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Minutes of Executive Board Meeting 86/42

10:00 a.m., March 10, 1986

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

| Executive Directors | Alternate Executive Directors |
|---|---|
| | Mawakani Samba |
| | M. K. Bush |
| | L. Hubloue, Temporary |
| | A. H. Mustafa, Temporary |
| H. Fujino | M. Sugita |
| G. Grosche | |
| Huang F. | |
| | Jaafar A. |
| | J. R. N. Almeida, Temporary |
| | M. Foot |
| H. Lundstrom | |
| M. Massé | |
| E. I. M. Mtei | A. Abdallah |
| | C. A. Salinas, Temporary |
| Y. A. Nimatallah | |
| | J. de la Herrán, Temporary |
| H. Ploix | |
| | J. de Beaufort Wijnholds |
| C. R. Rye | |
| | A. A. Agah, Temporary |
| A. K. Sengupta | |
| S. Zecchini | N. Coumbis |

L. Van Houtven, Secretary
L. Collier, Assistant

Also Present

Asian Department: P. R. Narvekar, Deputy Director; A. Ariyoshi, U. Baumgartner, I. Otani, S. M. Schadler, B. J. Smith. European Department: L. J. Lipschitz. Exchange and Trade Relations Department: S. J. Anjaria, J. Berengaut, J. T. Boorman, A. B. Petersen, C. M. Watson. Fiscal Affairs Department: V. Tanzi, Director; K.-Y. Chu, W. R. Mahler, Jr. Legal Department: P. L. Francotte. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; M. C. Deppler, P. R. Fenton, S. Takagi. Western Hemisphere Department: J. Ferrân. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: G. Nguyen, A. Ouanes, I. Puro, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: H. Alaoui-Abdallaoui, A. Bertuch-Samuels, B. Bogdanovic, G. D. Hodgson, Z. b. Ismail, S. King, H. Kobayashi, K. Murakami, J. K. Orleans-Lindsay, J. Reddy, B. Tamami, L. Tornetta, A. J. Tregilgas, H. van der Burg, Wang X.

1. JAPAN - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Japan (SM/86/24, 2/10/86; Cor. 1, 2/21/86; and Sup. 1, 3/6/86). They also had before them a report on recent economic developments in Japan (SM/86/36, 2/24/86; and Sup. 1, 3/4/86).

The Deputy Director of the Asian Department informed Executive Directors that effective that day, the Bank of Japan had reduced the official discount rate by 0.5 percentage point--to 4 percent from 4.5 percent. That action followed a reduction in the rate from 5 percent to 4.5 percent on January 30, 1986. The adjustments of the discount rate were intended to signal to the market important changes in monetary policy. As indicated by the authorities, the latest change had been because growth was moderate as a result of weak exports and increasing signs of uncertainty about business prospects in Japan.

The reduction of the discount rate announced March 7, 1986 appeared to have been widely anticipated and, to that extent, might have already been largely reflected in market rates, the Deputy Director of the Asian Department said. As the staff had indicated in the supplement to the staff report, a decline in market rates would have a positive impact on domestic demand. Moreover, the broadly coincident reductions in official discount rates in the major industrial countries could provide an important pyschological boost to the business environment for investment both in Japan and elsewhere.

Mr. Fujino made the following statement:

Developments during fiscal year 1985/86

Entering the third year of recovery, economic expansion in Japan is continuing in FY 1985/86, though at a somewhat moderate pace, and the rate of real growth is expected to reach 4.2 percent. More than four fifths of the growth--3.4 percent out of 4.2 percent--is accounted for by an increase in domestic demand. Exports, the growth of which played a leading role in the initial stages of recovery, have stabilized at a relatively high level. In their place, plant and equipment investment has shown a strong increase, particularly in large-scale enterprises. Moderate expansion has continued both in private consumption and in private housing investment.

In capital spending, while expansion has moderated in the electrical machinery industry, particularly in semiconductors, continued buoyancy has been observed in the automotive and general machinery sectors, where a strong need is felt for increased use of mechatronics (machinery-cum-electronics). No doubt, firm business profits and improved prospects for the expansion of domestic demand are among the contributing factors behind the strong performance of capital expenditures. Equally noteworthy, however, are the increases in research and development investment and investment for applying upgraded technology, both of which are relatively independent of cyclical factors. Reflecting a shift in emphasis from the external demand component to the domestic one, growth of capital expenditure has become more widely based, spreading to the nonmanufacturing sectors.

Prices remained stable with the consumer price index increasing by 2.1 percent and the wholesale price index falling by 2.4 percent for FY 1985/86. While the level of exports had been stable until the fall of 1985, a subsequent reverse J-curve effect, caused by the rapid appreciation of the yen, coupled with stagnant oil imports are expected to push up the current account surplus to $51 billion in FY 1985/86, compared with $37 billion for the previous fiscal year. The basic balance in 1985, however, registered a deficit of $15.5 billion, due to a large outflow of long-term capital which amounted to a record $64.8 billion.

In order to rectify the external imbalance and achieve steady growth centered on domestic demand, various policy measures have been adopted and implemented in FY 1985/86. "The Outline of the Action Program for Improved Market Access" was announced in July, pursuant to the decision on "external economic measures" in April. In October 1985, a package of measures to increase domestic demand, focusing on the utilization of private initiatives, was adopted and was followed by a second package in December 1985, which drew on the tax and other budgetary measures for FY 1986/87.

Following the September meeting of the Group of Five in New York, in coordination with other major industrial countries with a view to bringing about an orderly appreciation of non-U.S. currencies vis-à-vis the U.S. dollar, the authorities engaged in active exchange market intervention. Subsequently, in order to consolidate the gains that had been achieved in the exchange market, the authorities allowed short-term interest rates to increase by not offsetting the tightening of the money markets caused by intervention and seasonal factors.

The growth of the money supply as measured by M2 + CD accelerated in the latter half of 1985 to reach 9.3 percent in December over the previous year, partly reflecting special factors including the liberalization of interest rates on deposits of large denominations. Long-term interest rates, which had been declining gradually since the spring of 1985, reflecting the fall in U.S. interest rates, shot up in late October in the wake of a sudden rise in short-term interest rates but subsequently fell in mid-November. The strong performance of the yen in the exchange markets which took place since then allowed the authorities to ease money market conditions gradually, starting in mid-December, and on January 30, 1986 the authorities reduced the official discount rate by 0.5 percent.

The outlook for fiscal year 1986/87

The basic policy stance for FY 1986/87 is as follows:

- To remain flexible in conducting economic policies in order to both achieve a sustained expansion centered on domestic demand and secure stable employment conditions and to create a climate for full play of private initiatives. Monetary policy will be conducted flexibly and with due caution regarding domestic and international economic conditions and international currency developments.

- To maintain and reinforce the free trade system and to contribute to the revitalization of the world economy.

- To promote administrative and fiscal reforms in the public sector. Fiscal reform will be further advanced with a view to restoring adaptability of fiscal policy to the changing needs of society.

- To secure price stability. To this end, the authorities will continue to monitor monetary aggregates closely.

- To upgrade the industrial structure and to improve the infrastructure for a highly developed information society in order to lay the foundation for medium-term socioeconomic development.

Under the preceding policy guidelines, it is expected that the recent appreciation of the yen will exert a full and wide-ranging impact on all important economic variables. For one thing, economic growth will be exclusively led by domestic demand, which is expected to amount to 4.1 percent. Due to the appreciation of the yen, external demand will become a negative contributing factor, i.e., minus 0.2 percent, putting the rate of real growth for FY 1986/87 at 4.0 percent. Effects of improved terms of trade will be felt increasingly in the latter half of 1986 and are expected to underpin continued economic expansion. Private consumption is projected to grow by about 3.6 percent, reflecting a steady increase in real income to be brought about by improved terms of trade resulting from the appreciation of the yen. Continuous growth of investment for research and high technology, which is relatively independent of cyclical factors, and of investment by the nonmanufacturing sector, will support overall private capital investment, which is expected to increase by 7.5 percent, not greatly affected by the currency appreciation. The recent recovery in private housing investment will receive further impetus from policy measures that include an expansion in government-financed housing loans and a tax reduction on housing loans, and thus will result in a growth rate of 4.6 percent for housing investment.

In order to ascertain the effects that the exchange rate appreciation could have on macroeconomic variables, it might be instructive to recall the most recent experience of FY 1977/78 when, in response to the yen's appreciation, private domestic demand started to pick up relatively quickly. Growth of real income caused by price stability contributed to a gradual increase in the growth rate of private consumption. Capital investment, which had been stagnant since the increase in oil prices in 1973, started to pick up, reflecting favorable profit conditions. While differences in the external environment and the cyclical phase require due caution in applying that experience to today, the high responsiveness displayed by the Japanese economy in the past provides good prospects for rectifying excessive reliance on external demand and enhancing domestic demand in response to exchange rate changes.

Prices are expected to remain stable in FY 1986/87, with the wholesale price index falling by 1.8 percent and the consumer price index rising by 1.9 percent. The external balance will be particularly sensitive to developments of the exchange rate. Assuming that the exchange rate will remain unchanged from December 1985, there will be an initial reverse J-curve effect of the exchange rate appreciation as the reduction in export volume lags behind the rise in export prices expressed in foreign currencies. The current account surplus for FY 1986/87 expressed in U.S. dollars is expected to be $51 billion, the same level as that of FY 1985/86, with the surplus declining gradually later in the fiscal year. It is, however, the trend in volume rather than value that counts in the impact on trading partners' real external demand, growth, and employment. In this regard it may be worth noting that the current account surplus in terms of yen is expected to decline from ¥ 11.5 trillion for FY 1985/86 to ¥ 10.4 trillion for FY 1986/87.

Some further observations on policy aspects

The magnitude of the disequilibrium in public finance is still one of the largest among industrial countries. The fast increase in debt service payments leaves very limited scope for policy expenditures, thereby weakening the adaptability of fiscal policy to the changing needs of society. More specifically, the rapid aging of the population points to the necessity of continuing strong efforts for fiscal reform toward the goal of reducing dependence on borrowings and discontinuing reliance on deficit financing bonds by FY 1990/91.

In this context, restraint has been strictly exercised with respect to expenditures in the FY 1986/87 budget presented to the Diet, while appropriations have been made efficiently to priority spending. By reducing general expenditures (total expenditures less debt servicing and tax transfers to local goverments) below the level of the previous fiscal year for four consecutive years, the increase in total expenditures has been held down to 3 percent over the initial FY 1985/86 budget. On the revenue side, total tax revenue is expected to increase by 5.2 percent over the initial previous budget, incorporating the measures taken to promote equity and efficiency in tax treatment. Thus, the amount of newly issued government bonds will be reduced by ¥ 730 billion. Nevertheless, bond financing will continue to account for slightly more than 20 percent of total expenditures, and the interest payments are expected to rise by 10.7 percent over the previous fiscal year, resulting in debt servicing in total expenditures reaching 20.9 percent.

With respect to the tax system, the Prime Minister, in September 1985, submitted to the Government Tax System Council, for deliberation, a comprehensive review that would aim at achieving a fair and equitable sharing of the tax burden and establishing a simple and plain system, taking into account the changing socioeconomic environment and future needs. The Council is expected to begin the first part of deliberations by taking up the issues related to reducing the actual and perceived tax burden, and on the basis of further deliberations it will submit, by the fall of 1986, a report on the general guidelines for rectifying distortions in the tax system and for creating a structure for stable tax revenue.

