structural areas to make the economy more open and transparent. My authorities attach great importance to the staff recommendations in the area of the economic and social infrastructure needed to raise the standard of living. It is widely recognized by experts from both public administration and academia, that the key element in promoting a higher standard of living and a strong expansion in internal demand for housing, and durable and consumer goods is to eliminate distortions in agricultural trade. Economically irrational land utilization and domestic distributional systems are the consequence of agricultural sector protectionism, which has created an extraordinary gap between domestic and international prices. The authorities should progressively increase market access by making the internal markets more competitive and transparent. In this connection, I am encouraged by Mr. Yamazaki's assertion that his authorities intend to continue to implement the measures outlined in the Mayekawa Report.

Japan has made an important and commendable contribution to international policy coordination. Domestic demand continues to

grow much faster than in other major surplus industrial countries, the macroeconomic policy mix remains appropriate, and inflation is practically nonexistent. I hope other countries with major imbalances--especially other surplus countries--will also take positive and substantial steps to reduce those imbalances in a way which sustains noninflationary economic growth in the world economy.

Japan's increasing contribution to external economic cooperation and to the enhanced structural adjustment facility is evidence of its commitment to international cooperation. My authorities particularly welcome the recent statements by the Japanese authorities that they intend to take a more active role in the debt strategy, and we look forward to Japan's participation in the forthcoming Interim Committee meetings.

Mr. Abdallah made the following statement:

The staff should be commended for its excellent reports; in particular, the succinct treatment of structural and institutional developments reflected in the background paper may serve as a useful model for reports on other G-7 countries. I am in broad agreement with the main thrust of the perceptive staff appraisal, and especially with its emphasis on the need to pursue domestic objectives consistent with Japan's responsibilities arising from its increased weight in the world economy. I will focus my comments on the implications of those increased responsibilities, first for G-7 countries, and second for developing countries.

It is clear that the authorities were broadly successful in managing the economy in 1987. Policies promoting fiscal consolidation, monetary accommodation, and orderly external adjustment have achieved a higher growth rate in domestic demand of 4.7 percent, a noninflationary expansion of real output to about its potential rate of 3.8 percent, and, partly through currency appreciation, some reduction, to 3.6 percent of GNP, in the external current account surplus. The challenge is to continue along this path of autonomous economic expansion fueled by higher domestic demand--rather than by continued export expansion--and thereby to assume a larger responsibility for improving the short-term outlook for a world economy which is still confronted by persistent and unsustainable fiscal and current account imbalances. There are some encouraging indications that the authorities have confronted this challenge by fostering private demand and expenditure on social overhead capital. At the same time, though with greater difficulty, efforts are being made to extend the scope of indirect taxation, supported by an accommodative monetary policy made possible by the abatement of inflationary pressures and expectations and exchange rate stability. Japan needs to be especially cautious

in its balanced use of monetary policy instruments in managing exchange and interest rates because of its much larger economic weight, the near capacity levels at which its economy is now operating, and its commitments under the Louvre Accord--all of which are crucial to the process of international monetary coordination.

I strongly agree with the staff that, to ensure more efficient domestic resource use and to help reduce external imbalances, macroeconomic policy reform must be underpinned by more far-reaching structural reforms. The most obvious area for such reforms is in the agricultural sector--including land use--which has consequences both for food imports and domestic investment in residential housing. I join the staff in hoping that the authorities will move vigorously to make a comprehensive assessment of the prevailing nontransparent impediments in the distribution system to fuller entry by trading partners into Japanese markets. On the other hand, those trading partners would also need to exhibit the kind of initiative that has been shown by Japanese exporters in penetrating overseas markets.

Japan's recognition of the increasing role it can play in alleviating the international debt problem by channeling official development assistance through international capital markets and international financial institutions is appreciated. The assistance Japan can provide should be considered from two standpoints. With respect to trade, I was concerned to note in Table 4 of the most recent world economic outlook paper that total domestic demand in G-7 countries is forecast to decelerate from 3.2 percent in 1987 to between 2.6 percent and 2.8 percent in the next two years, or at the same rate as the growth in real output; as a result, net exports, after having been negative from 1983 to 1987, are likely to disappear. This has serious implications for developing countries--especially the low income and debt distressed among them--which attempt to reduce their reliance on external assistance. Japan, as the world's largest food deficit country, could explore ways to absorb a greater proportion of agricultural imports from the poorer developing countries.

Notwithstanding action on the trade front, however, developing countries will remain greatly dependent on external assistance to ensure growth and development. In this connection, I found Section III of the supplement to SM/88/55 on external developments particularly informative, and suggest that similar treatment be undertaken with respect to other major donor countries. In due course, these analyses should be incorporated into the world economic outlook exercise. I was pleased to note that in 1987, Japan began to increase its overall recycling of funds to developing countries by some \$30 billion, in part through quick disbursements of long maturity loans through the

Export-Import Bank of Japan to foreign governments and public financial institutions. In particular, we appreciate Japan's technical and other assistance on concessional terms to the poorest countries in sub-Saharan Africa and greatly value its being the largest single capital contributor to the Fund's enhanced structural adjustment facility, as well as its establishment of a special fund in the World Bank. While I warmly welcome the authorities' decision to advance the target date for the doubling of official development assistance by two years, I strongly urge that the real level of official development assistance be raised in an accelerated manner compared with the slow pace of from 0.2 percent of GNP to 0.3 percent of GNP registered between 1976 and 1986. Ideally, Japanese official development assistance should double by the end of the decade, and be about 1 percent of GNP by the 1990s, with the concessional element predominant and its geographical distribution widened. As countries in my constituency depend almost exclusively on such capital flows, the steady decline in official flows since 1981, leading to net reflows in 1985 and 1986, have had a devastating impact. It is urgently necessary that the outflows be reversed.

I join Mr. Ortiz in expressing appreciation to the authorities for their growing spirit of international cooperation.

Mr. Prader made the following statement:

In most respects, I agree with the well-balanced assessment in the staff report. I congratulate the authorities on the performance of the economy, which is indeed impressive, especially in that the markets have been adjusting rapidly to an economic environment that has changed fundamentally, owing to the sharp appreciation of the yen since 1985, which has confronted the economy with its greatest challenge since the oil shocks of the 1970s.

The favorable performance is largely due to the authorities' prudent policy stance. Given the continued major vulnerabilities of the global economy, it is comforting to note that the Japanese economy will, in 1988, stay on its present course of noninflationary growth, ensuring at the same time that domestic demand will continue to grow faster than output.

The substantial encouragement the Government has given to the adjustment process by implementing a policy mix consisting of a flexible fiscal approach and an accommodative monetary policy is noteworthy. Japan's economic policy has contributed greatly to easing worldwide currency and balance of payments tensions, and Japan has made considerable progress in reducing its external imbalance. The current account surplus has been

shrinking--in dollar terms--for a long time, indicating that Japan has overtaken all of the large industrial countries in its external adjustment process. Most of this adjustment results from the steep increase in imports. Figures for February 1988 show that imports from the United States were up by about 50 percent, and imports from the European Communities were up by more than 60 percent, compared with the same month in 1987.

These figures illustrate the extent to which the authorities have succeeded in meeting the challenge of reorienting the economy from export markets to the domestic market. Chart I on page 4 of SM/88/44 shows that ever since 1986, the foreign balance has made a negative contribution to GNP growth, and in his opening statement, Mr. Yamazaki confirmed that domestic demand grew faster than GNP during that period. In order to contribute further to the correction of international trade imbalances and to take on an even larger leadership role in fostering world economic growth, the authorities should continue their present policy stance by using structural measures to promote the allocation of more resources toward domestic consumption, where there still seems to be room for expansion.

In this connection, I note with satisfaction the very low tariffs on imports. However, information received from the private sector suggests that there remains much room for improvement in the area of informal barriers, which exclude foreign products from Japanese markets, in particular the stringent system of import standards and certification, licensing, and other regulations in the retail industry.

In his opening statement, Mr. Yamazaki pointed out an interesting trend in the strategy of Japanese corporations: a shift toward overseas production of Japanese goods and importation into Japan of such goods by Japanese corporations. The long-term consequences of this shift in production should not be underestimated, since they add to the beneficial effects of Japanese competition on world trade, where the sophistication, design, and quality of Japanese goods and services has substantially increased the standard of internationally traded goods and services. Given the high technological and management standards of Japanese companies, this growing internationalization of Japan's production and investment has already had significant effects on the development of many economies--largely in the newly industrialized countries, but also in the economies of many major industrial countries, as can be seen, for instance, from the impact of Japanese industry on automobile production.

The world economy has benefited from Japan's support of exchange rate stability. The authorities' active intervention to stabilize exchange markets is welcome. Experience with this intervention seems to substantiate the view that concern over

the inflationary effects of significant growth in monetary aggregates arising from exchange rate interventions is less warranted in an environment where exchange rates are almost wholly determined by capital movements. The position that the currency adjustment has gone far enough is supported by the substantial economic restructuring with which the Japanese economy has responded both to market forces and to policy initiatives.

As to monetary policy, the steady relaxation of monetary conditions combined with a policy of fiscal retrenchment has brought down interest rates considerably, leaving Japan with by far the lowest interest rates of all the major economies. The only worrisome aspect of these low rates seems to be that the yield curve has almost flattened out in recent months. I wonder whether this means that the accommodating monetary policy stance has reached the limits of its effectiveness, given the buoyancy of domestic demand, and where this leaves the authorities in case of renewed dollar weakness. Would the Reagan-Takeshita statement remain tenable in such a situation?

With respect to balance of payments developments, it should be stressed that the staff's medium-term scenario of gradual surplus reduction hinges on a further increase in capital spending, already at high levels. If this scenario is not realized, massive outflows of Japanese capital may place additional strain on the international capital markets. It should not be forgotten that in 1987 a large part of Japan's current account surplus was steered into official reserve accumulation by the Bank of Japan and an increased flow of resources through the international financial institutions. Part of the remaining Japanese capital seems to have flown, in the form of direct investment, to the newly industrializing economies in Asia, instead of to developing countries adjusting their deficits. Thus, to an extent, the Japanese current account surplus has only been moved along to create new surpluses elsewhere, leaving global imbalances relatively undiminished. It is in this connection that the medium-term scenario prepared by the secretariat of the Organization for Economic Cooperation and Development shows that a current account surplus reduction for these newly industrializing Asian countries increases Japan's surplus by about one third of the amount of the reduction.

As to fiscal policy, recent projections seem to imply that the medium-term goal of fiscal consolidation will be attained. Not only does this give the authorities room to introduce-- within the constraints imposed by the level of public debt-- discretionary economic measures in case the growth of domestic demand is again halted, for example, by a new exchange rate shock as in May 1987. It also allows for a rapid pursuit of the planned tax reform, in particular the revision of corporate

taxes, to support private investment. Since the better financial outlook will at the same time permit higher government capital spending, the basic assumption of the staff's medium-term scenario, namely, increased government investment, will be realized. This implies that contrary to the staff report, the GNP share of the general Government's capital expenditure will have to be increased further.

The responsibility the authorities have demonstrated and their commitment to ensure that some of the surplus flows back to developing countries, enabling those countries to share in the growth momentum of the economy, is appreciated. In this connection, Japan's generous contribution to the enhanced structural adjustment facility has been valuable for the success of the Fund's efforts and objectives.

Mr. Ismael made the following statement:

The authorities' remarkable achievement in 1987 in overcoming the "yen shock" reminds me of the great successes Japan achieved in dealing with the two oil crises in the 1970s. Pragmatic policy actions, flexible economic management, and full implementation were the keys to their success. I am in general agreement with the staff assessment.