Within the overall framework of expenditure restraint, highest priority has been accorded to the expansion of domestic demand. In order to secure a rate of growth in public works higher than that of the previous fiscal year, related loans from the Fiscal Investment and Loans Program (FILP) will be increased by 11.9 percent over the previous year. Moreover, the expansion of local public works will be encouraged. With respect to private residential construction, tax reduction on housing loans will be implemented and housing loans financed through the FILP will be expanded. A modest tax reduction has also been proposed on specified private capital investment. The need for encouraging and drawing upon private initiative has been particularly emphasized in the context of promoting domestic economic growth. With respect to privatization of public works, construction of the new Kansai International Airport will be started in FY 1986/87, and legal and financial provisions have been proposed to allow private sector participation in building the bridge/ tunnel spanning the Tokyo Bay and the Akashi Inland Sea bridge each costing $5 billion.

These measures, together with the measures for domestic demand expansion announced in October 1985, are expected to have the effect of pushing up GNP in FY 1986/87 by 0.5-0.7 percent.

In relation to the privatization of public corporations, the Nippon Telephone and Telegraph Public Corporation and the Japan Tobacco and Salt Public Corporation were transformed into private corporations on April 1, 1985. The National Railway will be converted into several private corporations in April 1987.

In view of the strong performance of the yen in the exchange markets, the authorities allowed the short-term money market rates to come down gradually starting in mid-December, and they reduced the official discount rate by 0.5 percent to 4.5 percent on January 30. It is expected that these measures, through a reduction in the general level of interest rates, will promote balanced growth in the economy, led by domestic demand, and will contribute to rectifying the external imbalance. Monetary aggregates as measured by M2 + CD are judged to be sufficient to sustain the expansion of domestic demand, after allowing for some temporary factors. Close attention will continue to be given to domestic and international economic conditions and international currency developments for the future conduct of monetary policy.

The exchange rate for the yen, which had been moving until September within a range of ¥ 240 to ¥ 250 after reaching a low of ¥ 263 in February 1985, appreciated sharply following the G-5 agreement in New York, subsequent coordinated interventions, and close policy coordination. Toward the end of 1985 it rose to ¥ 200, representing an appreciation of 25 percent over the previous year-end. The Bank of Japan, in this process, allowed the money market rates to rise in order to retain the momentum of the exchange rate adjustment. The strengthening of the yen, which my authorities had long aimed for, coupled with other policy measures are expected to have the effect of turning around the trend and of gradually reducing the current account surplus.

During the course of the last year, various market-opening and import-promoting measures, as well as measures for expanding domestic demand, were implemented with a view to rectifying the current account imbalance. In the Action Program announced in July, the authorities committed themselves, in addition to reducing tariffs and relaxing import restrictions, to improving and simplifying standards and certification requirements and other import procedures, to expanding foreign entry in government procurement, and to promoting imports in the area of services. Commitments made in the program are being faithfully and forcefully put into practice. It is hoped that these market-opening measures will contribute not only to restoring balance in our external account but also to providing momentum toward the rollback of protectionism in general.

It is sometimes argued that external imbalance being a reflection of the imbalance between investment and savings, improvement in the investment-savings relationship is a prerequisite for restoring external balance. Ex post over-saving exists behind the external surplus, as the two are mathematically identical by definition in the national accounts. However, this simple identity does not provide any clue to their causality, nor does it warrant any specific policy implications to be drawn from it. The anticipation that the current account surplus would be rectified by the adjustment mechanism of the exchange rate, through currency appreciation, did not materialize, due to the high exchange rate of the U.S. dollar, thereby bringing about a prolonged current account surplus and ex post oversaving. Since the G-5 agreement last September, the exchange rate has come to better reflect the underlying economic fundamentals than was previously the case, and this trend, supported by closer coordination of the economic policies in major countries, is expected to contribute to restoring balance. At the same time, the Government recognizes the need for change in the industrial structure and is considering possible measures. It is also expected that trading partners will take full advantage of the strengthened competitiveness by making a positive adjustment in the industrial structure.

During 1985, further steps were taken toward the liberalization of the capital and money markets and the internationalization of the yen, which will be carried on in 1986. First, regulations on deposit rates were further relaxed. Money market certificates (MMCs) were introduced as of April 1985, and restrictions on interest rates were removed as of October 1985 on deposits of ¥ 1 billion or larger. With regard to certificates of deposit (CDs), restrictions on minimum denominations, minimum maturity, and the ceiling for outstanding issues for each bank have been liberalized. Second, in order to expand the short-term money market in width and in depth, a bankers' acceptance market was created in June 1985. Short-term government bonds, which are intended to facilitate smooth refinancing of government bonds, were issued for the first time in February 1986. This will lead to the development of the market for short-term government securities. Third, with respect to participation of foreign financial institutions in the domestic market, it has been decided that nine foreign banks will be allowed in the trust banking business, and four trust banks have already started their operations. The Tokyo Stock Exchange decided to expand its membership and allowed, in December, six foreign securities houses to acquire membership. Fourth, necessary arrangements are being made with a view to establishing an offshore market in Japan before the end of 1986.

It is hoped that these measures will contribute not only to better allocations of financial resources and to the internationalization of the yen to a degree that corresponds to the strength of the economy, but also to the provision of financing to developing countries through the expansion of the international capital market in Tokyo. In promoting liberalization and internationalization measures, due consideration will be given to maintaining orderly market conditions and to the stability of the financial system as a whole. Regarding the effect of financial liberalization on monetary aggregates, no serious structural shift in M2 + CD, to an extent that would reduce the usefulness of this important indicator of the money supply, has been observed.

Promoting economic cooperation is one of the most important policy objectives of the Government and great importance is attached to the role played by official development assistance (ODA) in the development strategies of developing countries. In recognition, the Government revised its aid target last year to aim for an increase in the total amount of ODA during the seven years 1986-92 to $40 billion, and for that purpose, while expanding bilateral and multilateral aid and strengthening yen loans, to endeavor to double in 1992 the amount of 1986 ODA and also to improve its terms as much as possible, in spite of very severe budgetary constraints.

Mr. Rye observed that although the Board had not yet determined in detail the procedures for "new surveillance," the 1985 Article IV consultation with Japan presented a preview of the potential difficulties of both diagnosis and prescription. As to diagnosis, there was a very large difference between the outlook for the growth of the Japanese economy as portrayed by the staff on the one hand and the official forecasts on the other. According to the reassessment in Supplement 1 to the staff report (SM/86/24), that difference amounted to nearly 2 percent, much of which, however, could be more apparent than real. While there might be good tactical reasons for the official forecast to be left unchanged, it did not attract much credence currently, even in Japan. He asked Mr. Fujino whether he could describe the authorities' unofficial views at present.

Thirty-four private forecasters in Japan had figures for GDP growth in 1986/87 in the range of 2.0-3.8 percent--or an average of 3.0 percent--Mr. Rye noted. Since those forecasts had been prepared mainly at the beginning of the year, they were, perhaps, comparable with the estimate in the staff report of 2.8 percent, indicating that the staff might be only slightly pessimistic. The official forecast, however, was higher than the most optimistic private forecast. Although that did not indicate that the official forecast was wrong--there had been instances in the past when performance had exceeded all forecasts--there was a reasonable presumption that the official forecast was considerably optimistic.

The further revisions in the staff's supplement reflected the continued strengthening of the yen and to some extent the further fall in oil prices, Mr. Rye continued. He asked the staff whether it had also taken into account the expansionary effects of the most recent reduction in interest rates; if not, the gap between the forecasts would increase even further. The actual difference of view between the staff and the authorities on the diagnosis for the Japanese economy remained unclear. If that difference were substantial, it would raise interesting questions for new surveillance. The staff's macroeconomic prescription was predicated on the assumption that the Japanese economy would fall short of its growth potential in the period ahead. If the authorities did not share that perception, questions would remain on procedure for the new surveillance as there would seem to be no basis for a discussion of short-term policies. In the Board's various discussions of surveillance, the possibility of serious differences of that kind had not been addressed. The present consultation was a reminder that there were a lot of unanswered questions that would, in due time, need to be taken up.

For purposes of discussion, the Board could assume that, at least in the short term, the growth of the Japanese economy would fall significantly short of its potential, Mr. Rye suggested. Such an outcome would not be surprising, as it would be the almost inevitable consequence of the long-sought realignment of currencies. The staff's view, which he did not share was that the Japanese should, for the time being, set aside their objective of long-term fiscal consolidation in favor of short-term fiscal stimulus. However, fiscal consolidation was already lagging well behind target, and that the credibility of that economic policy would be at stake if further regression were to become evident. The Board should not ask the Japanese to run at risk; the burden of fiscal imbalance was, after all, a legacy of the past sacrifice of long-term fiscal consolidation for short-term stimulus--a practice that was probably, in the end, counterproductive.

His own prescription for the economy was, instead, to keep up the present treatment, but to increase the dosage, Mr. Rye said. The authorities should, first, to ease monetary policy, because the risks were small and the potential benefits large: 1 percentage point in growth over two years for each 1 percent reduction in the discount rate. Second, they should accept a relatively generous wage round to keep personal incomes and, hence, consumption as buoyant as possible, which entailed little risk as inflation was negligible. Finally, they should act on the fiscal front without unhinging progress toward longer-term consolidation.

Lasting solutions to Japan's external imbalance would be found in structural and trade policies, Mr. Rye commented. Policies aimed at promoting administrative efficiency, scaling back the role of government, and removing constraints to private sector activity represented the major focus of efforts to promote economic growth. However, he agreed with the staff that those policies had yet to be fully specified and, on the basis of the general proposals made thus far, it was not possible to assess whether they would have a major macroeconomic impact in the near future. The effectiveness of the program would depend on the manner in which laws and attitudes would be changed and on the decisions taken over the next two-and-one-half years.

He endorsed the staff suggestion that "Japan should take bold action to further open its markets," Mr. Rye stated. That action should include the reduction and elimination of manufacturing tariffs and the reduction of agricultural protection, and should address forcefully the barriers deriving from Japan's regulatory framework. It was particularly depressing to read, year after year, that the authorities had adduced "political considerations" against significantly liberalizing the heavily protected agricultural sector. Structural change of that sector was long overdue in Japan's own interests, as well as those of would-be suppliers of agricultural commodities, including many developing countries. His Australian authorities would be particularly concerned if measures were introduced to favor particular trading partners on noncommercial grounds to the detriment of other trading partners.

Demographic changes would, over time, reduce the present excess of Japanese savings, Mr. Rye continued. However, there was no reason why that process should not be given some impetus--particularly as the excess seemed to be partly sustained by government-induced distortions. For example, reform of the postal savings system was urgently required.

In his statement, Mr. Fujino had argued that as a simple matter of logic, the coincidence between excess domestic savings and external surplus did not indicate a causal relationship, Mr. Rye observed. However, it was easy to conceive of the mechanism whereby, provided outward capital flows were relatively unconstrained, surplus domestic savings could spill abroad, putting downward pressure on the currency and generating a current account surplus. While Mr. Fujino would perhaps reject that interpretation, further comment would be of interest. Finally, Japan's imbalances were part of a broader picture, and in the efforts to resolve or reduce them, other countries--principally other major industrial countries--would need to play their part.

Mr. Massé commented that Japan's economic performance had been very impressive over the past few years. The combination of strong growth--in excess of 4 percent--low inflation, and a large and growing current account surplus was a result envied by all. However, Japan's performance must also be looked at in the larger context of its contribution to the growth and development of the world economy. The staff report had appropriately emphasized the global aspect of Japan's performance, notwithstanding the continuing need to avoid downward pressures on the yen and to pursue fiscal consolidation over the medium term.

His authorities were in full agreement with the staff that the Japanese authorities' projection of real growth of over 4 percent for 1986/87 was overly optimistic, Mr. Massé stated. Indeed, one of the key concerns in the consultation was the difference between the staff's and the authorities' growth projections. Since the accord of the Group of Five in September 1985 and the subsequent tightening of monetary policy in Japan in October, there had been a significant increase in the value of the yen vis-à-vis the U.S. dollar. That movement in the exchange rate was expected to have a beneficial effect on the current account surplus although, because of J-curve effects, the results would take effect only in the medium term. In any case, the currency realignment that had taken place had reduced one of the major impediments to international macroeconomic adjustment.