The front-loaded stimulative fiscal measures implemented almost immediately after their announcement in May 1987 have succeeded in triggering a revival of domestic demand in the second half of 1987. I agree with the staff that the present economic trends are likely to continue, though at a more moderate pace, and I endorse the authorities' shift to a more neutral fiscal stance so that the medium-term objective of fiscal consolidation would not be compromised.

The accommodative monetary policy that has been pursued to ensure the growth of strong domestic demand is a good indication of the authorities' commitment to restructuring the economy to reduce international tensions. While I agree with the staff that the current monetary stance is appropriate, the authorities should remain on guard for any signs of a resurgence of inflation or inflationary expectations. The continued large increase in asset prices, after a sojourn in the fourth quarter of 1987, has to be monitored closely, even though the current upswing was largely a reflection of the increased confidence in the strength of the economy and the sound policies pursued by the authorities.

I agree with the authorities that the pursuit of external adjustment should not rely excessively on exchange rate action, and that a further appreciation of the currency could be counter-productive. The sharp rise in the value of the yen in the past

two years has given rise to large and favorable terms of trade for Japan, which in turn has helped to propel a strong growth in domestic demand. With the prospect of a more stabilized value for the yen in 1988, the positive terms of trade impact would diminish over the year, necessitating additional and appropriate policy actions to help sustain the growth of domestic demand in coming years.

Substantial progress has been made in structural reforms, particularly in the areas of financial liberalization and imports of manufactured goods. However, there are still many areas where structural reforms have to be introduced or pursued more vigorously. These areas include the inefficient land use regulations and policies, the substantial protection in the agricultural sector, and the generally restrictive market practices that have frustrated the distribution and sale of foreign goods in Japan.

The medium-term scenario presented by the staff on the recycling of Japan's surplus mentions the possibility of closing the savings/investment gap, and thus reducing the aggregate current account deficit of some major industrial countries, which would lower interest rates and provide an opportunity for Japan's surplus to be diverted to the developing countries in support of their adjustment efforts. This scenario is certainly desirable and not as unrealistic as it would appear; it can be brought about if other industrial countries pursue their structural adjustment policies in the same energetic manner as Japan. The developing countries, particularly the heavily indebted ones, must also consistently pursue realistic and strong adjustment policies.

Mr. McCormack made the following statement:

I congratulate the authorities for the robust performance of the economy in the past year, and I agree with the staff that the economy has responded exceptionally well to the challenge posed by the rapid and substantial appreciation of the yen. The remarkable economic recovery--to a real growth rate of 4.2 percent in 1987, compared with 2.4 percent in 1986--in the face of a further substantial negative contribution from foreign trade, clearly bears witness to the resilience and adaptability of the Japanese economy. I recognize the important role of the flexible fiscal and monetary policies pursued by the authorities in this recovery. I broadly agree with the staff appraisal.

In facilitating domestic adjustment and, at the same time, fulfilling their role in the international adjustment process, the authorities have sought to supply an appropriate degree of fiscal stimulus while pursuing an accommodating monetary policy.

Although they have had remarkable success in obtaining their objectives thus far, it is clear, with respect to both fiscal and monetary policy, that the authorities now have limited room for maneuver.

As other speakers have said, there is a delicate balance to be struck between the imperatives of medium-term budgetary consolidation and short-term fiscal flexibility. The role of public investment is particularly important; it helped to sustain domestic demand in 1987 and made a direct contribution to the narrowing of the savings/investment gap. For 1988/89, the authorities intend to maintain public investment at the 1987 level. If growth is as strong as projected in the staff paper, that level would be entirely appropriate; however, it might be prudent to consider contingency plans for more investment, should growth begin to falter.

On monetary policy, as the staff noted, a number of recent signals could point to a possible emergence of inflationary pressures. In particular, broad money has been growing significantly faster than nominal spending in recent months, even after allowing for the distorting effects of the trend shift in velocity associated with financial innovations and for other special factors, such as the introduction of a domestic commercial paper market in November 1987. To date there has been little evidence to suggest that the pace of economic recovery was substantially affected by the stock market decline, which was significantly smaller in Japan than elsewhere, and a considerable amount of excess capacity has apparently been worked off since the summer of 1987. Indeed, there have been reports of some sectoral bottlenecks, and new job offers have risen sharply. Partly reflecting these conditions and improved corporate profits, the upcoming round of wage negotiations could result in higher wage increases than in 1987, yet another potentially inflationary element. In the immediate wake of a substantial exchange rate appreciation, and following the stock market crash, inflationary expectations may be weak, but these moderating factors will diminish over time, and as they do, monetary policy will need to be monitored carefully. Mr. Prader's remarks concerning the yield curve are germane to this point.

In the light of the constraints on the role of fiscal and monetary policy in facilitating further adjustment, it is essential that priority be given to structural adjustment, which is an important area if progress is to be made in international policy cooperation. I recognize the important measures that have been taken to date and note the low tariff rate on manufactured imports; nevertheless, the nontariff barriers and the role of government controls and regulations are cause for concern. One example of such barriers is the monopolistic distribution system that prevents the full pass-through of the appreciation

of the yen to consumers and tends to distort consumer preferences. Therefore, the measures proposed recently by the Economic Council to liberalize and improve the competitive functioning of the domestic market are welcome, and are clearly in the right direction. I would appreciate more information regarding the planned implementation schedule.

I concur with the staff that reform in the areas of land use and agricultural pricing policy are of primary importance. In addition, deregulation of small savings and streamlining of the distribution system would be particularly helpful in further promoting the goal of economic restructuring. Such reform can be politically difficult, because it runs up against strong vested interests. However, the chances for success seem particularly good at present, given the current strong domestic economic environment.

I agree with the staff that structural changes do not lend themselves to quantification. However, in future staff reports, in light of the importance of structural changes, some estimation--even if somewhat rough--would provide a greater appreciation of the magnitude and effectiveness of the planned structural measures. In making this suggestion, I am aware of the pressures on staff resources, which this chair has previously emphasized, and I stress that no elaborate exercises are called for, but just some continued guidance over time as to how these measures are progressing.

I commend the authorities for the various initiatives undertaken in 1987 to support the flow of financial resources to developing countries and for their efforts to increase official development assistance.

Mr. Sliper made the following statement:

I commend the authorities for the very impressive economic performance over the past year, both in terms of economic trends and economic policymaking. Looking at recent trends, the factor that stands out the most is the very successful way in which the economy has responded to the huge revaluation of the yen in the past two years. Mr. Yamazaki noted in his opening statement that in 1987 the year-on-year appreciation was 31 percent compared with 25 percent in 1986.

Against this background, the overall growth performance in 1987 is commendable, as is the increase in domestic demand at about 4.7 percent. Certainly it exceeds the expectations expressed by Directors during the 1986 Article IV consultation discussion (EBM/87/40 and 87/41), when the Chairman accurately noted in his summing up that "Directors expressed doubt that the

current weaknesses of the manufacturing sector might spread to other sectors of the economy, accentuating general economic weaknesses." Fortunately, for both Japan and the world economy, this rather gloomy forecast did not eventuate.

The good economic growth reflects both a responsive private sector and public policymaking working in a coherent way. On this latter aspect, it seems that monetary and fiscal policy, together with the structural reforms that were implemented, all contributed to ensuring that the growth momentum was maintained during 1987.

The responsiveness of the manufacturing sector was emphasized in an article published in the Washington Post in February 1988, which examined how Japanese car firms were able to find ways to react successfully to the huge input price changes. The firms' attention to holding down costs and changing the source of supplies to reflect exchange rate changes provided an interesting account of how quickly major Japanese enterprises react to external shocks.

On the fiscal front, I was impressed by the extent to which the authorities had been able to implement tax reforms over the past year. The international press has often focused on the inability of the authorities to secure the approval of the Diet for a comprehensive indirect tax regime. This focus has masked the progress that has been achieved in a number of other areas. I refer in particular to the exemption of interest on small savings, a significant reform, which should, over time, do much to bring into balance domestic savings and investment.

In looking at the challenges for economic policy making in the future, the staff report is correct in highlighting three interrelated areas: continued tax reform; the regulatory environment, particularly for land; and agricultural reform. On tax reform, the most recent Economic Commission report seems to be on the right track. Its restatement of the earlier principles outlined in the Mayekawa Report is sensible, with an emphasis on reducing income, corporate, and inheritance tax rates, and replacing the existing commodity-specific indirect tax with a broad-based indirect tax. These measures would do much to improve the fairness and simplicity of the tax system. Although these reforms are not easy politically, I hope that further progress can be made over the next year. Like Mr. Grosche, I wonder whether the authorities' mention of a further study of the broad-based indirect tax means that they are deferring moves to get approval for it this tax year.

On the issue of land management, the interrelationship of high urban land prices with high agricultural subsidies is properly highlighted in the staff report. It is acknowledged

that the price of land will remain high in Japan, given its scarcity. Dismantling agricultural subsidies will do much to improve the situation, but reforms are needed in the regulatory environment and tax incentives. Effective land management will depend critically on the regulatory environment. For example, in the mid-1970s the Government introduced a law to inhibit the development of large retail stores. Before a store can be approved, it is necessary to get the agreement of local shopkeepers, 26 different features have to be separately approved, and 75 approvals have to be obtained from almost as many different government agencies. This process can take six to ten years, and every detail of the new store is subject to government approval.

The agricultural sector remains Japan's Achilles' heel. I like the way the staff has identified this issue in its report: "The issue of protection of the agricultural sector has always been clear: from an economic point of view, its dismantling will benefit Japan as well as the rest of the world." The problem seems to have been recognized by the authorities, but progress remains inordinately slow. Moreover, we would point to the danger of some measures being implemented in recent years which have tended to favor U.S. agricultural exporters.

Japan has continued to exercise real economic leadership over the past year. Its ability to respond effectively to the dramatic appreciation of the yen and to implement policies to expand domestic demand has done much to ease international tensions and bring about orderly adjustment. Also, its contributions to multilateral agencies like the Fund and the World Bank have been impressive. I hope that Japan will continue to play this leadership role and that it can expand its efforts, especially on the trade front, particularly in the Uruguay Round. A more open Japanese market for imports would do much to help recycle Japan's external surplus, and would greatly assist developing countries in expanding exports, thus providing liquidity and growth to assist in the management of debt problems.

Mr. Cassell said that he joined other speakers in agreeing that Japan had clearly made considerable progress over the past year in generating demand-led growth. From the staff report, there was no doubt that policymaking had been moving in the right direction, not only for the Japanese economy, but also for the world as a whole. That message, if anything, had been reinforced by the second supplement to SM/88/55, which showed that the growth of domestic demand in 1987 had been even higher than the staff had expected when the report was first written.

The economy's smooth adjustment had certainly been helped by the authorities' flexible policy stance and in particular by the fiscal measures that had been taken within the medium-term consolidation plan, Mr. Cassell noted. In addition, monetary policy had helped to support the recovery.

Although an accommodating monetary policy must be continued to ensure that inflation remained firmly under control, he strongly agreed with the authorities on the importance of promoting exchange rate stability among major currencies. The main objective for the coming year must be to maintain domestically generated growth and to further reduce the current account surplus.

Although macroeconomic policies would need to respond flexibly to changes in the outlook for the economy, there might be limits--reflecting for example the medium-term objective of fiscal consolidation--on that flexibility, Mr. Cassell commented. Therefore, macroeconomic policies designed to improve the structure of the economy would have an important role to play in the next phase of the program. Four areas seemed to be particularly important in that context:

First, on trade policies, as the staff had pointed out, there was clearly a need for further steps to reduce the overall level of agricultural protection, Mr. Cassell reiterated. That reduction was important not only for Japan's economy, but also for the efficient use of resources worldwide, particularly in Southeast Asia. As the staff report noted, the authorities had made impressive progress in recent years in reducing trade restrictions; however, the impression widely remained that exporting to the Japanese market was difficult. Import procedures still seemed to inhibit access to the market, which, in part, reflected the nature of the distribution system; so he was glad to see that the authorities were planning to encourage competition in that sector. The tendency for trade problems to be dealt with bilaterally--for instance, the semiconductor pact and the discussion over access to construction--was cause for concern. A multi-lateral approach to those problems would have been preferable.

In 1987, the staff had felt that distributors were able to retain a large part of the benefits of the lower import prices derived from the yen's appreciation, Mr. Cassell recalled. The wide gap between the wholesale and retail price indices was thought to reflect that gain. However, since then, the divergences between the two price indices had narrowed. The staff was expecting a small rise in the rate of inflation in 1988 as some of the factors which had put downward pressure on prices--notably, the appreciation of the yen--eased, but this would still leave the distributive sector with much of the windfall gains that may have been secured in the past. To judge from the background paper, the staff was inclined to give less weight to that factor for 1988, but he would be interested in the staff's comments on it, and in particular, on profit levels and distribution.

The second important structural issue was land reform, Mr. Cassell remarked. As the staff had pointed out, liberalization in that area to reduce distortions in favor of certain forms of land use should help to promote both welfare and activity. Structural changes to increase the availability of land for development could release considerable pent-up domestic demand, and thus help to absorb the high level of savings.

The third area was financial policies, Mr. Cassell said. One of the many interesting points that had emerged from the section on market and regulatory factors affecting capital flows in the supplement to SM/88/55 was the extent to which Japanese financial institutions had engaged in short-term borrowing abroad to finance longer-term investments. Those flows seemed, to some extent, to have been prompted by the rigidities in the domestic financial markets. Although significant progress had been made in recent years in liberalizing the financial markets, much still remained to be done, for example, in the deregulation of small deposits and in the development of short-term money markets. He wanted to know from the staff or Mr. Yamazaki the extent to which the authorities had a timetable for the next stage of financial reform. On the financial markets, tribute should be paid to the resilience of the Tokyo stock market in the face of the October 1987 turmoil. Indeed, the Nikkei stock index was now back to where it had been on the day before Black Monday, which was no mean feat, and he was sure many Directors would be happy if their economies had achieved even half of that progress.

As to the role of the Japanese economy in allocating savings within the world economy, the staff report had listed the wide range of policies the authorities had already undertaken to promote the flow of private sector money into developing countries, and the staff had urged the authorities to take further measures in that direction. The staff had claimed that the rate of return in developing countries might be greater than the markets currently perceived; however, that line of argument was rather tricky in that it assumed that the Government's perceptions of prospective yields were superior to those of private investors. Nevertheless, he would not quarrel with the conclusion that the staff had reached in its report.

Japan would find that being the world's major creditor nation carried with it a lot of responsibility, as other countries had in the past, Mr. Cassell concluded. The authorities had, in fact, gone a long way during the past year in discharging those responsibilities, although a good deal more remained to be done in the coming years. He joined previous speakers in commending the authorities' recent policies, in particular, the fact that further adjustment in the external balance was to be sought not through a further appreciation of the yen, but through comprehensive macroeconomic measures, such as the expansion of domestic demand, further trade liberalization, and changes in the industrial structure.

Mr. Marcel made the following statement:

During the Board discussion for the 1986 Article IV consultation with Japan (EBM/87/40 and EBM/87/41), many Directors, while commending the authorities on the performance of the economy, had expressed some doubts about the prospects for 1987/88, especially with respect to output growth. The current figures on economic performance clearly contradict those fears, since

the recovery was particularly strong in 1987, and there are good reasons to suppose that growth will continue to be buoyant in 1988.

Indeed, in 1987, the Japanese economy performed well in many respects: its output growth was one of the highest among major industrial countries, manufacturing production rebounded remarkably after a sharp decline in 1986--4 percent in 1987 compared with -0.4 percent in 1986, and a projected 8.4 percent for 1988--the rate of unemployment remained at a low level, and there was almost no inflation. This valuable outcome clearly shows that the authorities have succeeded in responding to the challenge posed by the considerable appreciation of the yen over a short time and the severe slowdown in exports that began in late 1985. Indeed, since 1985, a substantial economic restructuring has taken place: production and investment have been noticeably reoriented toward the domestic sector, bringing about a strengthening of domestic demand, and imports have sharply risen while export volume growth has stabilized, leading to a nearly balanced real trade account. This considerable adjustment was made possible partly by the large resilience of the economy, but it also resulted from the quality of the policies which were implemented. This impressive recovery provided a major contribution to international cooperation both in sustaining world economic growth and in correcting G-7 external imbalances.

The staff's medium-term scenario suggests that over the next five years Japan might continue to enjoy solid economic growth while gradually and significantly reducing the current account surplus to about 2 percent of GNP by 1992. This scenario clearly goes in the right direction; however, it shows that the reduction of the surplus will take some time, and that it will remain significant at the end of the program period; moreover, surpluses vary widely according to geographic zones.

There is no doubt that the path of the macroeconomic policies are sound, but further steps should be taken, especially in relation to structural policies. It might be fruitful for the staff to consider the impact alternative policies could have on the medium-term scenario.

On fiscal policy, the authorities tried to reach a compromise between the medium-term goal of fiscal consolidation and the short-term need to support domestic demand. They implemented a significant program of measures of stimulus without substantially weakening the financial position of the Government, as shown by the slight increase in the deficit of the General Government. This flexible fiscal policy is generally appropriate, but I wonder whether there is still room for maneuver in this area. According to his opening statement, Mr. Yamazaki seems to think that there is no more room, while the staff report points out

that a further acceleration of public spending could bring about a crowding out of the private sector. I would appreciate further comments from both Mr. Yamazaki and the staff on this point.

The present monetary policy stance seems suitable in that it allows room both to sustain domestic demand and to alleviate upward pressure on the yen. It is clear that a new appreciation of the yen could be detrimental not only to Japanese growth, but also, by bringing about a loosening of market confidence, to the strength of international policy coordination. Consequently, provided that the rate of inflation continues to follow the same trend, exchange rate stability should remain the most important goal of monetary policy.

It is clear that the achievement of growth without inflation and the pursuit of external adjustment in the coming years will depend first and foremost on the quality of structural policies implemented. Indeed, the authorities should make every effort to eliminate rigidities and distortions in consumption/saving patterns and to generally liberalize the economy.

One of the most difficult problems in the case under discussion is the persistently high level of savings, and the savings ratio is expected to rise slightly in 1988. Because the drive to save stems from both cultural and demographic factors, the level of savings is not easy to reduce. Certainly, the aging of the population is likely to bring about a lowering of the savings ratio in the long term. However, immediate action should be taken in the context of the comprehensive tax reform, particularly to reduce the income tax burden on households. Another possible way to reduce the savings ratio would consist of reforming the social security and pension systems. It is clear that higher wages would encourage a higher level of consumption. Likewise, an increase in leisure time would augment private consumption.

I agree with the staff that substantial changes are needed in areas such as land use, housing, and agriculture. In this regard, I would appreciate further information from Mr. Yamazaki on the concrete measures his authorities are ready to take in these areas.

A greater openness of the Japanese economy is certainly crucial in the external adjustment process now under way. The substantial progress already made in tariff reduction and other areas is welcome, but at the same time, it must be recognized that exporting to Japan remains a difficult task. Certainly, the traditional behavior of the Japanese consumer can help to explain this fact, but there are still many impediments to imports, in particular in the distribution system. The authorities should seek as far as possible to open the economy.

Japan, as the largest supplier of foreign savings, has a decisive role to play in the global allocation of capital flows, especially to developing countries. As shown in the background paper, net flows to developing countries have remained roughly stable in relation to GNP over the past ten years, apparently without having any correlation to the current account balance. In addition, the staff survey shows that Japan's official development assistance remains less concessional than that of most other industrial countries. In this context, the recent initiatives taken by the authorities to increase financial flows to developing countries is welcome, particularly the \$20 billion recycling plan and the doubling of official development assistance by 1990. I strongly encourage the authorities to persist in this direction, especially by implementing policies to promote private flows to these countries.

Mr. Dallara made the following statement:

Let me start by joining other Directors in commending the authorities for the progress they have made with respect to policy implementation and economic performance during the past year. The highlights of these developments have already been well summarized by the staff and touched upon by other Directors. The performance of domestic demand, both with respect to key areas of investment and consumption, is particularly noteworthy, and the current account adjustment in real terms is welcome, although the performance does raise questions about the medium-term outlook.

The staff report appropriately emphasizes the importance of needed additional structural reform. Progress in structural areas would be in conformity with the undertakings made in January 1988 by the authorities, as well as the commitments most recently reaffirmed in the joint Reagan-Takeshita statement. We fully agree with the staff's reference to the need for radical changes, in particular with regard to land use patterns, agricultural protection, and better access to Japanese markets. I need not elaborate on these crucial areas in light of the very pointed and valid comments made in the staff report and by other Directors. I would add to this list the need for further progress in financial market reform and tax reform.

We hope that the five-year plan to be issued in two months will be quickly followed by action, because my authorities have been disappointed at the lack of immediate follow-up action to the Mayekawa report, which is something in the range of two years old.

Over the past year, fiscal policy has played a particularly important role in helping to sustain growth, despite some

skepticism at the outset of the year on the basis of the initial budget projections. The stimulus package later embodied in the supplementary budget seems to have had a positive effect. For 1987-88, the staff report notes some rise in the ratio of the central government deficit to GNP, perhaps to 3 1/2 percent, and the general government ratio to nearly 1 percent of GNP. We have the impression that the staff has given too much attention to the central government deficit and not enough analysis and attention to the broader measure of the General Government, an approach which we consider particularly paradoxical in light of the fact that on the occasion of each supplementary budget the authorities make a special point of stressing the role of local governments. Yet, the staff's focus continues to be too heavily on the Central Government.

Second, revenues are growing much more rapidly than anticipated. We would have welcomed, and would still welcome, any indications the staff or Mr. Yamazaki may wish to make on the likely actual outcome in the fiscal year just coming to a conclusion with respect to the central and general government budget positions. We have the impression that revenue growth, which is clearly exceeding expectations, might give the Government more room for action than had been anticipated. Certainly the pickup in domestic demand in the last year lessens the need for stimulative fiscal action. On the other hand, there is an expectation that there could be some modest slowing of the economy later in this year. If that does occur, we would encourage the authorities to consider a supplementary budget, since we consider that there might be somewhat more potential scope for action than suggested either in the staff report or in Mr. Yamazaki's statement. Any plans or tentative thinking on this front would be most welcome.

Turning to tax reform, I welcome the actions which have been taken, including those pointed out in particular by others, including Mr. Sliper, who welcomed and stressed the potential importance over the long run of the elimination of tax exemptions for small saver schemes. We hope that, as tax plans evolve this year and the discussions and negotiations with the various interested parties proceed, consideration could be given to a phased implementation of additional tax steps so that tax cuts might be implemented on an effective date earlier than the implementation of indirect revenue measures.

Turning briefly to monetary policy, we would have a slightly different perspective, perhaps, than that of the staff, or for that matter, most other Directors. We recognize, of course, the important contribution that monetary policy has made to the growth of the economy and to exchange rate stability. In that connection, we welcome the reaffirmed commitment of the authorities to policies which would continue to promote, in cooperation

with other countries, further exchange rate stability. At the same time, the easing in short-term rates in the Japanese financial markets has been particularly modest since the joint Reagan-Takeshita statement on January 13, 1988. Short-term exchange rates, as measured by the Gensaki rate, have declined only on the order of 8 basis points. With larger declines in the United States in short- and long-term rates, the differential in favor of the dollar has narrowed quite noticeably over the past two months.