However, a slowdown in growth to only about 2 percent in 1986/87, as projected by the staff in Supplement 1 to SM/86/24, could have serious repercussions for Japan as well as for the rest of the world, Mr. Massé continued. It also brought into sharp focus the policy dilemma faced by the Japanese authorities in reconciling their objectives of ensuring adequate growth of their economy, reducing the current account surplus, and consolidating the fiscal balance. In his statement on March 7, 1986 announcing a 0.5 percentage point reduction in the discount rate, the Governor of the Bank of Japan had indicated his concerns about excessive fluctuations of the exchange rate and about growth prospects for domestic demand. He shared those concerns and therefore urged the authorities to be flexible in the stance of monetary and, particularly, fiscal policies. At present, the risk of slow growth in the Japanese economy was high. Despite the need to consolidate the fiscal position, there was scope for relaxing the policy stance without endangering the achievement of those longer-term goals.

A conflict obviously existed between a desire to pursue further fiscal consolidation and the need to support weakening domestic demand, Mr. Massé commented. In light of the staff's new estimate that withdrawal of stimulus from the external sector could be as much as 1 1/2 percent of GNP in 1986/87, support of domestic demand must take precedence. While he endorsed the authorities' medium-term strategy of fiscal consolidation, he urged them to provide more evidence of short-term flexibility in the present circumstances, particularly with respect to spending by local governments and public enterprises.

He recognized that the authorities had legitimate concerns as to the medium-term evolution of the fiscal position, Mr. Massé went on. Central government deficits had remained high in past years and had fallen less rapidly than general government deficits. Nevertheless, general government--central government plus public enterprises and local governments--

deficits as a share of GNP were the second lowest--after the Federal Republic of Germany--among the countries of the Group of Seven, and the net debt was considerably below that of other major industrial countries. The current level of fiscal deficit should also be viewed against Japan's high savings rate and large current account surplus. Accordingly, if domestic demand did not strengthen as forecast by the authorities, serious consideration should be given to actual tax cuts and, perhaps, increased expenditures. Fiscal drag might be hindering growth and consumption, and the possibility of a reduction in personal income taxes in advance of tax reform should not be excluded.

There appeared to be some room at present for action to ease monetary conditions, Mr. Massé remarked. Until recently, monetary policy had been constrained by exchange rate considerations, but the turnaround in the yen/dollar exchange rate had significantly eased that constraint and shifted the focus to domestic concerns. The reduction in international oil prices had also offered the authorities' more flexibility. In Supplement 1 to SM/86/24, consumer prices were projected to increase by only 0.3 percent during 1986/87 so that inflation was not a real concern. He welcomed the 0.5 percentage point cut in the discount rate in late January and the further 0.5 percentage point cut announced on March 7. Exchange rate considerations might allow even further easing of interest rates.

If the appreciation of the yen were maintained, it should over time help to reduce the imbalances associated with Japan's large current account surplus, Mr. Massé said. As the staff had noted, however, the J-curve effect tended to increase the current account surplus in the short run, and that surplus had been enhanced by recent oil price declines. Boosting domestic demand at present might therefore help to mitigate some of those effects.

His Canadian authorities welcomed the market liberalization measures introduced during the previous year by Japan, including support for a new round of multilateral trade negotiations, which would also involve services, Mr. Massé stated. Those measures went in the right direction toward increasing and liberalizing world trade. Some of the tariff reductions and other measures had been taken as a positive response to concerns of his Canadian authorities, but, they considered that more steps remained to be taken in the areas of agricultural, fishery, and forestry products. His authorities also viewed with concern the decision to give interest and employment subsidies to small and medium-sized exporting firms hurt by the yen's appreciation. He trusted that such assistance would be short term and directed toward aiding industries to adjust.

In a longer-term context, the authorities' establishment of a commission to tackle tax reform was welcome, Mr. Massé commented. As a first step, the commission should consider reducing tax incentives that currently favored savings. If such reforms were implemented, they might contribute to stabilizing the savings-investment balance and thereby help to reduce the current account surplus in future. Another area that merited examination was land-use regulations, since lower land costs could help significantly to encourage housing expenditure.

The measures undertaken for a number of years to liberalize financial markets were commendable, Mr. Massé said. Nonetheless, further steps appeared necessary, especially with respect to liberalization of short-term markets and the reform of the postal savings system. He hoped that the authorities would adopt more flexible and expansionary monetary and fiscal policies in order to encourage stronger domestic demand and increased growth throughout the economy. In the current economic circumstances, those policies would benefit both the Japanese economy and the international system in general.

Ms. Bush observed that Japan, having the second largest economy among Fund members, clearly had a substantial impact on worldwide economic developments. In particular, its economic policies and performance had an impact on world growth and global current account imbalances. The uncertain prospects for economic growth and external balance in 1986 continued to reflect two chronic and interrelated issues: how Japan could contribute to world economic growth with less dependence on foreign demand, and how its current account surplus and high propensity to save could be reduced. There seemed to be an undercurrent of discouragement in the staff paper regarding both issues. Moreover, those apprehensions had been reinforced by the revised forecast in Supplement 1 to SM/86/24, which reflected the recent strong appreciation of the yen and the sharp decline in world oil prices. Of concern were the implications for international adjustment--particularly for the developing countries--of the prospect of successive increases in Japan's current account surpluses averaging about $17 billion a year in 1985/86 and 1986/87. While the increase during the current year might be largely due to events beyond the control of the authorities--the J-curve effect and oil price reductions--that did not absolve Japan, as a major industrial country and a leader in international trade, from a responsibility to strengthen its efforts to contribute to orderly world economic adjustment. The staff had pointed out a number of areas where action would be appropriate, and she supported those recommendations. Japan should take steps immediately to offset weak domestic demand, thereby reducing its current account surplus.

The combination of yen appreciation and oil price declines had resulted in a reduction of approximately one half in the yen price of oil, relative to the average for 1985, Ms. Bush noted. The Ministry of International Trade and Industry was reported to be considering lowering electric power rates, but not before the summer. There were private Japanese estimates of windfall profits for electric utilities of ¥ 960 billion and for oil companies of ¥ 950 billion in 1986 resulting from yen appreciation and oil price declines. She wondered whether windfall profits of that magnitude would be realized and to what extent it was considered desirable that they be passed on to the consumer through a reduction in regulated utility rates and energy prices so as to offset the deflationary effects of a higher yen. She would be interested to learn whether specific policy steps had been taken or were under consideration that would affect that pass-through.

The staff report had suggested a policy dilemma in 1986, since the authorities' medium-term strategy of reducing the role of Government and cutting the fiscal deficit seemed to be inconsistent with the use of fiscal policy to support demand, Ms. Bush remarked. Over the longer term, the use of monetary and fiscal policies should be facilitated and complemented by structural measures aimed at shifting the sources of demand from exports and government consumption toward investment and private consumption. However, the staff had concluded that those structural measures could not have much effect very soon. While she did not question the fact that even good policies promptly implemented took some time to work, the outlook for the year and over the medium term could be improved if the authorities responded to economic growth and balance of payments developments in a flexible manner that would contribute to the world economic adjustment process. In that connection, a new impetus had been given to international cooperation in recent months, and she welcomed the willingness of the authorities to take account of views expressed in international forums. She hoped that that attitude could be converted into further positive actions in 1986.

Fiscal policy could be expected to play a particularly important role, Ms. Bush continued. One of the main conclusions in the staff report, reinforced in Supplement 1, was that economic growth in Japan in 1986 was likely to fall considerably below its potential. For fiscal year 1986/87, the staff at present forecasted GNP growth of only 2.1 percent, compared with the authorities' forecast of 4.0 percent, before the sharp oil price drop. In part, that rather modest growth rate reflected the fact that the original staff report indicated that the 1986/87 budget was likely to withdraw stimulus from the economy amounting to about 1 percent of GNP. She continued to support, in general, the medium-term objective of Japanese fiscal policy of reducing the role of the Government and the size of the fiscal deficit. But she also agreed with the staff that the authorities should show some flexibility in their fiscal policy during the current year, as they had in the past. For example, any withdrawal of fiscal stimulus would seem inappropriate. She was not suggesting a pump-priming effort through an increase in central government expenditure, but fiscal action at other government levels and, in particular, tax reforms would be helpful. Some expenditure action by local governments, investment by public enterprises financed with the help of the Fiscal Investment and Loan Program, and the possibility of a government wage increase and of a revenue shortfall as a result of slower than expected income growth might all contribute to a reduction by about one half in the withdrawal of fiscal stimulus embodied in the 1986/87 budget. Furthermore, in 1985 the ratio to GNP of the fiscal deficit of general government, which was a broader concept than the deficit of the Central Government, had been quite small, at 1.7 percent of GNP, having fallen from 3.6 percent of GNP in 1982. Those considerations suggested that there might be some leeway for fiscal flexibility during the current year.

For some time, reform of Japan's tax system had seemed desirable, Ms. Bush commented. Tax reforms growing out of the ongoing comprehensive study of the tax system offered an opportunity to modify the tax structure in a way that fostered a somewhat different mix of economic growth, with a more sustainable external balance. The staff noted that an income tax cut in anticipation of the complete overhaul of the tax system to be introduced in 1987/88 had been firmly rejected by the Japanese authorities. But given the need for measures that would contribute to greater domestic demand, she wondered whether a reduction of fiscal drag might be achieved by reducing taxes, in such a way as not to undercut the planned broader tax reform. Perhaps a sufficient consensus on certain aspects of the present tax system existed that would permit some anticipatory changes earlier, reserving the detailed and comprehensive changes for 1987/88; she would welcome any comments by Mr. Fujino on that matter. She hoped that, in general, when formulating tax reform proposals, the authorities would fully take into account the effects of tax reform on those economic variables in Japan that had major influences on the rest of the world economy.

The two reductions in the discount rate made possible by the appreciation of the yen, the fall in oil prices, and the decline in interest rates elsewhere were welcome, Ms. Bush said. She hoped that the authorities would follow a flexible monetary policy in the coming months in line with developments in world markets. She strongly supported ongoing financial reforms aimed at strengthening market forces and at closely integrating the Japanese financial market with world markets. Clearly there was still room for further progress in areas such as interest rate deregulation; the participation of foreign financial institutions in Japanese markets; the development of short-term capital markets, especially for bonds; and further liberalization and expansion of the Euro-yen market. More specifically, she wondered whether the Japanese authorities agreed with the staff that interest rates on smaller deposits needed to be liberalized without delay and that to do so would require reform of the postal savings system; she also wondered what stood in the way of such liberalization and reform. The staff also urged issuance, in sizable amounts, of short-term government bonds and a strong secondary market in such bonds, which would provide investors, including foreign investors, with an attractive yen investment instrument. However, she would appreciate information on how large the issuance of those bonds had been in February relative to Japan's money markets and the potential demand. Perhaps there was some scope for substantially increasing the issuance of such securities. Also, some market observers had claimed that the 16 percent withholding tax on short-term bonds hampered the expansion of that market, since many other major world money centers did not impose such taxes at present. She wondered what consideration might have been given, in designing that security, to international practice and the likely impact of the withholding tax on the security's attractiveness to foreign investors.