The emphasis and attention given by the authorities to the importance of exchange rate stability would suggest the need to be particularly mindful of this objective in the formulation of monetary policy during the period ahead. And, in light of the near nonexistence of inflationary pressures at this time, we hope that the authorities would look for, and act upon, any scope that may exist for some further pursuit of an easing of monetary policy, which might be reflected in further declines in short-term rates.

With respect to the financial markets, tremendous changes have taken place in recent years. We will not review those changes in detail, but first commend the authorities for the opening of their financial markets, for the internationalization of the yen, and for the modernization of those markets. Nevertheless, there remain a number of areas which are still badly in need of additional reform. These include notably the privileged postal savings system, which remains to be tackled in a definitive way; the related and long overdue need for deregulation of short-term interest rates; particularly for small depositors; the institutional segmentation of the financial business; and the limited access of nongovernment borrowers to the long-term bond market. We urge the authorities to build on the progress they have achieved in recent years, which is, on the whole, impressive, and carry forward these past efforts into new steps and new objectives of liberalization.

The staff report provides some interesting analysis regarding external imbalances. First, let me say that we welcome the real changes in Japan's external position that are evidenced in the data for 1986 and 1987. However, as in the United States' own external position, the nominal changes have been very slow to emerge. Indeed, measured in dollar prices, which is admittedly only one way to look at it, the nominal size of Japan's current account and trade imbalances actually rose modestly between the third and fourth calendar quarters of 1987.

I make this point not out of particular concern for 1987 or 1988, but because we are concerned with regard to the medium-term outlook for global imbalances in general, including the Japanese position. We thought the staff report was a bit too

sanguine about the possibility of a 2 percent GNP surplus in 1992 or 1993. We felt that, perhaps, given the analysis in the most recent world economic outlook exercise, there are important questions concerning the sustainability of medium-term external positions. In light of that, the case for additional efforts and where they may be appropriate, particularly in the structural field, to reduce Japan's current account surplus in the medium term, are needed as an important part of Japan's overall contribution to global payments adjustment.

Another part of this problem, which is noted in the staff report, is Japan's effort to open its market globally. In particular, we suggest the need to ensure full access for the newly industrializing economies of Asia so that trading positions *between Japan and those economies could contribute to a more sustainable global position.* We will not belabor the need for additional opening in the trade and agricultural area, in light of the points which have been made by other Directors, but only stress the importance of additional actions in those areas.

In conclusion, we welcome the strong performance of the economy, and the fact that it has taken place in the context of growing and impressive efforts by Japan to collaborate internationally, not only with this organization but with other key industrial countries in the multilateral process of economic policy coordination. Indeed, we believe this process is bearing fruit and, in part, that this is due to the substantial efforts of the Japanese authorities. We hope that they will continue this effort, build on the progress that has been made, strengthen their efforts where appropriate, and contribute to a more sustainable global outlook.

Mr. Feldman made the following statement:

Japan's economic performance through 1987 continued to be impressive. After 12 years of growth, GNP during 1987/88 is expected to increase by about 4 percent. This consistent record of sustained growth was accompanied by a noninflationary domestic environment and by a sustained low level of unemployment.

As explained in the staff report and in Mr. Yamazaki's opening statement, the economic expansion has continued the positive trend initiated in 1986 of domestic demand growing more rapidly than GDP. The central role of domestic absorption is based on the accelerated increase in residential and equipment investment, coupled with a firm trend of increasing private consumption. This expansionary pattern is undoubtedly contributing to the elimination of the large external imbalance which currently characterizes the economy. It is important to emphasize that these positive developments were achieved in an

unstable external economic environment, characterized by the existence of considerable international payments imbalances that resulted in a large appreciation of the yen over a short period of time.

In this context, the authorities were able to achieve their economic goals by successfully implementing an appropriate mix of fiscal and monetary policies, created to bolster domestic demand in the short run without jeopardizing the long-run objectives of fiscal equilibrium, price stability, and sustained growth. In addition, the authorities are planning to implement appropriate mechanisms for longer-term domestic demand expansion, a commendable movement.

An enlarged domestic demand in conjunction with domestic markets more open to foreign products will allow the economy to diminish current large external imbalances and simultaneously play a more important role in the world economy.

It is expected that Japanese import markets, particularly those related to agricultural products, will be further liberalized, helping to enhance domestic absorption and reduce external imbalances, which would indirectly contribute to improving the external position of a number of potential supplier countries.

Although steps have already been taken in this direction, import liberalization in the agricultural sector could be further strengthened. Moreover, my authorities hope that the recent appreciation of the yen will not be followed by protectionist measures in other areas. The further opening of Japanese markets to agricultural and food products from developing countries would be a positive step toward improving the role of Japan in the world economy and the situation of developing countries, as well as to removing price and allocative distortions in the Japanese economy. In fact, as the staff explained in the supplement to SM/88/55, the ratio between the producer price and the world price for rice is not only high, but has also widened significantly since 1982. I fully agree with the staff that, from an economic point of view, the dismantling of protectionism in the agricultural sector would benefit both Japan and the rest of the world. Also, I understand from the staff report that the implementation of structural reforms, especially the elimination of tax discrimination in favor of the agricultural use of land, will not only generate a reduction in the cost of food and other consumer goods, but also will help to enhance the quality of life in urban areas. Therefore, deregulation in the production and distribution of rice is welcome.

With respect to external policies, I agree with Mr. Yamazaki and the staff that a further appreciation of the yen could be counterproductive and that artificial exchange rate stability

cannot be imposed on the market. Instead, all of the industrial countries need to work together toward the elimination of imbalances and closer policy coordination.

My authorities understand that any kind of mechanism aimed at recycling savings should be encouraged. I feel that excessive savings in Japan have, as a counterpart, huge demands for their absorption in other regions of the world. The question is how to find proper ways of channeling those funds. In this regard, the involvement of the Government and the banks in efforts to solve the current difficulties in the debt strategy is certainly welcome.

As imbalances in other industrial countries subside, it is hoped that the Japanese savings surplus will increasingly flow to developing nations which have embarked on growth supported programs. The recycling of Japanese financial resources has already started, and is welcomed by developing countries.

It would be helpful to know the authorities' expectations with respect to the magnitude of capital flows in international financial markets, including foreign investment from Japan to developing countries for 1988 and beyond. Chart 4 of the first supplement to SM/88/55 indicates that most of Japan's funds keep flowing to the industrial world. My authorities hope that, both through official assistance and by channeling funds through international capital markets, Japan will play a leading role in bringing new solutions and constructive alternatives to the debt problem.

Mr. Sengupta made the following statement:

Economic performance in 1987 was impressive by all accounts; not only did Japan face the challenge of the sharp appreciation of the yen, but it also showed that it was possible to raise the level of economic activity and price stability by pursuing a mix of fiscal and monetary policies that provide a stimulus to domestic demand. More important, this performance underscored the confidence of the markets in the authorities' present policies; as a result, the stock market crash of October 1987 and the later volatility of foreign exchange markets had no visible impact on the economy's expansion.

The present course to maintain noninflationary growth, ensuring at the same time that expansion in domestic demand would be faster than in output, seems to be best for the current situation. To achieve this goal, tax cuts coupled with a dramatic increase in public works expenditures are being undertaken.

Monetary policy has been accommodating, especially since the October 1987 stock market crash. Given the low rate of inflation and inflationary expectations, a larger weight is given to exchange rate stability in the pursuit of monetary policy, which is justifiable in view of the rapid restructuring of the economy from being export based to drawing sustenance from domestic demand as well. The authorities' commitment to exchange rate stability is reflected in the number of times they have intervened in the market. The staff should provide some information on such intervention, because it is difficult to know the degree or extent of such action in the absence of information on movements in gold and foreign exchange reserves. It would be interesting to know which of the major industrial countries had to bear the largest burden owing to Japanese intervention.

Sustainable exchange rate stability can be achieved only if the major industrial countries adopt a coordinated set of macroeconomic and structural policies. The authorities realize this, and as Mr. Yamazaki said in his opening statement, they consider that--apparently with reference to past G-7 statements--the current close policy coordination among the major countries should be maintained and intensified. While I agree that exchange rate stability should be pursued, I do not see much evidence of policy coordination among the major countries. Table 1 of SM/88/44 on economic indicators shows that the imbalances will remain unsustainable over the medium term.

Suppose the fiscal deficits of the OECD countries, particularly the United States, do not come down as projected and the savings/investment gaps of these countries, reflected in their current account deficits, continue to be high. If Japan's savings/investment gap is reduced, it would raise real international interest rates, which would create deflationary pressures in the world economy and make life particularly difficult for the developing countries. This would call for a slower rate of reduction of the Japanese surplus or savings/investment gap. If the deficits of the industrial countries fall, there will be downward pressure on interest rates; however, the fear that, if the Japanese surplus does not fall at the same time, the decline in interest rates may go too far to stimulate excessive expansion in the industrial countries, rekindling inflation in those countries, need not be realized if the surplus is recycled to the developing countries.

The developing countries can still absorb substantial foreign investment, and if the rate of interest is kept low, the chances for such absorption would be high, even if nothing else is done and the matter is left to market forces. However, if the process is aided by some international financial intermediation in the form of guarantees, insurance, cofinancing,

infrastructural support, interest rate subsidies, and a blending of commercial finance--all of which will improve the operation of the market forces--such recycling could have great potential in restoring growth in the world economy. The staff should be congratulated for taking note of this point, one this chair has consistently advocated. The authorities have gone a long way to help in this process of recycling capital, but the burden should be shared internationally because it helps international adjustment. Mr. Cassell has noted that the Japanese have made a big effort in this direction, and I hope he will support a continuous recycling of surpluses to the developing countries.

The difficulties of the Japanese policy approach are made clear in the medium-term scenario set forth in Table 4 of SM/88/44. If real GNP growth remains at 3.6 percent or 3.7 percent, which is significantly lower than the 5 percent average of 1984/85 and 4.2 percent of 1987, the rate of investment is expected to rise steadily from 27.9 percent to 30.5 percent. This is a very tall order given that other industrial countries have achieved at best 17-18 percent.

The staff has devoted sufficient attention to the flow of financial resources to developing countries. In particular, the informative report on capital flows in the first supplement to SM/88/55 makes clear that Japan has taken a number of commendable initiatives during the past year. There was a substantial increase in official development assistance flows in 1986, but as this increase reflected the yen appreciation vis-à-vis the dollar, the ratio of official development assistance to GNP remained at about 0.3 percent. In this context, it is noteworthy that a doubling of the annual level of official development assistance in 1992 may still not improve the official development assistance to GNP ratio substantially, given the projections for medium-term GNP growth. The authorities should further improve this ratio and take a lead in promoting quicker adjustment in developing countries.

Mr. Ovi made the following statement:

The economy has performed well over the past couple of years, owing to constructive economic policies, which--according to the staff--have been designed mainly to stimulate domestic demand and to encourage a restructuring of the economy to restore growth and reduce international economic tensions. I note with great interest that this policy strategy will be pursued in the period ahead, as the accommodative stance of demand-management policies will be maintained and the structural reforms accelerated to sustain noninflationary growth. I am in general agreement with the staff assessment of the short-term prospects of the economy.

The medium-term goal of fiscal policy continues to be fiscal consolidation, implying more precisely the ending by 1990/91 of the Government's reliance on bonds issued to finance its current deficit. Although government investment, as a percentage of GNP, may increase slightly, the implementation of this policy strategy could result in a medium-term tightening of fiscal policy, thereby contributing to the maintenance of a net savings ratio of about 2 percent of GNP. Rough estimates indicate that this would mean that, at present exchange rates, Japan, even in 1992, will have an external current account surplus of \$65-70 billion.