Japan's main problem continued to be its very large current account surplus, Ms. Bush stated. If international current account imbalances were to be reduced, both surplus and deficit countries must assume responsibility. Clearly, the United States would be unable to reduce its large deficit if other countries--notably Japan--did not accommodate a decline in their large surpluses. Such large imbalances were unsustainable, both on economic and political grounds. Japan had recently benefited enormously from the sharp drop in the price of oil; with that benefit came increased responsibility for reducing its external imbalance. For example, the staff's revised estimate of the current account surplus in 1986/87 was for a $12 billion increase in the earlier estimate to $71 billion. It was disappointing that the authorities' forecast for 1985/86 at the time of the previous Article IV consultation discussion on Japan of a surplus of $34 billion had been understated by about $25 billion, compared with the staff's current estimate for 1985/86. Admittedly, a large part of the difference had been due to a lower oil import bill than expected. Nevertheless, the income gains from that development evidently had not shown up in substantial additional import growth. In fact, Japanese import growth in volume terms in 1985 had been about zero.

Furthermore, Japanese import volumes during the past year had been only 2 percent above the level in 1979, Ms. Bush added. However, import volumes of industrial countries as a whole had increased 21.8 percent over the same period. While Japanese import volumes were projected to increase in 1986 and 1987, it was only at a rate comparable with that of industrial countries as a whole. Also, direction of trade data in the report on recent economic developments showed that at least in the first nine months of 1985, developing countries had generally experienced declines in value terms in their exports to Japan. For example, Japanese imports from Southeast Asia had fallen by 7 percent, from Latin America by 17 percent, and from Africa by 17 percent. Given the critical need for developing countries to expand their export markets, and the limitations on other countries in providing continually increasing markets, it was vital that Japan's contribution should improve substantially. A key role in resolving the developing countries' debt problem was at least moderate economic growth and open markets in the industrial countries. Specifically, in connection with U.S. Secretary Baker's debt initiative, her authorities welcomed the positive Japanese response shown, both by the Government and by the banks. She looked forward to strong contributions to that cooperative effort on a case-by-case basis, and she hoped that the Japanese authorities would show greater flexibility in their export credit guarantee coverage policy in those cases.

The enormous benefits that Japan had gained from international trade in the past years, and its very strong export position, currently placed it in a prime position among member countries to resist protectionism, Ms. Bush continued. Of course, the benefits of trade with Japan had been mutual, and all countries--including her own--shared the responsibility for resisting protectionist pressures. She recognized that the Japanese authorities had adopted a number of market-opening measures in the past two years. In the industrial area, tariffs were generally quite low; but nontariff barriers continued to constitute both an economic and a political barrier to the solution of problems posed by Japan's large current account imbalance. Therefore, she strongly urged the authorities to move rapidly to eliminate nontariff barriers. She welcomed Japanese support for a new round of multilateral trade negotiations.

It was difficult to accept protectionism in agriculture and a few other sectors on the grounds that they were highly sensitive politically, Ms. Bush continued. She did not underestimate the political pressures that could be put to bear on governments to provide support to specific economic sectors; her authorities had had considerable experience in the past few years with trade problems affecting U.S. agriculture and other economic sectors owing, in large part, to foreign competition during the period of the rising dollar. Yet it was dismaying to learn of measures already being taken by the Japanese authorities to provide financial support to exporters--notably the new subsidized credit program for small exporting firms--who had only recently begun to feel the effects of the rise in the yen exchange rate. She would be interested in Mr. Fujino's comments on those measures. Those actions seemed precipitous and could seriously impede Japan's adjustment to a lower imbalance on current account.

During the past year the authorities had continued to pursue financial policies with the long-term soundness of Japan's fiscal balance in mind, Ms. Bush observed. Economic growth, price stability, and a favorable employment situation had been maintained. Some important structural reforms were under way to deal with the persistent overdependence of the economy on foreign demand and the chronic problem of a very high savings rate. Eventually those reforms, plus the demographic factors outlined by the staff, should begin to bear fruit. However, prospects for adequate economic growth and a reduced current account surplus during the year appeared rather bleak. The sharp rise in the yen and the fall of oil prices added a new dimension of uncertainty, but also of opportunity. The authorities could improve the prospects for growth and current account reduction through judicious use of the tools available to them. She strongly urged them to do so; at the minimum, the Japanese authorities should not take actions that tended to thwart the adjustment process.

Mr. Grosche commented that after an impressive performance in terms of growth, employment, and price stability over the past three years, recent developments and the revised outlook for 1985/86 and 1986/87 posed some difficult policy challenges for the authorities. On the one hand, policymakers in Japan had to play their part in the reduction of the large trade imbalances between Japan and its major trading partners that exerted a negative impact on the global economy. On the other, they had to avoid a major slackening of economic activity without jeopardizing the progress made in reducing fiscal imbalances. The answers to Japan's present dilemma should be sought in a strengthening of domestic demand while reinforcing policies to open domestic markets to foreign competitors. Although there might be conflicts between the different policy objectives, some recent developments could assist the authorities in their difficult task. In particular, the fall in oil prices and the declining trend in international interest rates, confirmed by the recent cut in discount rates in several countries, should alter somewhat the relatively weak outlook for domestic demand.

More was needed, however, Mr. Grosche continued; additional measures to strengthen domestic demand were important as the exchange rate alone would probably not make an important contribution to a reduction of Japan's large trade surplus, despite the marked appreciation of the yen against the U.S. dollar. To the contrary, because of the J-curve effect and oil prices, the current account surplus expressed in U.S. dollars was expected to grow from $59 billion to $71 billion in the next fiscal year. In terms of GNP, the surplus would be reduced only slightly from 4.1 percent to 3.9 percent. The OECD in a recent study prepared for the Working Party Three had made similar projections. In that study, the OECD predicted different reactions of the Japanese and German current accounts to the recent appreciations of the yen and the deutsche mark. Although a substantial reduction in the German surplus was foreseen by the OECD, the Japanese current account was projected to react only slightly, pointing to a severe problem that the Japanese authorities must face. Indeed, Japan's trade surpluses embodied a large structural component reflecting sizable internal imbalances. Domestic economy and industrial employment had remained sluggish for some time despite the tremendous export boom. Obviously, the particular characteristics of the Japanese foreign trade system tended to discriminate against domestic demand and imports. He therefore welcomed the initiative of the past year to open markets to foreign imports. But significant barriers remained. The strong vertical integration of the Japanese enterprises, the distributional network that was linked to domestic producers, and a complex regulatory framework made it particularly difficult for foreign suppliers to gain access to Japan's domestic markets.

He therefore joined the staff in urging the authorities to strengthen their trade liberalization efforts and to take bold action to further open Japan's markets, Mr. Grosche remarked. Foreign competitors must also improve the quality of their products and their marketing strategies in order to overcome a traditionally strong preference among Japanese consumers for domestic products. But measures to reduce tariffs and import restrictions could help, accompanied by some moral suasion in the spirit of the unprecedented and commendable appeal by Prime Minister Nakasone to the Japanese public in 1985.

Although the steep appreciation of the yen had placed a substantial burden on many manufacturers, he cautioned against a cushioning of the effects, Mr. Grosche said. According to press reports, the Government was contemplating tax relief or subsidized credits to assist small and medium-sized companies. If introduced on a larger scale, such measures would clearly run counter to the objective of reducing the trade surplus. The challenge lay with the domestic economy. In contrast with Germany, for example, the potential for growth was large with considerable scope for strengthening the various components of domestic demand without jeopardizing other domestic economic objectives such as price stability and a consolidation of public finances. The role of monetary policy in that effort had been greatly enhanced by the fairly strong value of the yen, the excellent price performance, and declining international interest rates.

With regard to the potential for wage increases, he tended to be less restrictive than the staff, Mr. Grosche noted. Obviously, the exchange rate squeeze was felt by many exporters; however, favorable cost and productivity developments in the manufacturing sector in general should offer some scope for stimulating private consumption through somewhat higher wage increases. Also, a reduction in working hours and the adoption of a five-day workweek could be considered. Industry and labor must determine wages and working hours, but perhaps the authorities could use the existing channels of communications between the Government and the business community to recommend some action within the framework of Japan's flexible wage system.

It would be undesirable for the public sector to withdraw demand stimulus in the coming fiscal year, Mr. Grosche commented. He appreciated the concerns of the authorities about the magnitude of the disequilibrium in public finances. The level of outstanding central government debt was worrisome, and the rising share of interest payments in government expenditure was progressively reducing the Central Government's room for financial maneuver. So far as the central government budget was concerned, the authorities had therefore little choice but to maintain their cautious stance. However, considerable progress had been made in reducing the overall public sector deficit, which should provide sufficient scope for other government levels to support domestic demand. He welcomed the authorities' indication that efforts would be made on the level of local governments and public enterprises to provide a positive stimulus, for example, through increased spending on public works--notably sizable increases in loans from the Fiscal Investment and Loan Program. Much could be gained if such a flexible approach, combined with the effects of automatic stabilizers, resulted in a neutral, instead of the projected contractionary, fiscal stance in 1986/87. In addition, consideration should be given to the staff's suggestion to cut income taxes in anticipation of the comprehensive reform of the tax system under way. Although he had noted the authorities' rejection of such a proposal and Mr. Fujino's explanation of the procedure under consideration, there was perhaps an opportunity to act in the near future, since the need for a revision of the tax system had long been recognized and accepted.

While all the political difficulties emanating from an income tax cut could not be determined, he had some doubts about the reaction of consumers, Mr. Grosche said. Given the high propensity to save, the increase in disposable income might result in even higher savings. Therefore, accompanying measures would need to be taken to reduce the incentives to save provided by the Japanese tax system.

He warmly welcomed the various steps taken in recent years, and especially during 1985, to liberalize Japan's financial markets, and he encouraged the authorities to continue their efforts, Mr. Grosche concluded. The staff's recommendations provided useful guidance in that respect, and they had his authorities' full support.

Mrs. Ploix commended the Japanese authorities for the outstanding results of their economic policy in terms of inflation, external accounts, growth, and employment--although by Japanese standards unemployment remained rather high. Moreover, several shifts of emphasis in 1985--toward more balanced growth, reduction of import restrictions, and strengthening of the yen--had undoubtedly followed a path expected by the international community. However, the "excessive virtue" of Japan, with the spectacular perpetuation of large external surpluses as a consequence, had given rise to some resentment and complaints.

The problems posed by the large imbalances were not new, Mrs. Ploix observed. Since September 1985, however, there had been a recognition of their acuteness and of the need to remedy them in a concerted manner. To that end, the ministers of the Group of Five had stated that their countries were committed to mutually consistent policy measures designed to provide a sound basis for continued and more balanced economic expansion with low inflation and a greater convergence of economic developments. That was a decisive departure from the policy of benign neglect, and time was needed to evaluate the consequences. At present, those commitments must be translated into policy actions.

It was agreed that policy measures in Japan should aim at achieving improved equilibrium, Mrs. Ploix continued. To reach that objective, the five policy guidelines set forth by Mr. Fujino were commendable--in particular, the first, stressing flexibility--as an increase in domestic demand and investment without inflation and a larger fiscal deficit was important.

The staff had not discussed the impact on the Japanese economy of the drop in oil prices, Mrs. Ploix noted; she wondered how the Government intended to use that decrease. In addition, the staff had provided few medium-term projections beyond 1987/88, which seemed inappropriate given the economic importance of the country.

In 1985 it had been stated that a new balance in the economy would be established through, first, a different sharing among economic variables, Mrs. Ploix recalled. By systematically favoring profits versus wages, investments versus consumption, and enterprises versus households, the current distribution generated further imbalances in the balance of payments by leading to the creation of wealth with the sole purpose of exporting it. The second measure was a change in the value of the yen. Third, a revival in domestic demand was called for because exports had contributed in a significant way to growth. Currently, the process of readjusting the yen parity was well under way. However, policies must be aimed at avoiding deflationary risks to the Japanese economy. Furthermore, the recovery of domestic demand seemed to have fallen short of expectations: production had been stagnant since August 1985, and although wages had increased in real terms, consumption had remained sluggish.