As the staff noted, a crucial question arising from this scenario is whether an annual current account surplus of approximately \$70 billion over the next five years would be consistent with the goal of reduced international economic tensions. This seems somewhat doubtful. As seen in the recent world economic outlook exercises, most of the counterpart of the Japanese surplus will emerge as a corresponding deficit in other industrial countries. Such a surplus in Japan over a number of years may have a profound impact on exchange rates in the medium term, and thus jeopardize efforts to stabilize exchange rates. Renewed exchange rate turbulence, together with a further sharp appreciation of the real effective value of the yen, would inevitably require additional restructuring of the economy. Moreover, continued large current account surpluses could strengthen protectionist sentiment abroad. As a consequence, the favorable growth prospect portrayed in the staff's medium-term scenario may not be realized. From a national as well as a global point of view, it therefore appears necessary to reduce the Japanese savings/investment gap more rapidly than the staff projected. This can probably only be achieved by a combination of further structural reforms and a somewhat more expansionary fiscal policy than forecast. The latter requirement would apply particularly in the case of receding growth. Such a policy could contribute to diminishing international tensions and calls for protectionist measures against Japanese products.

Structural policies may make an important contribution in achieving the main policy objectives. In this connection, the role structural policies have played in the recovery of the economy since 1986 and in the reorientation of the economy from export-led toward domestic demand-led expansion is interesting, and I am pleased that structural policies will be the focus of the Government's five-year economic plan, expected to be released in May 1988. I have noted especially that the authorities recognize that radical changes are needed in a number of crucial areas such as land-use patterns, agricultural protection, and market access. The land use reform should imply a substantial liberalization of trade in agricultural products, and thus remove some of the most criticized restrictions on Japanese

imports. In this connection, the authorities' announced willingness to lift quantitative restrictions on several agricultural items and to work with other governments in establishing new rules for agricultural trade is welcome.

The main obstacle to manufacturing imports seems to be the organization and operation of the distribution system. Hence, I fully agree with the staff that there is a need to improve market access, and I hope that effective measures to deal with this problem will be carried out as soon as possible. Such measures are vital to enhance the impact of exchange rate changes and to achieve more balanced trade between Japan and the rest of the world.

I welcome the positive spirit of the Japanese authorities in the Uruguay Round of GATT negotiations.

During the past year, Japan undertook major initiatives to channel financial resources amounting to \$30 billion to developing countries over a three-year period. However, the bulk of these funds will be committed in the form of loans on market terms, and Japan's level of official development assistance will remain relatively low, which is regrettable, given the developing countries' need for external financing on concessional terms and Japan's huge current account surplus and extremely strong financial position. The Nordic countries would, therefore, welcome a rapid increase in official development assistance as a percentage of GNP.

In a period of severe foreign exchange market turmoil, the authorities have shown responsibility and willingness to cooperate internationally in an effort to maintain economic growth and to control exchange rate adjustments, thereby alleviating international tensions and pressures. As the second most important economy, Japan has a very important role to play in the further adjustments which are needed to mitigate protectionist pressures and to secure a reasonable, noninflationary rate of growth in the world economy. Although the tasks ahead are formidable, I trust that the authorities will rise to these challenges as they have in the past.

Mr. Hogeweg made the following statement:

The 1986 Article IV consultation with Japan took place while the economy was only starting to recover from the 1986 slowdown, and Directors generally agreed that Japan should strengthen domestic demand. In this light, it is not surprising that the staff appraisal of Japan's policies and the results achieved is highly favorable, and I fully agree with it. The volume growth of domestic demand has been very strong indeed.

Fiscal policy has helped to bring about this result. However, the expansionary stance of fiscal policy in 1987 is not visible in the unexpectedly low outcome of the public sector deficit. On one hand, some public sector investment does not appear, owing to the privatization of two public enterprises; on the other hand, the buoyancy of the economy has resulted in sharply higher revenues.

The present accommodative monetary policy stance seems to be appropriate as long as it is conducive to continued non-inflationary growth and exchange rate stability. However, a further easing of monetary policy like that in 1986 and 1987 could result in inflationary pressure, given the strong rise in share and real estate prices and the fall in unemployment. In this connection, that the present rate of money growth is three times as high as that of nominal incomes is cause for concern. The staff rightly notes that ultimately control of inflation must remain the primary objective of monetary policy.

I agree with the staff and the authorities that a further appreciation of the yen could be counterproductive given the satisfactory adjustment of the economy, and because it might impair business confidence. However, the current account surplus, although expected to show further falls, seems to remain at too high a level in the early 1990s. Given the undesirability of a further yen appreciation, the medium-term objective of fiscal policy and the necessity to return to more moderate rates of monetary expansion over time, further adjustment of the current account balance will have to come from structural measures. Structural policy issues are clearly spelled out in the staff report and previous speakers have commented on them. However, I stress the importance of reforms in the tax system, land use regulations, and the distribution system. Reform of the distribution system could contribute significantly to diminishing the feeling among many of Japan's trading partners that entry into Japan's market is not always easy.

The pace of structural adjustment will be important in shaping medium-term developments. The most striking feature of the illustrative scenario presented by the staff in Chart 5 of SM/88/44 seems to be the remarkable lack of change after 1988. Maybe a more rapid pace of reforms than that incorporated in the scenario could change that picture.

The rapid increase in official development assistance flows is appreciated, although there is still a long way to go to reach the UN target of 0.7 percent of GNP.

Mr. Zecchini made the following statement:

Impressive results have been achieved by the authorities in their efforts to reorient the process of economic expansion from the export sectors to the inward looking sectors. Domestic demand in 1987 was allowed to increase more than output, at a higher rate than in recent years, and the highest among major industrial countries. Results were even more impressive in view of the magnitude of the exchange and external trade shocks that have affected the system and the speed at which the economy has been able to recover from these shocks. While experiencing a steady appreciation of the yen, in the order of 50 percent from early 1985 to the end of 1987, growth in manufacturing production turned negative in 1986, the first time in a decade, but afterward rebounded by 4 percent in 1987. In a similar pattern, profitability in the industrial sector decreased significantly during 1986 and then recovered strongly in the second half of 1987. These results bear witness to the high flexibility of the Japanese economy to appropriate macroeconomic and structural stimuli and confirm the validity of recent Fund recommendations for more initiatives to expand domestic demand and to overcome some structural rigidities.

Also, external imbalances have been reduced. Last year, the current account surplus declined in nominal and real terms. However, in view of the size of the remaining external disequilibria of Japan, as well as of other important economies, more has to be done in the future to achieve balance, and a continuity of efforts is required.

In fact, these successful results have to be attributed to an appropriate setting of demand policies and to the implementation of structural reforms for which the authorities have to be commended. The challenge now is to maintain an excess of domestic demand growth over output expansion in order to continue the correction of the external surplus. In the past two years, the terms of trade effects, owing to the yen appreciation, have sustained the buoyancy of domestic demand through their impact on real income. As for the future, however, we share the authorities' view that further exchange rate appreciation should be avoided. Therefore, since there is limited room for expansionary demand policies, the burden will have to fall on structural adjustment measures.

The effectiveness of structural improvements in bringing about an orderly adjustment of the external surpluses, while at the same time minimizing the domestic costs for the economy, is highlighted in one of the simulations presented in the last world economic outlook. Section IV, paragraph 3, of the World Economic Outlook Medium-Term Scenarios paper (SM/88/52) demonstrates how widespread and far reaching the effects of increased

efficiency of investments in Japan and of a greater openness of the Japanese markets to foreign goods are. This econometric simulation shows, in particular, how beneficial for the growth of developing economies, as well as for Japan, these additional measures are, and this should inject a higher measure of confidence in the policy approach of the authorities.

Since I am in broad agreement with the staff appraisal and the sections of the world economic outlook devoted to Japan, I will limit my comments to a few points pertaining to demand policies and structural reforms.

In 1987, fiscal policy was appropriately used to facilitate the expenditure shift from the tradable to the nontradable goods sectors of the economy and at the same time to sustain domestic expenditure levels. The package for fiscal stimulus presented in May 1987 was adequately tailored to meet both of these objectives. In this respect, the authorities should be commended for the rapid implementation of most of the planned measures, including the public investment program. On the revenue side, the approved package of measures, although appropriate, fell somewhat short of the original goals, particularly with respect to the size of the cuts in tax rates for personal income and corporate taxes. Moreover, the introduction of a broad-based indirect tax was rejected. Therefore, new efforts should be undertaken to fully achieve the goals of the original reform package along the lines suggested in the report of the Government Tax Commission issues in February 1988.

As for fiscal policy, in 1988 it seems that the policy stance is still unclear as the final result will depend on local governments' plans. Nevertheless, fiscal policy should not withdraw its support of the expansion of economic activity. Furthermore, priority will have to continue to be given to public investment programs, in view of the relatively low stock of social capital, and to infrastructure.

Monetary policy should continue to be aimed at striking a proper balance between supporting economic activity and stabilizing inflation and the exchange rate. A further appreciation of the yen seems inappropriate at this juncture because of the disruptive effects it could have on business confidence and the restructuring process. Moreover, exchange rate changes seem to have proved relatively less effective than changes in relative expansion of domestic demand in bringing about the correction of the country's external imbalance. In particular, the impact of exchange appreciation on external competitiveness appears to be buffered by the relatively low pass-through of the exchange rate movement into Japan's export prices: according to staff estimates, the observed pass-through was only 50 percent in 1986 and

70 percent in 1987. Moreover, the price elasticity of Japanese exports and imports is significantly lower than the corresponding income elasticities.

Turning to structural policies, we agree with the staff's contention that medium-term developments in Japan will be greatly influenced by the extent and the pace of structural reforms. Therefore, we look forward to the forthcoming five-year economic plan of the Government.

Efforts should be concentrated on reforms of land regulations, agriculture, and the market distribution system. In this respect, it has to be stressed that agricultural protectionism imposes very high costs on Japanese consumers, as measured by the excess of domestic prices over world prices. As indicated in the supplement to the background paper on recent economic developments, producer prices for rice in Japan are almost nine times higher than world wholesale prices and producer prices for beef are about three times higher. Needless to say, protectionism in this field is particularly harmful to developing countries which depend on exports of primary products. It is reassuring that in spite of the political difficulties that removing these distortions might entail, the Government recognizes that radical changes are needed in these areas.

Liberalization and internationalization of the financial sector will have to continue. In this area, some scope might exist for relaxing further prudential regulations imposing ceilings on the holdings of foreign currency securities by institutional investors. Moreover, we noticed in the supplement to the background paper that the authorities are considering relaxing the regulations that allow life insurance firms to pay dividends on policies only from realized income and not from capital gains. This regulation has prompted investment in high interest rate currencies despite the risk of depreciation. While the removal of this restriction will certainly improve resource allocation, it will also affect portfolio preferences and eventually exchange rate behavior. Staff comments on the extent of this reform and its likely impact on financing flows would be welcome.

Finally, appreciation should be expressed for the recent initiatives to increase official financing flows for developing countries, particularly nonofficial development assistance flows, culminating in the \$20 billion recycling package.

Mr. Al-Assaf made the following statement:

Like other Directors, I commend the authorities for their skillful management of the economy since the 1986 Article IV

consultation. The results achieved are impressive, whether measured in terms of their direct effects on the Japanese economy, or in terms of their contribution to the functioning of the world economy.