Japan's financing capacity was large, Mrs. Ploix stated; it allowed for the worldwide recycling of capital and was an essential variable of international macroeconomic equilibrium. She wondered which policies would permit the reabsorption of the structural, growing surplus of the Japanese current account. It had been suggested that the solution would be brought about through the internationalization of the yen and the liberalization of the Japanese financial markets. That welcome liberalization was slowly under way, and the expected effects were appearing at a slower rate.

The rate of savings had to be stressed for two reasons, Mrs. Ploix continued. First, it was a factor behind Japan's industrial competitiveness and its current account surplus. A high rate of savings also helped to maintain low interest rates and exerted a downward pressure on the national currency exchange rate as capital was invested abroad. The particularly high rate of household savings in Japan was a variable affecting indirectly, but appreciably, the current account surplus. Incentives aimed at a decline in the rate thus appeared desirable, especially as the differential with other countries was not likely to regress in the medium term, as demonstrated by several studies. The issue was a difficult one--given the rapid aging of the population and the system of savings for retirement--but required an answer.

The second reason for focusing on the rate of savings was because it restrained the increase in domestic demand needed to enhance growth and develop imports, Mrs. Ploix remarked. A restructuring of household savings was called for rather than an undifferentiated decrease in the overall savings rate. That decrease could be brought about by a transfer of Japanese financial portfolios to, for example, housing investments, currently hindered by exorbitant prices. One could foresee, for example, an active policy aimed at reviving construction, which would affect housing and land supplies and would exert a downward pressure on prices. The measures described by Mr. Fujino were welcome, but could be intensified. Indeed, public expenditures, which favored domestic activity, would inevitably increase the overall tax bill. Such an increase could be brought about essentially through indirect taxes, given the already heavy income tax burden.

A decrease in financial savings could also be achieved through a reduction in the number of incentives, especially the fiscal exemptions on earned interest, Mrs. Ploix commented. The reform of the fiscal system affecting savings seemed timely, inasmuch as the current situation encouraged tax evasion and increased disparities. Measures to automatically increase the low propensity to consume could be accompanied by incentives, especially for consumption of durable goods, such as an extension of consumer credits.

Those suggestions could lead to a counterbalancing of forces, Mrs. Ploix continued. The authorities were actively considering or in fact introducing measures consistent with those ideas; they should be reinforced. Nevertheless, the impact on the rate of savings was likely to be only marginal. Even if the household saving rate eventually declined owing to the aging of the population, given the multitude of other determinants Japan was likely to maintain a large current account surplus in the short and medium term.

She was concerned that protectionism was building up: as a prominent member of the international community, Japan had a clear responsibility to sustain world growth through appropriate actions, Mrs. Ploix concluded. She welcomed the decision to increase official development assistance and urged the authorities to move further in that direction. It was important that Japan should help developing countries increase their exports and export capacities.

Mr. Wijnholds commented that the staff's view of the Japanese economy in an international context was appropriate in light of its size and its obvious importance for the world economy, as well as the contentious issues of trade and exchange rates in which Japan and other countries were involved. He welcomed the willingness of the authorities to take account of the views expressed in international forums.

Japan's economic performance had remained impressive in many ways and its record of noninflationary growth in recent years was admirable, Mr. Wijnholds said. Currently, however, the authorities were facing difficult policy dilemmas, which had become more acute in light of matters such as the threat of protectionism and the need to contribute to world growth. Concerns about Japan's policies focused mainly on the risk that its growth would fade, as exports were no longer leading the way, and that its continued large surpluses on current account would cause increasing international friction. Those concerns were not new, but they seemed to have become more urgent. The recent strong appreciation of the yen--following the meeting of the Group of Five in September 1985--had been helpful in easing tensions, but because of the J-curve effect its influence on the balance of payments would not be apparent for some time. In addition, the fall in oil prices was contributing to a substantial increase in the surplus on current account. Because of those developments it was important that Japan's economic growth did not falter.

The withdrawal of stimulus by the external sector was projected by the staff to be 1.5 percent of GNP, which would lower overall growth for 1986/87 to just over 2 percent of GNP, Mr. Wijnholds observed. He agreed with the staff that that was below Japan's capacity for noninflationary growth. As domestic demand had grown only modestly by Japanese standards in previous years with the stimulus provided by strong export growth, it was unlikely that it would surge ahead when that external stimulus diminished. Therefore domestic demand should grow more strongly than envisaged by the staff under present policies, although he realized the difficulties. The authorities had understandably given priority to consolidation of central government finances. The central government deficit remained substantial and should not be allowed to return to former levels. However, the financial deficit of the general government was low--in fact, one of the lowest among the industrial countries. The position of the social security sector was a complicating factor that should not be taken lightly. But since deficits in that sector would only materialize in coming years and substantial reserves would have been accumulated, a further reduction of the general government deficit did not seem appropriate. He therefore supported the staff's view that withdrawal of demand stimulus through the budget in a situation of weakening domestic demand should be avoided.

He welcomed the cuts in interest rates that had taken place, Mr. Wijnholds commented. They should help to stimulate sluggish investment, including residential investment, where there appeared to be considerable scope for greater activity. Opportunities for further cuts should be utilized without delay.

The authorities' aim to address the domestic structural causes of the strong surplus on the external current account by achieving a better balance between savings and investment was commendable, Mr. Wijnholds said. Japan's high savings ratio was mainly due to demographic factors beyond the authorities' immediate control. Although the staff had mentioned that the savings ratio was likely to decline considerably in coming years, that development would not alleviate the present situation. The intended tax reform, in particular the envisaged reduction of tax incentives to save, should therefore be implemented as soon as possible. Bringing labor conditions in Japan more in line with those in other industrial countries also seemed to be a way to decrease the incentives for savings or--from a macroeconomic viewpoint--to stimulate consumption. Perhaps a higher retirement age and more leisure time, without a loss in income, could be considered for the Japanese labor force, although those measures would obviously take time to implement.

The achievements in trade and financial liberalization thus far were impressive, Mr. Wijnholds stated. Nevertheless, much remained to be done. In the area of trade, the widespread feeling remained that informal regulations, and the dominant position of the trading companies, were barriers to importers. It had often been said that Japan had a keen interest in maintaining an open and liberalized international trading system. Therefore, enabled by its large current acount surplus, Japan should continue to move vigorously to liberalize its imports, including those in the sensitive area of agriculture. Financial support for small exporting firms, which had recently been increased, did not correspond with the needed reduction of the external surplus.

The process of financial liberalization seemed well under way, Mr. Wijnholds remarked. However, the momentum for further action should not be lost. In particular, further deregulation of interest rates appeared to be desirable, which implied a reform of the postal savings system because it absorbed private savings at above-market interest rates; its reform would contribute to a more efficient allocation of capital.

Japan had played a constructive role in channeling its national savings surplus to countries with savings deficits, Mr. Wijnholds noted. Outflows of long-term capital had continued in enormous amounts, and Japan had not added to its already ample reserves despite its large current account surplus. Japan's official development assistance and its intention to double the level of ODA in the coming seven years were commendable. However, under present circumstances an even stronger effort would be desirable given the relatively modest level of assistance.

Mr. Lundstrom observed that the Japanese economy had proved remarkably strong during the past few years, and the authorities should be congratulated on that performance. However, forecasts suggested that domestic demand would be insufficient to compensate for the shortfall caused by reduced external demand, which, according to recent information, would be even more pronounced than envisaged earlier. Economic growth was expected to be below its potential in 1986 and 1987. The inflation rate was estimated to fall to a level that could be regarded as equivalent to price stability, while the current account surplus would continue to increase. Those circumstances and developments strengthened opportunities for an expansion of domestic demand and a further opening of import markets. Present international economic conditions could be considered favorable for the Japanese economy. His authorities, therefore, believed that Japan should contribute more actively to the maintenance of international demand and growth. The need to do so was underscored by the likelihood that oil exporting countries might find themselves forced into reducing their demand, owing to a deterioration of their foreign balances.

The Japanese current account surplus amounted to about 4 percent of GNP and constituted the dominating economic problem for a balanced development of the economy, Mr. Lundstrom stated. At the same time, lower oil prices had stimulated real incomes in Japan, which was a good starting point for boosting domestic demand. Economic policy should be directed toward supporting such a development.

Since the meeting of the Group of Five in September 1985, the yen had substantially strengthened in international exchange markets, Mr. Lundstrom noted. Through the J-curve effect, the appreciation would, in the short run, tend to increase the trade surplus, but in the longer run the appreciation would reduce the surplus, thereby easing international pressures to introduce trade restrictions. The size of the estimated current account surpluses for 1986 and 1987 would create substantial international problems by impairing the prospects for a reduction of the large balance of payments imbalances that characterized the world economy.

Developments over the previous few months had improved opportunities to conduct an active monetary policy, Mr. Lundstrom commented. Price pressures were low, and the reduction in oil prices should lower inflation further. The appreciation of the yen and a falling trend in international interest rate levels made it easier to support domestic demand through monetary policy without bringing about a new depreciation of the yen. He welcomed the 0.5 percentage point discount rate cut announced March 7, and he hoped that it would be followed by further reductions.

He appreciated Mr. Fujino's remarks on savings, investments, and the external surplus and his comment that their identification did not provide any clue to causality, Mr. Lundstrom said. However, it did verify the imbalance between Japan's savings and investments, which seemed to be mainly a structural phenomenon and thus should be addressed primarily through structural measures. Therefore, tax incentives for savings could be reduced while investments in social infrastructure were increased. Because of the particularly strong increase that could be foreseen in the transfer burden as a result of demographic shifts, he supported the view of the staff and the Japanese authorities that it was necessary to be prudent in further raising public interest expenditures. But there was still room for stimulating economic activity, especially on governmental levels other than the Central Government. Policy should be directed toward concrete measures that supported expansion of private sector demand, which would be especially important if economic growth tended to stagnate.

During recent years, Japan had actively strived for the internationalization of the yen and the deregulation of financial markets, Mr. Lundstrom recalled. He hoped that the strength of the yen would not result in a weakening of those efforts. In the longer run, those measures could contribute markedly to global adjustment. Developing the short-term markets, including the issuance of short-term government bonds and the establishment of secondary markets for such bonds, was likely to be particularly rewarding.

The measures taken by Japan to liberalize trade were welcome, but they did not necessarily lead to a more noticeable reduction in the trade surplus in the short run, Mr. Lundstrom remarked. Those measures were, however, supportive of the ongoing preparations for a new round of multilateral trade negotiations, in which Japan was bound to play a leading role. Nevertheless, elimination of trade barriers in Japan should not be limited to ordinary customs reductions or adjustments of quotas.

His constituency appreciated Japan's efforts to alleviate the financial position of developing countries, Mr. Lundstrom concluded. At the same time, he agreed with the staff that the recently announced targets for official development assistance left room for even stronger efforts; Japan was still only halfway to the target of 0.7 percent of GNP.

Mr. Foot commented that the Japanese authorities currently faced difficult conflicts in several areas of policy--in particular, achieving continued strong economic growth while reducing the fiscal imbalance in the medium term and curbing the large external surpluses that had significantly contributed to the growth of protectionist pressures in the world economy.

He sympathized with the authorities' medium-term objective of reducing the fiscal deficit, particularly given the substantial rise in the level of central government debt, Mr. Foot continued. Nevertheless, the authorities should implement the strategy flexibly and should take into account the outlook for activity in achieving their fiscal objectives. The recent evidence of slower growth in domestic demand while the yen had appreciated was likely to weaken the external sector's contribution to growth and emphasized the need to be cautious in withdrawing fiscal stimulus from the economy. He was not sure of the justification for the staff's suggestion that policy relaxations should perhaps take place at the local government, rather than central government, level. For many reasons, the stance of the overall public sector should be the relevant indicator of fiscal policy. It was not clear why changes in the overall financial position of the public sector should be viewed differently depending upon the extent to which they reflected changes in local authority, rather than central government, taxes and revenues.