I am pleased that the policy orientation of the authorities will be maintained in 1988, and the confirmation in Mr. Yamazaki's opening statement of the strength of investment activity and of a noticeable improvement in the employment situation is encouraging. Therefore, I agree with the authorities on the desirability of a continued neutral fiscal policy stance. On monetary policy, I agree with Mr. Yamazaki that the continuation of the relaxed stance of the past two years could lead to some conflicts; however, in view of the absence of any perceivable inflationary pressures and the desirability of implementing policy coordination objectives within the Group of Seven, I would tend to view the potential risks of the present monetary stance as minimal.

There seems to be little doubt that the process of external adjustment will continue to proceed steadily, as it did in 1986. This would be a welcome development, especially if it brings an easing of international trade tensions and improved exchange rate stability. Looking beyond 1988, however, I am less certain about the prospects of a continuous decline in the trade surplus.

To some extent, the staff report is raising a similar question in pointing out the value of maintaining at least a moderate surplus to the rest of the world. For Japan, a trade surplus may be an unavoidable fact of life in the present circumstances. After all, even if Japan is now the second largest economy in the world, it is also a country without any substantial natural resources. Developing countries that provide the bulk of these resources do not have, as a group, domestic markets sufficiently developed to absorb a commensurate volume of Japanese exports. Therefore, the trade deficit of Japan vis-à-vis the rest of the developing world must be counterbalanced by a trade surplus with industrial countries. Most critics of Japan's surplus tend to agree that, in principle, there is nothing wrong with it. However, most agree that the magnitude of that surplus is excessive. This so-called excessive surplus is only partly the consequence of Japan's success in penetrating other industrial countries' markets. Another part of this surplus can be attributed to the sharp decline in world commodity prices experienced in recent years. I would have been interested to see some discussion of that point in the staff report, in particular to get an idea of the amount that would have to be added to Japan's import bill, assuming Japan's import prices would have remained at their average real level of the past ten years. It may be that a good portion of Japan's surplus could be accounted for in that way, and the staff should comment on that point.

From a world perspective, the manner in which Japan's surplus is being reduced may be as important as the magnitude of the adjustment itself. In this respect, the prospects for a further reduction in Japan's trade surplus in 1988 owe much to the fact that the growth performance in most other countries is expected to be rather unremarkable. Another reason for the expected reduction in Japan's trade surplus in 1988, however, is the progress made by the authorities in reducing trade barriers to a point where, on average, tariffs are presently below those of other industrial countries. A third reason is, of course, the expansion in domestic demand.

The authorities should be commended for their efforts in that direction, and for expanding their efforts toward intensifying the forms and the magnitude of assistance to developing countries. On this particular point, Japan's renewed commitment to assume a greater burden in resolving the debt crisis is welcome. Japan's level of official development assistance remains rather low, as Mr. Sengupta mentioned, and the three-year package of \$30 billion announced in May 1989, while welcome, will not raise Japan's contribution significantly as a proportion of its GDP. Furthermore, that package was based essentially on a recycling of resources toward multilateral institutions. I wonder whether the efforts of Japan at raising the level of its assistance are more likely to result in an increase of bilateral and private transfers.

Mr. Santos made the following statement:

It is refreshing to note from the staff report that the economy has been able, once again, to overcome a major challenge that confronted it during the past two years. By quickly adapting to the changing circumstances created by the sharp appreciation of the yen, the economy has demonstrated its high degree of resilience. Such an impressive adjustment in a short period of time is a reflection of the authorities' commitment to shoulder their international responsibilities in fostering global adjustment through appropriate demand management and improved structural policies.

Since I am in broad agreement with the staff appraisal, I will confine my remarks to some specific points raised in the staff report.

On the challenges of the medium term, as indicated in the staff report and Mr. Yamazaki's opening statement, the sustained withdrawal of external demand and the measures undertaken in the fiscal area to stimulate domestic demand helped the economy to continue its recovery in 1987. That the rebound in overall economic activity took place in an environment of price stability

is noteworthy. In general, the policies pursued by the authorities have produced positive economic and financial developments and those achievements are commendable. For the medium term, as others have already pointed out, the authorities will have to contend with the major issue of how to maintain a relatively high noninflationary growth rate led principally by vigorous domestic demand, while continuing to effect an orderly reduction of its external current account surplus. This task appears difficult given the prevailing vulnerabilities in the world economy. However, viewed against the impressive manner in which the authorities have adjusted and the flexibility shown in their cooperation with other major industrial countries in global efforts to achieve a more sustainable pattern of fiscal and current account balances, I trust they will again overcome those challenges.

On the formulation of macroeconomic policies, the authorities should continue--as in the May 1987 fiscal package--to try to strike an appropriate balance between the short-term need to encourage the growth of domestic demand, and the medium-term objective of fiscal consolidation. Indeed, the implementation of fiscal policy during the ensuing fiscal year should continue to reflect the underlying strength of the economy. In this context, the additional action envisaged in the area of tax reform is encouraging. These are steps in the right direction that should help to boost private investment while establishing a more equitable tax system and greater efficiency in resource allocation. As for monetary policy, since the stance followed over the past two years has supported the growth of domestic demand, which needs to be sustained, and since inflationary pressures and expectations have subsided, the continued pursuit of the present stance would be appropriate. However, price developments need to be monitored closely.

Progress made in the area of structural reforms is substantial, and the intention of the authorities to formulate comprehensive structural policies based on the recommendations of the Mayekawa commission and the five-year plan is welcome. Since these policies aim at removing and easing deep-seated rigidities to help in sustaining noninflationary growth, improving the quality of life, and fostering smooth international relations, the authorities should persevere to overcome political obstacles that might impede their implementation. In addition, significant progress has been made in the area of financial market liberalization, especially in the international context, as described on pages 33 and 34 of SM/88/55. In the area of trade liberalization, the authorities have taken further welcome measures to reduce international tensions by widening the market for imports, particularly for manufactured goods on which quantitative restrictions have been lifted and tariffs reduced to one of the lowest levels among the major industrial countries. Nevertheless,

I agree with the staff that there is room for greater openness in the Japanese market for foreign goods, and the authorities should endeavor to intensify efforts to ease the situation, especially for developing countries.

While I recognize and welcome Japan's awareness of its growing international responsibilities and the importance it attaches to official development assistance, the level of that assistance, as a proportion of GNP, remained at the 1985 level of 0.29 percent, well below the UN target of 0.7 percent of GNP. However, the authorities' commitment to help poor nations directly through substantial contributions to the multilateral financial institutions, in particular, the generous contribution to the enhanced structural adjustment facility is appreciated.

Mr. Zeas made the following statement:

Japan's economic performance in 1987 was outstanding on several fronts. Contrary to the expectations for 1987, the growth of real GNP at a rate of 4.2 percent was the largest among the G-7 countries, while the rate of unemployment, the rate of inflation, and interest rates were the lowest. Despite the large appreciation of the yen, over two consecutive years, the external current account in 1987 registered another substantial surplus of nearly \$87 billion, equivalent to 3.6 percent of GNP and equal to the 1985 surplus. I share the staff's concern about the long-term desirability and sustainability of these surpluses and the international responsibilities this entails in terms of capital transfers and recycling.

Although Japan's unemployment rate was as low as 2.6 percent in 1987, it has doubled compared with the rate prevailing in the 1970s. The somewhat different definition of unemployment used by the authorities tends to underestimate the rate of unemployment as defined by other G-7 countries. However, because pension benefits are low, a large proportion of retirees--20 percent--remain in the labor force, probably causing the figures for unemployment to be larger than they would be otherwise.

There is an outstanding esprit-de-corps and loyalty existing among a significant portion of the working class toward employers, which is rewarded by the large companies mainly through providing long-term stability and training for workers. The understanding between employers and employees seems to have created excellent working relations and has fostered productivity.

Apart from the well known lack of natural resources, another characteristic of the economy is the high propensity to save, which has been promoted by a 40 year-old tax system that relies mainly on direct taxation and exempts interest income on savings

accounts. The preferential treatment of income on personal savings, as explained in Mr. Yamazaki's opening statement, will be eliminated in the coming fiscal year.

The whole world has benefited from high-quality, low-priced Japanese exports, and I welcome and encourage the Japanese success in this area. However, I cannot be as complimentary about the import side of the economy, where trade barriers remain, particularly on agricultural imports.

On fiscal policy, the authorities have a medium-term plan aimed at reversing some of the imbalances of the late 1970s. Thus, the issuance of deficit financing bonds for current expenditures of the Central Government's general account is expected to be eliminated by 1991.

The authorities have again attempted to introduce an important tax reform for 1988 aimed at reducing corporate income tax and establishing a broad-based sales tax instead of a commodity-specific one. Since these reforms have encountered parliamentary opposition, I wonder whether there will be further efforts on the part of the Government in this area. The impact of the stimulus of maintaining high expenditures on public works will probably be partly offset by larger than expected tax revenues. As a result, the overall fiscal deficit in 1988 is expected to be at the same level as in 1987.

The medium-term nature of the adjustment program followed by the authorities should be emphasized since, even for a country with large external surpluses, policy changes need to be carried out slowly--over a period of years--to make them politically feasible.

Monetary policy during 1987 was guided by the main objective of controlling inflation, but it was also influenced by exchange rate considerations derived from the need to adjust international imbalances. Thus, for the year as a whole, broad money (M2 plus CDs) was allowed to increase faster than in previous years to 11.5 percent and, with the sharp appreciation of the yen, short- and medium-term interest rates declined to about 4 percent and 5.5 percent respectively by the end of the year. One of the reasons for the large increase in the money supply--equivalent to almost three times the increase in nominal income--was the substantial credit expansion by the Bank of Japan at subsidized interest rates, aimed at compensating businesses for the losses derived from the appreciation of the yen and at softening the effects of the stock market crash.

I agree with the staff that monetary policy was carried out successfully and in coordination with the other G-7 members,

keeping in mind the adjustment of international imbalances and the welfare of the world as a whole. The authorities deserve credit for these actions.

With respect to the medium-term outlook, according to the calculations made by the staff, it seems quite feasible that Japan will be successful in achieving an annual growth rate of 4 percent, which is compatible with the potential output of the economy. This goal appears to be in line with the maintenance of the overall fiscal deficit at present levels of nearly 1 percent of GNP and with a gradual reduction--perhaps too gradual--of the current account surplus to the equivalent of 2 percent of GNP by 1992. A very important effort will be necessary in the area of structural reforms; however, it is fair to expect that any structural reforms deemed necessary to obtain these results will be met by the authorities with their traditional efficiency. Nevertheless, the medium-term results could differ depending on the policies that the other important industrial countries of the world will follow.

Turning now to matters which are of specific concern to the low- and medium-income countries vis-à-vis Japan, the authorities' proposal to recycle \$30 billion of official resources over a three-year period through the World Bank, the Japan Export-Import Bank, Asian Development Fund, and the Fund is welcome. If this initiative is fully carried out, it would be a very important initiative for Japan. It would not be sufficient to wait for capital market forces to determine the direction of its important surpluses, especially after the United States has further reduced its deficits. The recent statement made by the Minister of Finance, that he sees a greater role for Japan in the debt strategy, is encouraging. I hope that these official resources, along with those of any other surplus countries, can be utilized, for instance, through loans to medium-income countries observing adjustment programs and wishing to participate in various debt relief schemes. History shows that during periods of crises special mechanisms were created to direct resources, not only according to market forces, but also giving due consideration to world welfare criteria.

The authorities should play a larger leadership role with respect to official development assistance for the least developed countries, as Japanese contributions in recent years have fallen well below the UN agreed target of 0.7 percent of GNP. The increase in contributions carried out by the authorities could set an example for others to follow.

The important recent import liberalization measures adopted by the authorities with respect to manufactures is welcome, and I sincerely hope that, considering the strong position of the external sector and its favorable medium-term outlook, the

authorities can dismantle the remaining protectionism of the agricultural sector. This action, which could open important opportunities for the less developed countries, could benefit the Japanese population, help reduce international tensions, and more important, under the present circumstances, set an example for other countries to follow.