The general government deficit was considerably smaller than that of the Central Government, as was the stock of general government debt compared with that of the Central Government, Mr. Foot observed. Those differences partly reflected financial flows within the public sector; in particular, the surplus run by the social security funds in recent years was almost totally accounted for by transfers from the Central Government equal to about 60 percent of its deficit in 1983/84. It could be argued that the buildup in central government debt partly reflected the need to accumulate surpluses in the social security funds to provide against the heavy burdens that were likely to be placed on the social security system by the aging of the population in the coming years. If one accepted that argument, the conclusion was that a proper analysis of the fiscal problem associated with the buildup of central government debt required careful consideration of the flow of funds within the public sector--in particular, the extent to which the social security system was funded and the evolving outlook for its financial obligations. In short, it was possible to argue that emphasis on the Central Government's position was overdone. The apparent ease with which current levels of central government debt were financed in Japan through extension of the range and maturity of government bonds was noteworthy.

He welcomed recent cuts in short-term interest rates, the timing and extent of which seemed to have balanced the Japanese authorities' desire to sustain domestic activity with the need to avoid undermining the appreciation of the yen, Mr. Foot said. It was particularly important that the yen's appreciation should not be reversed as, even at its present level, substantial current account imbalances were likely to continue in the foreseeable future. As to the monetary aggregates, Mr. Fujino had remarked that financial liberalization had had no serious structural impact upon the demand for broad money and certificates of deposit although the changes had caused some acceleration. In the United Kingdom and the United States, structural change similar to that in progress in Japan had actually caused a sizable impact upon both broad and narrow monetary aggregates.

Appreciation of the yen was bound to require structural adjustment in Japan, which could only be hindered if help were given to marginal exporters to keep them in the export field, Mr. Foot commented. Such help should at most be kept to the short term. While other countries could do more to improve their penetration of the Japanese markets, he urged the Japanese authorities to ensure speedy and comprehensive implementation of the Action Program. His authorities had some concerns about the agricultural sector, although he recognized the political clout that it carried in all countries. Because of the value they placed on Fund surveillance, his authorities regretted that the trade policy section of the report (SM/86/24) contained relatively few views of the staff.

The moves currently under way in Japan toward financial liberalization were welcome, particularly insofar as they contributed to making overseas investment in Japan more attractive, Mr. Foot remarked. However, in the past year the pace of financial innovation in the United Kingdom and the United States had been very fast. Although there were difficult issues connected with financial houses and prudential supervision, too slow a pace of financial innovation in Japan could actually increase the gap between what foreign institutions could do in Japan and what Japanese institutions could do abroad. The highly structured system did not seem to give enough competitive edge to the process of financial innovation, and he urged the authorities to press ahead in that area, otherwise the hoped-for benefits would not be reaped.

Mr. Zecchini observed that Japan's record of economic achievements in the past three years was so impressive that it was impossible to deny that its policy discipline had met a degree of success unmatched at present in the world economy. In 1985, real GNP had continued to grow at a comparatively high pace in a context of almost no inflation. Even the 2.6 percent unemployment rate in 1985--considered a historically high figure for Japan--would be a record low for many industrial countries if they could achieve it.

However, economic policies that were sound from a domestic point of view might not necessarily be appropriate from an international one, Mr. Zecchini continued, especially if they did not "foster orderly economic growth" and "orderly underlying economic and financial conditions" for the entire world economy, as the Board's recent discussion on surveillance had pointed out (EBM/86/29 and EBM/86/30, 2/19/86).

To that end, the contribution of Japan's economic policy had not fulfilled all the expectations that the rest of the world had held for it, Mr. Zecchini commented. Two main factors overshadowed its otherwise optimal economic performance: the uncertain prospects for growth in 1986/87 and the lack of correction of the large, positive imbalance in the external account. As to the first, the staff appeared less optimistic than the authorities and projected 2.1 percent growth for 1986/87, which appeared to fall considerably short of what was desirable, from both an international and a domestic point of view. Unemployment would be negatively affected, since it seemed highly sensitive to changes in the pace of economic growth.

As to the external imbalance, the present current account surplus was too large and persistent, hampering the adjustment of other countries that had to re-equilibrate their current account positions, Mr. Zecchini noted. No significant correction in the surplus appeared in sight, and it was, in fact, expected to widen considerably in dollar terms in 1986/87.

Overall, the evolution of Japan's economy in the current business cycle had lent additional support to the already established evidence that its growth was increasingly dependent on export trends, Mr. Zecchini remarked. Growth of domestic demand had lagged year after year compared to the dynamics of external demand. It was crucial for the stability of economic growth of both the Japanese and the world economy to reduce such a dependency. Assuming that the Japanese authorities had come to share that view, their first problem was to choose the correct policy instruments by which that goal could be attained. The authorities also faced conflicting policy objectives to the extent that the needed reduction of the current account surplus had to be coupled with the maintenance of satisfactory economic growth and the consolidation of public finances.

Recently the policy approach had been based on the use of monetary stringency, exchange market intervention to prop up the yen, and some liberalization of the financial market, Mr. Zecchini said. Following the September 22, 1985 agreement of the Group of Five, the Japanese authorities had done their part by favoring a sharp appreciation of the yen through the use of monetary policy and market intervention, and by making some--although limited--policy adjustments to provide some stimulus to the economy.

However, those policy measures did not seem adequate to deal with the authorities' conflicting objectives, Mr. Zecchini commented. The recent tightening of monetary policy could not support simultaneously the rise of the yen and increased levels of activity and investment at a time of declining fiscal impulses to growth. In recognition of those limitations to the effectiveness of monetary policy, interest rates had been lowered a few days previously. But an excessive variability of interest rates should be avoided since that would raise uncertainty and perhaps instability with respect to the future appreciation of the yen.

In such a context it would be advisable to enlarge the set of independent policy instruments to match the different objectives, Mr. Zecchini noted. The authorities should not limit themselves to traditional demand management to steer the economy through the present phase of the business cycle but should also introduce systemic changes that would eliminate the present structural excess of saving over investment in the coming years. Those changes should lead to the expansion of both consumption and investment expenditures without favoring the latter at the expense of the former. He therefore supported the proposals mentioned in the staff appraisal.

The policy dilemma appeared more acute in the fiscal area, Mr. Zecchini remarked. A reduction in the deficit of the Central Government's general account to 3.2 percent of GNP for 1986/87 was warranted from the point of view of fiscal consolidation. Nonetheless, the possible withdrawal of stimulus from the economy that could derive from that reduction was worrisome; it could amount to 1 percent of GNP and would add to the sharp negative impact expected from the foreign balance projected at 1.5 percent of GNP. He therefore endorsed the staff's recommendation that more flexibility should be applied in the implementation of the consolidation program. For instance, additional expenditures by local governments, greater investment by public enterprises, and more public works should be carried out. Moreover, cuts in the personal income tax should be enacted rapidly, particularly with a view to boosting the spending pattern of the household sector.

He welcomed the reduction of the discount rate on March 7, which appeared warranted in light of recent interest rate trends abroad, the strength of the yen, and lower inflation forecasts, Mr. Zecchini said. It was equally important to pursue the liberalization of domestic financial markets; progress had been rapid but uneven in that area. With respect to domestic markets, the liberalization of interest rates had affected only large-denomination assets, benefiting institutional and corporate investors rather than households. A liberalization of interest rates for smaller denominations was needed to increase competition in financial markets and to enhance the relative attractiveness of yen-denominated assets for both Japanese and foreign investors. Initial steps to further liberalize interest rates could include a substantial decrease in the minimum denominations of certificates of deposit and of money market certificates and an easing of the limitations on the amounts that could be issued by individual banks.

He looked forward to the imminent issue of short-term government bonds, Mr. Zecchini commented. If sufficiently deep primary and secondary markets for those bonds were to be favored, and the monetary authorities given the possibility of making greater use of open market operations, bonds with denominations accessible to household investors would have to be issued. He asked the staff for more information on the expected maturity and denomination of those bonds.

Some reduction in the current account surplus would be favored by the sharp appreciation of the yen vis-à-vis the U.S. dollar, Mr. Zecchini noted. At the end of January 1986, the yen's exchange rate vis-à-vis the deutsche mark and the French franc had been approximately at the same nominal level as a year earlier. Further realignment with respect to major European currencies would therefore seem warranted in the medium run, and he hoped that recent movements in that direction would be reinforced by more pronounced trends in the coming months. Nevertheless, a reduction of Japan's current account surplus would have to be favored to a larger extent by both a sustained growth of domestic demand and an improved access of imported manufactured products in the domestic market. In the latter case, it must be acknowledged that, in a world characterized by mounting protectionist pressures, Japan had distinguished itself for its ongoing trade liberalization. However, while progress had been achieved in some areas, the agricultural sector continued to have a high degree of protection, and nontariff barriers--such as the tightly controlled distribution system in the internal market and the customs procedures--often hampered the access of foreign manufactured goods.

A comparison of the ratio of imports of manufactured goods to GNP for some industrial countries in 1984 was noteworthy, Mr. Zecchini continued. That ratio was equal to 3.2 percent for Japan, 6.8 percent for the United States, 17.6 percent for Germany, and 16.6 percent for Italy. The value of that ratio for Italy was important because, like Japan, it had to import almost all raw materials and energy inputs. Those ratios might explain in part the perception that access of manufactured products to the Japanese market was still relatively difficult. Ways to improve the access of imports to Japan were often difficult to determine as not only economic but also cultural and historical factors were involved.

He appreciated the serious consideration that the Japanese authorities were giving to the international repercussions of their economic policies, and their willingness to cooperate internationally to mitigate some of those repercussions, Mr. Zecchini concluded.

Mr. Nimatallah remarked that the economic performance of Japan had continued to be impressive in 1985. Led by a rapid expansion in exports, economic growth in 1985 had been strong for the third consecutive year, prices had remained virtually stable, and unemployment had continued to be low by international standards. In addition, the economy had shown a remarkable degree of resiliency and flexibility to changing markets and technology. That structural adaptability and the favorable overall economic performance in the recent past gave assurance that Japan could do more of the same. He therefore commended the authorities for their good management of the economy.

There were some differences between the staff and the authorities in the assessment of Japan's economic prospects for 1986/87, Mr. Nimatallah noted. In particular, there were differing views on the potential contribution of domestic investment to economic growth. As a result, differences in emphasis on the respective role of fiscal and monetary policies had emerged. He continued to adhere to the view that a reduction in the fiscal deficit should be pursued on a gradual basis at a pace that allowed the private sector to make up for the possible loss in stimulus that a fiscal retrenchment entailed. Therefore, the speed of preparing the private sector in Japan to absorb and manage the transferred resources from the public sector should determine the rate at which the authorities could withdraw their fiscal stimulus over the coming years. In other words, the role of the private sector in the growth process would largely be determined by the authorities' efforts to create the proper environment conducive to enhanced private sector participation, where those efforts included tax reform and a monetary policy that paid due regard to stimulating domestic investment by lowering interest rates. In that regard, he welcomed the two reductions in the discount rate to 4 percent.

The challenge facing the Japanese authorities was how to achieve a smooth transition from public stimulus to private sector stimulus on the one hand, and from less external demand stimulus to more domestic demand stimulus on the other, Mr. Nimatallah continued. For those purposes, he hoped that flexibility would be exercised in implementing fiscal and monetary policies in Japan so as to maintain the growth rate envisaged by the authorities.

During the past year, monetary policy had helped to sustain noninflationary growth and had strengthened the yen, Mr. Nimatallah remarked. Since the yen had appreciated, there was a valuable opportunity for the authorities to put more emphasis on realizing domestic economic objectives, such as enhancing domestic investment.

The authorities had recently made commendable progress toward freer trade and liberalization of financial markets--including fostering the internationalization of the yen--Mr. Nimatallah commented. The authorities' intention to increase Japan's official development assistance, despite fiscal retrenchment, was welcome. Overall, recent policy actions had attested to the prudence of the authorities and their willingness to take international concerns into consideration in formulating economic policies, particularly those related to Japan's external imbalances. In the short and medium term, a lasting solution to those imbalances would require appropriate action not only in Japan, but also in other large industrial countries. In that context, the September 1985 meeting of the Group of Five and subsequent developments, particularly in the area of exchange rate realignment, underscored the importance of increased international cooperation and coordination.

Mr. Huang observed that, compared with most industrial countries, over the past three years economic growth in Japan had been rapid--with an annual rate of growth of more than 4 percent--and the low level of unemployment had been particularly impressive. However, the staff projected a possible decline in foreign demand for Japan's exports, and a lack of significant improvement in domestic demand in 1986/87 might require the authorities to take positive measures in order to sustain economic growth.

Japan's economy was one of the largest in the world, and the monetary and fiscal policies pursued by the authorities were not only important for domestic economic activities but also had some bearing on the world economy as a whole, Mr. Huang noted. In recent years, priority in monetary policy had been given to the exchange rate because of Japan's concern over its large trade surplus with its trading partners. However, after the September 1985 meeting of the Group of Five in New York, intervention in the foreign exchange market, followed by a rise in interest rates in Japan, had made the yen stronger, which could over time be helpful in reducing Japan's large trade surplus and easing protectionist pressures.

The authorities, however, should be cautious in implementing a monetary policy that was too restrictive on both the domestic and the world economy, Mr. Huang continued. Japan's large trade surplus, low level of inflation, and strong yen, as well as the recent drop in oil prices, should make it possible for the authorities to ease the present tight monetary conditions. During the previous Article IV consultation discussion on Japan (EBM/85/34), Executive Directors had endorsed the authorities' intention not to reduce interest rates until a stronger yen had been established. He considered that the authorities were in a position to reduce interest rates at present, and he welcomed the recent reduction in the official discount rate as well as the fall of short-term interest rates.

Fiscal policy had been traditionally restrictive in Japan, Mr. Huang remarked. It would be undesirable for fiscal operations to withdraw stimulus from the economy in 1986/87 in view of the likely withdrawal of external stimulus and the consequent weakening of aggregate growth prospects. He welcomed Mr. Fujino's statement that the authorities were currently contemplating fiscal measures to expand domestic demand so as to sustain economic growth. Additional measures might be required, however, if the fiscal policy measures in place proved to be insufficient to expand domestic demand.

Japan's large trade surplus had caused repercussions both domestically and externally, and demands for its reduction had become strident in recent years, Mr. Huang commented. Therefore, any initiatives by the authorities to further open Japan's markets to foreign products were most welcome, and an earlier implementation of the announced measures to reduce restrictions on imports would be even more agreeable. The recent intervention in the foreign exchange market was one of the concrete and positive steps taken by the authorities, and a strong yen as a result of the intervention would undoubtedly be helpful in easing protectionist forces elsewhere and in reducing Japan's trade surplus, as well as the corresponding deficits of its major trading partners. However, developing countries, who generally had less diversified export sectors and were heavily dependent on the export of their agricultural and textile products, had not greatly benefited from the recent exchange rate changes but instead had been frequently frustrated by protectionist measures in those areas. He nevertheless welcomed the authorities' acknowledgment of the existence of protectionist measures on developing countries' agricultural imports as well as the maintenance of quotas for textile imports. However, Japan's position with regard to declining domestic demand for textiles was not a supportive argument for lowering import quotas on them. On the contrary, such quotas were ineffective if actual imports could not reach the quota limit. The market should decide how much to import.

In view of the size of its economy, Japan's potential contribution to the revitalization of the world economy was enormous, Mr. Huang stated. With that objective, Japan's largest contribution could be to ease its restrictive monetary and fiscal policies, to stimulate domestic demand, and to roll back protectionism. Thus, trade deficits would be reduced not only in industrial countries but in developing countries, thereby greatly benefiting Japan in the form of sustained economic growth.

His chair appreciated the increased efforts of the authorities in making official development assistance available to the developing countries, and he welcomed the authorities' intention to double that assistance over the next seven years, Mr. Huang said. He hoped that the UN target of 0.7 percent of GNP would be met as soon as possible.

Mr. Hubloue commented that with a growth rate of about 4 percent, well above the average for the industrial countries as a whole, the Japanese economy had continued to perform strongly in 1985. At present, however, the strong impetus of foreign demand was rapidly dwindling, owing to emerging changes in U.S. budgetary policy and the strong appreciation of the yen, and raised the question of whether domestic demand would pick up sufficiently to consolidate Japan's growth momentum. Projections for the next fiscal year indicated that the answer was uncertain: without policy changes, according to the staff's estimates, growth might slow to half its 1985 rate. Discussions between the Japanese authorities and the staff had therefore rightly focused on what policy actions should be taken to counteract that less favorable scenario, and they were to be commended for emphasizing in those discussions the increasingly important role the Japanese economy was expected to play in creating conditions for sustained growth of the world economy.

In that debate, the question of Japan's high savings rate naturally arose as a major obstacle to higher domestic consumption and a more balanced trade position, Mr. Hubloue continued. While the staff was correct in stressing the benefits of worldwide distribution of Japan's excess savings and of the responsiveness of the economy to external demand, it was also true that those excess savings made the growth of the Japanese economy too dependent on foreign demand and created structural trade imbalances that continuously threatened to generate protectionist pressures in other countries.

The staff had concluded that Japan's high savings rate was largely due to demographic factors. That could be expected to change only slowly and therefore to only gradually bring down the savings rate, Mr. Hubloue noted. If that were true, perhaps direct measures to discourage household savings, such as tax disincentives, would not be very effective as the consumer might choose to offset the reduction in his net income from financial assets by curbing his propensity to consume instead of his propensity to save.

Since the possibility of bringing down the savings rate seemed limited in the short term, the authorities should consider strengthening domestic demand through the use of accommodating financial policies and smoothing out the external imbalances through further liberalization of their financial and import sectors, Mr. Hubloue said. In that connection, he was heartened to learn from Mr. Fujino that both internationalization of the yen and trade liberalization retained their high priority among policymakers. Further steps to promote the use of the yen as an international reserve asset and in international trade transactions seemed warranted to counter the structural downward pressure exerted on the yen by large outflows of private capital. Further measures to open the Japanese market to foreign products were equally welcome and should be backed by steps to increase the Japanese consumer's willingness and ability to buy them. It would be desirable to reduce the level of protection of the agricultural sector and to expose domestic food prices to the rules of international competition so that consumers could spend a larger share of their disposable income on foreign goods. An additional policy course aimed at reducing the threat of protectionism against Japanese exports would be to broaden the range of goods exported and to further diversify Japan's export markets. In recent years, overconcentration in too few markets and too few sectors might have been important factors in the emergence of protectionist pressures outside Japan.

Those policies would take time to bear fruit and did not address the immediate concern of the Japanese authorities, which was to stimulate domestic demand while simultaneously consolidating the recent gains of the yen, Mr. Hubloue continued. Medium-term policies should therefore be supported by appropriate monetary and fiscal policies. In recent months, the authorities had managed their monetary policy masterfully to support the yen's appreciation vis-à-vis the U.S. dollar since September 22, 1985. Their decisions, first, to tighten monetary policy to convince the markets of their desire to consolidate the yen's appreciation, and second, to relax interest rates in line with those of other major countries showed that they enjoyed a high degree of monetary flexibility, which would continue to be needed in order to reconcile exchange rate and domestic demand considerations.

The rigor of the authorities' commitment to their medium-term fiscal goals seemed more in question in the light of present circumstances, Mr. Hubloue commented. Because of the great uncertainty as to whether the Government's growth projections would in fact materialize, he supported the staff's recommendation that at the present stage fiscal policy should stimulate demand through additional public works, spending, possible income tax cuts, and appropriate fiscal incentives. Such incentives could be used, for example, to direct some part of domestic savings into residential investment, which would further support the Government's intentions as expressed in the declaration of the Group of Five on September 22, 1985 and would probably produce some shifting in the consumption/savings ratio. Such policies would probably require temporarily abandoning the goal of eliminating the issuance of bonds to finance current spending, but in view of the high domestic savings rate and the overall budget position of the public sector, that should pose no major problem.

The authorities were to be commended for their efforts to increase their official development assistance and for the important role Japan had begun to play in channeling financing to the developing countries, Mr. Hubloue said. Those efforts provided additional and welcome evidence of the greater, more active role Japan was called upon to play in shaping the world economic environment of the future.

Mr. Jaafar noted that economic performance in Japan since the 1983 recovery had been impressive. It was better than in any of Japan's partners in the OECD, with records of price stability, low unemployment, and an extremely high rate of economic growth--on average, in excessive of 4 percent a year. Those achievements, however, had resulted in some concerns expressed by the rest of the world, particularly among the major partners. Mounting current account surpluses had been the most significant source of concern, which had led also to trade frictions abroad. The main counterpart was the U.S. external imbalance deriving from the large U.S. fiscal deficit that had raised interest rates and the value of the dollar. Of particular interest was the strong role played by exports in the Japanese upswing in 1984 and part of 1985, followed closely by the related strong showing by private capital investments.

He concurred with the thrust of the staff appraisal, Mr. Jaafar said, but it was interesting to observe the differences between the authorities' projections and those of the staff for fiscal years 1985/86 and 1986/87. The authorities projected a strengthening of growth in 1985/86 by 4.2 percent and a moderate increase of 4.0 percent in 1986/87, mainly led by domestic demand in 1986/87. Staff projections were less sanguine with sharply lower rates in both years, reflecting major differences in its perceptions of economic activities on the domestic front. Several issues were relevant in explaining the differences. First, given Japan's heavy dependence on the U.S. market, an important factor was the possible future trend of growth in the U.S. economy. An upward turn in the coming quarter was possible at present because of lower interest rates and oil prices. A more upbeat growth rate in the United States would have an important impact on Japan's export performance, notwithstanding the recent yen appreciation.

Second, Mr. Jaafar continued, it was not incorrect to heavily discount any expectation of strengthening domestic demand in 1986/87 unless a significant positive impact of lower energy bills could somehow induce greater demand for employment than currently projected. Factors that could keep domestic demand depressed were mainly the continued withdrawal of fiscal stimulus, projected at a large 1.0 percent of GNP in 1986/87, on top of the strong recessionary impact of the sharp rise in the yen. Third, Japan's strong private investment performance had been mainly export-induced; unless that sector revived soon, it was not likely that more vigor than observed in 1984 would be realized. Fourth, the high wage settlement of 5 percent in 1985, on top of the 4.5 percent settlement of the previous year, might not be significant. The unemployment rate had not improved sufficiently and the recent strong investment in the private sector had been more at the expense of labor absorption. Pending the tax reform package, rising personal taxes could cancel much of the benefits of the wage increases.

In sum, much would depend on the U.S. economy and the positive impact of lower oil prices, Mr. Jaafar stated. Under the circumstances, the staff's projections appeared to be less off the mark than the official figures. Nevertheless, it was possible that the combined two-year current account surplus would exceed the staff projections of $114 billion. Indeed, that massive figure could prove destabilizing on the foreign exchange front unless more was done to correct the large imbalances.

The determination shown by Japan to maintain the gains on the yen were commendable, but the sharp rise--about 30 percent--raised questions about its future course, Mr. Jaafar remarked. The rise had not been followed by any improvement in Japan's current account surpluses, despite the slowdown in exports. Imports, however, had continued to be sluggish. Japan's domestic policies, on both the monetary and fiscal fronts, appeared insufficiently supportive of the external objective; furthermore, developments elsewhere--notably in the United States--did not seem to support a stabilization of the yen at the current level. Concerted and joint efforts would be needed by all parties concerned to address the fundamental policy divergences.