Mr. Jiang made the following statement:

I join previous speakers in commending the authorities for impressive achievements under very difficult circumstances during 1987, a turning point for the economy, which has now vigorously recovered from the slowdown induced by the sharp appreciation of the yen since 1985. The impressive acceleration of output growth to a rate of almost 4.2 percent in 1987, plus the broadly stable price performance, has shown that the economy has the potential to proceed in a healthy way toward structural adjustment and eventually to attain the goal of transforming an economy characterized by export-led growth into one that places more reliance on domestic demand as a growth stimulus.

In the past, economic recovery in Japan was often initiated by the resurgence of exports, which triggered a revival of fixed business investment, which in turn usually led to a pick-up of private consumption and residential investment. A reversal of this sequence occurred in 1987. Because of the fast increase in real disposable income and personal wealth that resulted from a sharp rise in asset prices over the past two years, a significant increase in private consumption emerged at the forefront of the cycle. With the low mortgage rates in Japan, there was a spontaneous upsurge in housing demand, which propelled residential investment to record levels. Fixed business investments were spurred onward, resulting in a housing boom. This phenomenon signals a new trend in the adjustment process, and will have a great bearing on the future of the economy.

Although the economy's quick response to market signals reflects its adaptability and underlying strength, the role played by the Government in adopting the correct policy measures to ensure the necessary stimulus for domestic demand growth should be commended. In addition, the steps undertaken by the authorities over the past year to eliminate distortions in production and investment are welcome. On the fiscal side, the authorities proposed a new set of stimulus measures in May 1987, including an increase in public investment and a tax cut, totaling up to 1.7 percent of GNP. Monetary policy was further relaxed throughout the year. Together, these policies have stimulated domestic demand and have enhanced the internal absorption of savings. It is encouraging that the authorities are determined to implement more structural reforms and that the forthcoming

five-year economic plan of the Government will incorporate future recommendations proposed by the Mayekawa Report in 1986 and by the Economic Council in 1987 in order to address structural issues.

Regarding economic prospects, both the staff and the authorities have predicted that present trends will continue into 1988 and that the economy will grow at a rate of about 3 3/4 percent while prices remain stable. I agree with the staff that, in terms of policy considerations, maintaining the domestic economy on its present course of noninflationary growth is essential not only for Japan, but also for the world as a whole. It is not unreasonable to note, however, that uncertainties still exist both inside and outside the Japanese economy, which could cause problems for sustained growth. Although the stimulative policy measures introduced in May 1987 by the authorities will take effect gradually, the stimulus provided by private consumption has diminished somewhat since the stock market crash in October 1987, and uncertainties still exist, which could weaken growth in the major industrial countries and again induce turbulence in the financial markets. Consequently, there is still a danger that the yen could appreciate further and the counterproductive effect on the sustained growth of the country that would result is of great concern. In this context, I agree with the authorities that external adjustment should not rely excessively on exchange rate action, and that exchange rate stability is needed to avoid the adverse impact of further fluctuations in exchange markets on business confidence. The authorities are correct to emphasize the role of appropriate policies by the major trading partners to maintain exchange rate stability, and thus the importance of international cooperation and policy coordination.

With respect to structural issues, I agree with the staff that medium-term developments in Japan will be greatly influenced by the progress of sectoral adjustment and the pace of structural reform. Therefore, it will be necessary for the authorities to make greater efforts to implement the structural reform on a consistent basis. An issue of utmost importance is the reduction of Japan's large current account surplus. The authorities are aware of the fact that Japan should share the responsibility of helping facilitate global economic growth by fostering a sound international environment, but they need to take more forceful steps to open up Japan's markets for imports. A liberalization of trade in agricultural products would go a long way toward resolving the perennial problem of inefficient use of land--one of the crucial areas of structural reform that needs to be tackled immediately.

The authorities' initiatives, adopted in 1987, to increase the flow of official development assistance to the developing

countries is welcome. The authorities are to be commended for the efforts and commitments they have made continuously in this regard. However, in view of the continued deterioration in economic conditions in the low-income and heavily indebted developing countries, I hope that any recycling of the Japanese surplus will be implemented in a way which will best serve the economic development of the world as a whole, and especially in a way that will be most useful to the developing countries in addressing the problems that block their economic development.

Mr. Salehkhrou made the following statement:

Like other speakers, I am impressed by the better than expected economic performance, which, as the staff rightly commented, is largely due to the inherent resilience of the economy and the authorities' appropriate and timely response to the challenge posed by the substantial appreciation of the yen over a fairly short time. As it appears from the staff's well-balanced reports and Mr. Yamazaki's opening statement, the set of stimulative measures adopted by the authorities, combining accommodative financial policies and the implementation of structural reforms, has already produced favorable results. Led by strong domestic demand, real GDP growth recovered in 1987, after experiencing a deceleration in 1986. This improvement facilitated the gradual adjustment of the current account and was achieved within the context of stable consumer prices. I am in broad agreement with the staff appraisal.

With respect to the external position, the authorities succeeded in reducing the current account surplus from 4.3 percent of GDP in 1986 to 3.6 percent of GDP in 1987. The reduction was made possible mainly by the sizable appreciation of the yen, a trend which has continued since 1985, as well as by the sharp fall in oil prices, and it was buttressed by the supportive measures introduced by the authorities to boost domestic demand.

As a result, since 1985, the export volume has declined by 4 percent while the volume of imports increased by 19.9 percent. In this connection, I note the substantial increase in recent Japanese investment in the manufacturing activities of some major trading partners for exports to Japan, as part of the country's efforts to reduce trade friction and to stem the rise of protectionist pressures in trading partners against Japanese exports. Manufacturing in third countries to benefit from their existing comparative advantages--such as cheap labor or low taxes--and re-export to the home country is economically justifiable and at times well rewarded as evidenced in the case of several low-wage countries. However, aside from certain short-term gains in terms of reduced tensions and avoidance of protectionist pressures, I am not certain any longer-term benefits can

be realized by Japan from similar activities in other major industrial countries. The staff should comment on the sustainability of this activity and on related issues, including voluntary export restraints.

While such measures are welcomed by Japan's trading partners, particularly those industrial countries with large deficits, I note with concern that this trend has been accompanied by a disquieting deterioration in Japan's trade flows with developing countries. Despite the substantial increase in trade relations with the newly industrialized Asian economies, Japan's trade with developing countries as a whole continued to decline, owing to the fall in commodity prices, which led to a turnaround from a deficit in 1985 to sizable surpluses in 1986 and 1987. Given the resource-poor base of Japan and the authorities' commitment to strengthen domestic demand, the ample opportunities available to enhance trade and economic cooperation with developing countries should be greatly utilized. This is consistent with Japan's responsibilities in external adjustment. Such effort on the part of a surplus country like Japan would be particularly timely and necessary, considering the increasing protectionist tendencies in other major industrial countries, especially those in the process of adjusting their enormous trade deficits.

In this respect, while I fully agree with the staff that easing market access for manufactured and agricultural products benefits Japan as well as the rest of the world, there remains scope for further action on the part of Japan to increase technological transfers to, and industrial partnerships with, developing countries. In this regard, I am heartened by the emphasis placed by the authorities, as noted by the staff on page 18 of the first supplement to SM/88/55, "on the provision of technical aid to assist technology transfer in order to establish the foundation for sustained growth. This should be regarded as a welcome change, given Japan's relatively poor performance in the past.

In the same vein, the emergence of Japan as the largest international lender, following the accumulation of sizable current account surpluses in recent years, was unfortunately not matched by a similar increase in Japan's flow of resources to developing countries. The staff reports are very informative in this respect. I note with particular interest that:

- During the period 1983-86, the share of Japan's flow of financial resources allocated to developing countries declined from 37 percent to 12.3 percent;

- The condition of Japan's aid remains less concessionary due to a relatively high loan component, mostly on commercial or near commercial terms; and

- Official development assistance as a percentage of GDP increased slightly from 0.20 percent in 1976 to 0.29 percent in 1986.

It is against the background of declining shares of developing countries in trade and financial relations with Japan that one should consider the recent initiatives to enhance official and private financial flows to developing countries. The program of recycling \$30 billion over three years, along with the fairly sizable contribution to the enhanced structural adjustment facility, are steps in the right direction. I welcome the authorities' recent decision to allow commercial banks to write-off part of their loans to some heavily indebted developing countries. At this crucial juncture of the debt situation, the contribution of surplus countries like Japan is vital in alleviating the debt burden of developing countries. In this respect, further efforts on the part of the Japanese authorities are essential, given the fact that the bulk of foreign capital transactions in Japan are dominated by the private sector.

In this light, Mr. Yamazaki's statement that 1987 should be noted for the marked increase in Japan's contribution to external economic cooperation is encouraging. It is hoped that the authorities' intensified efforts in discharging the country's responsibilities in the area of assistance to, and cooperation with, developing countries would indeed be commensurate with its international economic status.

Mr. Othman made the following statement:

The authorities should be commended for their success in reorienting their economy from depending largely on external demand to depending on domestic demand as the main stimulus of economic activity. Since the weakening of external demand in 1985, the authorities have taken the necessary actions to achieve the twin goals of reducing the external surplus in an orderly fashion and maintaining noninflationary growth. The authorities' effective economic policy management has been instrumental in the impressive economic performance of 1987. Real GNP growth recovered; both inflation and unemployment rates remained low; the external surplus declined as planned; and the medium-term outlook continued to be favorable.

I am in broad agreement with the staff appraisal. With respect to financial policy, the authorities have struck a remarkable balance between achieving their medium-term objectives of consolidating fiscal policy and maintaining price stability and their short-term objective of stimulating domestic demand and growth. In particular, we have noted the increase in capital expenditures, which aside from the desirable effect on aggregate

demand, could also have a positive impact on Japan's potential growth over the medium and long terms. This is especially true in light of the fact that, compared to other major industrial countries, there seems to be a large scope in Japan for further developing the physical infrastructure.

There has been a substantial appreciation of the yen in the past two years, and the coming period of strengthening policy coordination among major industrial countries could be expected to foster exchange rate stability and bring about further adjustment in their external positions. On trade policy, a number of positive developments have taken place, especially the three-year action program, started in July 1985, aimed toward the reduction of tariffs on a great number of agricultural and industrial items, as well as the improvement in market access. The increasing degree of trade liberalization has led, *inter alia*, to a dramatic change in Japan's geographical trade pattern mainly in favor of the newly industrialized Asian countries, a welcome development that we hope will be extended further through additional liberalization measures.

Finally, with respect to capital outflows, Japan by virtue of its current account surplus has been the largest international lender in recent years. However, despite the substantial increase in net outflows of long-term capital, the share of the developing countries has declined. In this context, we welcome the authorities' intention to channel more capital outflows to developing countries. Furthermore, we agree with the staff that more capital flows with a low interest cost could be directed to developing countries, particularly if the aggregate current account deficits of the other industrial countries is reduced. Regarding official development assistance, the authorities have undertaken a number of encouraging initiatives, including the contribution to the enhanced structural adjustment facility and the bringing forward of the targeted date for doubling official development assistance from 1992 to 1990. However, official development assistance, as a ratio of Japan's GDP, remained at about 0.3 percent, which is well below the relatively modest UN target of 0.7 percent, and we look forward to a further increase in Japan's official development assistance.

The Director of the Asian Department said that Mr. Dallara's admonition that, in examining fiscal policy, the general government budget, should be looked at, rather than just the central government budget was appropriate. Indeed, the staff had tried to examine the general government budget, but the Central Government had been emphasized because it had so much influence on the objective of fiscal consolidation. Also, there had been a purely statistical problem owing to the difficulty of obtaining budgetary data

from local governments, in particular for the most recent period. Therefore, the staff analysis for the General Government had been more limited than its analysis for the Central Government.

The supplementary budget data had been included in the staff projections for 1987/88, the Director explained. For the fiscal year ended in March 1987, the general government deficit amounted to one half a percentage point of GNP. That deficit was expected to increase to 1 percent of GNP in 1988 and then to decline slightly in 1989.

Although the concept of fiscal stimulus had not been emphasized in the staff report, owing to statistical difficulties, a fiscal stimulus of about 0.5 percent was expected in 1988, and it was expected to be broadly neutral in 1989, the Director of the Asian Department explained. Given the current strength of demand in the economy, there did not seem to be any need for further fiscal stimulus.

A staff representative from the Asian Department said that with respect to monetary policy, the flattening of the yield curve implied an absence of inflationary expectations. However, there had been an increase in the rate of inflation, so there was some room for accommodative monetary policy. The economy was growing rapidly, and there were indications that it had already exceeded its absorptive capacity. In addition, there was some concern that while broad monetary aggregates were growing rapidly, it was difficult to interpret the movement of those aggregates. The authorities were following the appropriate course of action and carefully monitoring the inflation rate to adjust monetary policy if necessary.

The domestic price trends were described on page 14 of SM/88/55, the staff representative observed. Over the past year, the authorities had taken a number of measures to promote the pass-through of the improvement in the terms of trade to consumers. A study conducted by the Economic Planning Agency had estimated that about 70 percent of the savings derived from that improvement had been realized by consumers and 30 percent had gone to profits. It was clear that the economy was rapidly adjusting to the terms of trade gains; profits were increasing in sales and in the distribution system, which was to be expected in a period of rapidly growing domestic demand.

It was difficult to determine what size current account surplus would be appropriate. A monitored surplus had the beneficial effects of alleviating interest rate pressures on the one hand, and on the other hand, there was the need to reduce the surplus to guard against international tensions. It was difficult to quantify the effects of those options, which were dependent on political pressures, both in terms of domestic protectionism and the general state of the industrial economies. The staff regarded the reduction that had been recommended in the staff report as appropriate. The surplus of Japan was declining broadly in line with the deficits of major debtor countries.

Mr. Yamazaki made the following closing remarks:

I recall that at the March 1987 Board discussion on Japan's Article IV consultation (EBM/87/40 and EBM/87/41), many Directors questioned the attainability of the authorities' official forecast because of a divergence of views between the staff and the authorities on the strength of the economy. It is therefore encouraging that the staff's growth projection for 1988/89 presented in the staff report for the 1987 Article IV consultation is almost identical to my authorities' official forecast, which envisages continued strong growth centered on domestic demand and a steady reduction in the current account surplus. Also, I note with pleasure that many Directors shared my authorities' view concerning the robust economic growth.

Under these circumstances, I have little to add to the staff analysis of demand components in the background paper. According to the short-term economic survey of principal enterprises issued by the Bank of Japan, corporate earnings figures have been revised upward, and business sentiment is brighter than in previous expansionary stages. After a temporary increase in December 1987, the current account surplus narrowed sharply to \$3.5 billion in January 1988, compared with \$4.8 billion in the same month of the previous year. As the staff noted in the second supplement to SM/88/55, the estimate for GNP for the last quarter of 1987 showed a steady increase of 7 percent per annum that led to the real GNP growth rate of 4.2 percent for 1988, exceeding the staff's projection.

As described in the staff papers, the employment situation improved remarkably in 1987, and the authorities expect a continued increase in the level of employment. It is difficult to compare the unemployment rate in Japan with that in other countries, owing to differences in statistical treatments. However, taking into account such factors, my authorities believe that the current unemployment rate in Japan is lower than in other major industrial countries. In fact, according to an informal study by the Labor Department, the expected unemployment rate in Japan, calculated on the basis of U.S. standards, does not differ essentially from the current rate of 2.7 percent.

As to a possible increase in the rate of unemployment due to low pension benefits, the fact that the level of pension benefits in Japan is sufficiently high when compared with benefits in other major industrial countries should be stressed, although, owing to the relatively low number of pensioners currently in the overall population, the present social benefit burden is also low. The number of pensioners will increase dramatically in the near future, and, to accommodate this eventuality, my authorities intend to proceed with a comprehensive tax reform.

At present, my authorities have made no official projection for the medium-term outlook beyond 1988/89. However, a study is under way by the Economic Council, which hopes to come up with a new economic plan. Although the specific contents of the plan will not be available before the middle of 1988, I believe the economy will continue to grow steadily, led by domestic demand without rekindling inflation, and that the current account surplus will be reduced to a level commensurate with the size of the economy. Hence, the basic thrust of the staff's medium-term outlook coincides with that of the authorities, since it envisages a continuation of steady growth with the pace of domestic demand growth exceeding the overall growth rate.

Also, my authorities intend to contemplate the full-fledged structural reform measures requested by many Directors in designing the economic plan for the coming period; they will provide the details of that plan as soon as they become available.

With respect to the basic policy direction, there is little, if any, difference of views between the staff and my authorities.

The temporary increases in the short-term interest rate in the third quarter of 1987 simply reflected the high demand for short-term funds, which was a natural phenomenon at that time of the year, and should not be interpreted as a change in the stance of monetary policy. Although the Bank of Japan allowed the seasonal factor to surface in the market, it did not have any intention of tightening the monetary condition further.

My authorities have some reservations about the validity of the staff's analysis of fiscal balance using the ratio of the general government deficit to GNP. The general government deficit is small, owing to the surplus in the social security fund. The rapid aging of the Japanese population necessitates certain amounts of surplus in the social security fund for the future. It is, therefore, misleading to judge the stance of fiscal policy based on a comparison of the general government deficit. The deficit in the central government budget will still be large, even after the expected reduction envisaged in the 1988/89 budget takes place.

The staff and some Directors expressed moderate concern about inflation, specifically, such factors as the high rate of capacity utilization, the rapid increase in the monetary aggregates, and the remarkable improvement in the employment situation. My authorities strongly believe that the rekindling of inflation is the most important impediment to the sustainable growth of the economy, and therefore, they would like to review the phenomena just mentioned with great care. However, thanks to the beneficial impact of the appreciation of the yen, as well as the decline in oil prices and the resultant increase in

low-priced imported goods, the inflationary pressure is not emerging for the moment. Some signs of a bottleneck centered in the construction sector emerged during the autumn of 1987, leading to a surge in the prices of construction materials. After that, however, the prices fell back with the relaxation of the supply-demand condition. Of course, the overall economic situation *should be carefully monitored to maintain the present price stability*. Under these circumstances, the present level of short-term money market interest rates is appropriate.

The settlement of the 1987/88 budget has not yet become clear. However, I suppose there is excess revenue in the settlement of the budget for 1988/89, legally speaking, half of which is to be allocated to reduce the issue of government bonds; the fiscal situation is still severe enough to justify such allocations.

The Central Government does not control the local governments. Therefore, it is not appropriate to make assessments of the fiscal stance from the standpoint of the General Government.

Concerning the possibility of front-loading the public works, a decision would have to be reached after giving due consideration to the economic conditions following the budget's approval by the Diet. It is difficult to give any indication at the present time.

While many Directors appreciated the reduction in Japan's current account surplus and asked the authorities for further external adjustment, some Directors stressed that Japan should maintain a moderate surplus to help debtor countries. In this connection, the staff paper emphasizes the role of Japan as a provider of savings to the rest of the world. Moreover, the supplement to SM/88/55, on Japanese capital flows, properly indicates that, with the intermediary function of its financial institutions dramatically increasing, Japan's influence on the global allocation of capital extends beyond its current account surplus. My authorities fully agree with the staff that countries with current account surpluses should contribute to promoting the worldwide recycling of funds. To this end, my authorities are already committed to recycling funds amounting to \$30 billion, and they look forward to a smooth recycling of Japanese funds to provide the needed money for the growth of developing countries.

My authorities have already committed themselves to accelerating the pace of increasing official development assistance in the emergency economic measures. The official development assistance budget for 1988/89 increased by 6.5 percent, exceeding the 1987/88 increase of 5.8 percent. Moreover, in dollar terms, the increase is equivalent to 29 percent. In 1986, Japan was already ranked second, next to the United States, for the size of

actual official development assistance expenditures. Furthermore, for 1988/89, the overall official development assistance-related budget of Japan, including the lending program, amounts to approximately \$10 billion, which exceeds that of the U.S. budget for the same fiscal year.

Concerning the framework of future financial liberalization, great progress has been achieved in the liberalization of short-term money markets, which have reached a stage compatible with other developed countries. Treasury bills, which were introduced a few years ago, as against financial bills, will have a significant role to play in the development of the money markets.

Concerning the liberalization of deposit interest rates, great progress was witnessed in large deposits, mainly through the liberalization of money market certificates. The role of the money market certificates as an ice breaker for such liberalization will continue in the future, and will lead to the liberalization of the interest rate on small deposits. Although this plan will inevitably involve political sensitivities, the Government is determined to go ahead with its early implementation in spite of those difficulties.

As to the need to open the market, the number of imports have increased significantly in recent months, mainly owing to the increase in manufactured goods imports brought about by the rapid change in the industrial sectors and the shifting of production sites to overseas locations. This increase in imports verifies that the import market of Japan is already considerably open.

As regards tax reform, I agree with the staff that current commodity-specific indirect taxes cause a distortion in resource allocation, and a fundamental review of the indirect tax system is an essential factor in the comprehensive tax reform. However, I am unable to provide any specific outline of the tax reform while the matter is being studied by the Tax System Council. No deadlines have been set either for the completion of the Tax System Council's study or for the introduction of reform measures. In light of the emerging problem, however, my authorities hope to come up with a proposal in due course, as stated in the staff report.

The high price of land was referred to by some Directors as one of the few unfavorable developments in the economy. The increase in land prices should be monitored carefully since it could lead to a change in inflationary expectations and would be translated into high service prices. My authorities decided on emergency land price measures in October 1987, including the enhanced surveillance of land prices, intensified supervision of financial institutions and real estate companies, and a temporary

freeze on sales of government-owned land. Very recently, there has been the encouraging phenomenon of a sharp deceleration in land prices centered in metropolitan areas.

The staff paper stressed the need for dismantling agricultural protection and streamlining the distribution system. It should be stressed that those issues involve highly delicate political implications. Nonetheless, my authorities would like to continue reviewing the present measures and distribution system in accordance with the principles of the GATT as well as the contents of the Mayekawa Report, giving due consideration to international economic relationships.

Before concluding, I am tempted to reiterate the views of my authorities conveyed at the Board meeting on the Ninth General Review of Quotas (EBM/88/40) on March 18, 1988. Taking into account the good performance of the economy, my authorities are prepared to cooperate in helping solve the problems besetting the world economy. In particular, they would like to intensify cooperation with international financial institutions, of which the Fund should no doubt be given top priority. Unfortunately, however, there may be a serious risk that the growing discontent about Japan's present quota share would hinder efforts to that end. I would like to reiterate the strong desire of my authorities that our quota share be made commensurate with the size of our economy.

The Executive Directors agreed to continue the discussion that afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/41 (3/18/88) and EBM/88/42 (3/21/88).

2. APPROVAL OF MINUTES

The minutes of Executive Board meetings 87/121 through 87/123 are approved. (EBD/88/82, 3/14/88)

Adopted March 18, 1988

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/88/71 (3/17/88) is approved.

APPROVED: November 14, 1988

LEO VAN HOUTVEN
Secretary