Under the circumstances, Japan was required to implement measures supportive of domestic demand, Mr. Jaafar continued. The 1986/87 package, reflecting a continued strong commitment to budgetary consolidation, while correct in the longer-term context, should not be pursued without flexibility. Concerns over the strong deflationary impact of the yen's rise concurrent with strong current account surpluses were precisely what gave rise to calls for modifications in favor of injecting budgetary stimulus. The austere 1986/87 fiscal package, projected to withdraw stimulus from the economy equivalent to over 1 percent of GNP, could not be viewed without concern in face of the strong recessionary trend. He joined the staff and others in calling upon the authorities to adopt a stimulatory fiscal stance in the current fiscal year. In taking such measures, the authorities could also introduce some tax cuts immediately, notwithstanding the planned implementation of tax reforms in the following fiscal year.

Scope existed at present for monetary policy to play a larger role to stimulate domestic demand, Mr. Jaafar commented. The most recent joint discount rate cuts by Japan, for the second time since January 1986, and the major partners--including the United States and Germany--were positive moves that should encourage investment and economic activities globally.

The long-awaited package of measures for opening Japan's markets to foreign goods and services was welcome, Mr. Jaafar said. Still, in the short term there remained some doubt whether the package would really be effective in helping promote imports, thereby correcting the trade imbalances. There remained some skepticism, particularly about the effectiveness and comprehensiveness of the measures to promote exports such as textiles and farm products, from developing countries. Much more needed to be done in that area.

It seemed clear that recent signs of weaknesses in domestic demand had been strong, Mr. Jaafar noted. Under the circumstances, he urged the authorities to adopt a more flexible approach in their policies in support of the discount rate.

He congratulated the Japanese authorities for the goal they had set to double the amount of official development assistance in the seven years 1986-92; nevertheless, the figure would remain far below the UN target, Mr. Jaafar concluded.

Mr. Mtei observed that following the effects of the second oil price shock that had pushed the world economy into a deep and prolonged recession, the performance and durability of the Japanese economy could best be described as remarkable. For the third consecutive year, the economy was witnessing in 1985/86 another steady and stable expansion, although at a moderate pace. Real output growth at 4.2 percent in 1985/86 would decelerate somewhat from its level of 1984/85; the rate of inflation, meanwhile, was expected to remain low with the consumer price index estimated to rise by only about 2 percent over the same period.

In contrast to the initial upswing that had propelled the economy out of recession and that had been led by a rapid export expansion following a strong recovery in the world economy, particularly in the United States, growth in 1985/86 was mainly attributed to the continued strengthening of domestic demand, Mr. Mtei noted. That domestic impetus emanated mainly from private investment in plant and equipment, an aspect that had underscored the adaptability of Japanese industry to economic and technological changes. However, the export sector remained significant, and its contribution to value added had stabilized. The contribution to GNP growth had apparently remained at a high level; Chart 24 in the report on recent economic developments indicated that export volumes, which had picked up strongly in the middle of 1982, had remained firm in the second half of 1985.

Developments in the domestic economy and the prospects for further rapid expansion of exports had led the staff to advise the authorities to stimulate domestic demand, and he agreed with the staff, Mr. Mtei said. That could be achieved with some measure of certainty through fiscal stimulus, although the authorities wished to reduce the central government deficit. It was encouraging that the authorities considered that stimulation of domestic demand could still be achieved through the expansion of programs at different levels of government operations. He encouraged the authorities to speed up the implementation of those domestic programs at the local government level, as had been suggested, which could have the desirable effect of strengthening domestic absorption and affecting the balance of payments by increasing import demand.

The Japanese economy continued to maintain a strong current account balance of payments position vis-à-vis the rest of the world, Mr. Mtei remarked. The current account surplus had widened to the equivalent of 3.7 percent of GNP in 1985 compared with 2.8 percent in 1984. The authorities were aware that that had been the source of friction in Japanese relationships with trading partners, where protectionist pressures against Japan had been mounting. As that position was clearly undesirable, Japan could play an important role in taking up the leadership role which the U.S. economy had assumed in the second half of 1982 in pulling the world economy out of recession through an expansion of the domestic economy. One measure to reduce trade frictions was for Japan to take the leadership in removing trade barriers and restrictions. As Japan had been a major advocate of trade liberalization, it was appropriate that that country should take the lead in promoting the growth of world trade. To do so should be considered one of the most effective ways of achieving trade liberalization. He welcomed the leadership that Japan had taken to speed up discussions of the next round of multilateral trade negotiations.

He commended the authorities for their continued assistance to developing countries, with official development assistance at 0.35 percent of GNP in 1984, Mr. Mtei said. He welcomed the authorities' commitment to double ODA in the next seven years.

Mr. Mawakani stated that he agreed with the staff's assessment of recent economic developments and policies in Japan and their special bearing on the sustainability of global economic recovery. As in the preceding two years, Japan's economic performance in 1985/86 had been on the whole satisfactory. Although real growth had slowed somewhat, it was reassuring to note from Mr. Fujino's statement that unlike developments during the early part of the recovery, a significant proportion of the economic expansion that had taken place had stemmed from an increase in domestic demand, reflecting vigorous activity in plant and equipment investment. Further expansion in private consumption and investment in private housing had also taken place. Nevertheless, a strong export performance had occurred during the first three quarters of the year. Although that performance had been uneven, it reflected the past restructuring efforts of Japan's industrial sector toward high-technology goods and the economy's competitiveness and adaptability to meet external demand.

Japan's rate of inflation had remained stable and continued to be one of the lowest among the industrial countries, Mr. Mawakani noted. The fiscal deficit as a proportion of GNP had been further reduced in step with the authorities' medium-term objective of fiscal consolidation. The economic expansion that had taken place over the past three years had created some employment opportunities, although Japan's unemployment rate--which, at about 3 percent, was high by historical standards--was low compared with rates in other industrial countries. Those achievements were commendable and reflected the appropriateness of the authorities' economic and financial management, based on prudent and cautious policies that had contributed to the country's strong economic position and the sustainability of the international recovery.

Japan's growing external current account surplus was projected to reach $59 billion in 1985/86 and to rise to $71 billion in 1986/87, Mr. Mawakani remarked. The Japanese authorities had been mindful of the problems created for their trading partners and for general international trade by their buoyant economy that had been heavily dependent on external rather than domestic growth and characterized by outflows of long-term capital. As the staff correctly pointed out in its report, "the interests of the international community and Japan coincide in sustained, strong economic growth in Japan, near to its potential rate." Japan's commitment, as a major industrial country, to pursue policies geared to ensuring sustainable noninflationary growth and further opening up its markets to foreign suppliers was beyond any doubt. That commitment had been reaffirmed in the Bonn Declaration and the G-5 announcement of September 1985. The Japanese authorities had taken significant steps, prior to that commitment, to liberalize financial markets and to enhance the international role of the yen, as well as to remove trade barriers against the major economies in particular. Unfortunately, those steps had not achieved the desired results, and the current account surplus was projected to rise further to $71 billion. It was hoped that the recent significant appreciation of the yen vis-à-vis major international currencies would help to contain the sizable external account surplus.

The Japanese authorities' efforts in pursuing sound fiscal discipline aimed at ensuring better control over expenditure, improving the efficiency of the tax system, and eliminating deficit-financing bond issues by 1990 had merited wide support in terms of the medium-term fiscal consolidation objective, Mr. Mawakani commented. That fiscal consolidation needed to be implemented flexibly. From the international point of view, the exercise of flexibility in the pursuit of fiscal policy should take into account the staff's suggestion in "World Economic Outlook - Policy Interactions in Industrial Countries" (SM/86/46, 2/28/86) that Japan and the European countries should examine the possibility of shifting their fiscal policies in an expansionary direction in 1987 corresponding to 1 percent of GDP, which would be sustained through the medium-term period. The proposed shift in fiscal policy would involve a postponement of the fiscal consolidation efforts rather than a major turnaround of the fiscal stance. The advantage of such a policy shift was to stimulate demand and activity, and in the short term, the adverse effect on output resulting from a U.S. fiscal contraction would be reduced by about one half, compared with a situation where policies outside the United States were left unchanged.

From the point of view of developing countries, an easing of fiscal policy in the industrial countries outside the United States was expected to raise both the demand for developing country exports and their prices, Mr. Mawakani continued. The assumed magnitude of the proposed fiscal action might increase the export revenue of developing countries by 1-1 1/2 percent after a two- to three-year period, and the incremental export revenue could be used to finance higher imports that would help developing countries to attain a projected real GDP increase of about 1-1 1/2 percent. In the face of a slowing down of economic activity in the United States, the authorities of Japan and the major European countries were urged to examine the scenario of the policy interactions of a brief postponement of fiscal consolidation in their countries as part of the process of fostering international cooperation and helping to find solutions to the debt problems of developing countries.

He was pleased to learn from Mr. Fujino that his Government considered promoting economic cooperation as one of the most important policy objectives and that it attached great importance to the role played by official development assistance in the growth strategies of developing countries, Mr. Mawakani noted. He therefore welcomed the Japanese authorities' renewed effort to improve aid appropriations despite the country's budgetary stringency.

Mr. Sengupta commended Japan for its many successes: strong economic growth for the third consecutive year, moderation in price increases, and reduction in fiscal deficits. It was almost a miracle, in the context of the current orthodoxy of economic thinking regarding the trade-off between inflation and unemployment, that the staff described the rate of unemployment reached in November 1985 of 2.9 percent as a "historic high"--when the rate in other major industrial countries varied between 7.0 percent and 13.0 percent--at a time when the inflation rate in consumer prices was about 2 percent and wholesale prices actually negative.

Balance of payments developments once again had been marked by large current account surpluses in spite of the stagnation in the volume of exports, Mr. Sengupta commented. The yen had appreciated after the

September 22, 1985 meeting and, in particular, in February 1986 against the U.S. dollar, the pound sterling, the deutsche mark, and the French franc. The low interest rate differentials in respect of investments of relatively long maturities and the decline in oil prices, as well as sheer productivity of the Japanese system, seemed to suggest that the yen would remain strong in the coming period. Japan should be legitimately proud of its achievement--it was in the process of becoming the most important economic power, and he hoped that it would play the role of leadership that was expected of it in the world arena. Nothing should be done to slacken the momentum of growth of the Japanese economy.

Recent developments had cast some doubt on the optimism about the growth rate in 1986/87, and many Directors had referred to the differences between staff and official projections for that year, Mr. Sengupta noted. Those differences had implications for surveillance; perhaps official projections were overly optimistic. Indeed, the decline in export demand and the more or less stagnant domestic demand could lead to a lower growth rate than shown in official estimates. However, Mr. Fujino had confirmed that the official projection for 1986/87 had not changed in spite of the rapid yen appreciation in February 1986 and the prospects of a sharp fall in oil prices. He hoped that Mr. Fujino was correct, but, even if staff projections turned out to be too low, demand should be stimulated through some easing of fiscal and monetary policies without completely changing the medium-term policy stance, thereby allowing Japan to increase its imports from the rest of the world.

Exports of developing countries to Japan seemed to have declined in value terms in 1985, with serious implications for the growth of those countries, Mr. Sengupta continued. Protectionist pressures from the textile and agricultural sectors were matters of concern, and he hoped that Japan would open its markets further.

Japan's ability to increase imports was a function mainly of its growth, the removal of trade barriers, and, to a lesser extent, its exchange rate, Mr. Sengupta observed. The exchange rate, however, depended on a sustainable level of the current account surplus. There were no criteria to determine the appropriate exchange rate in a floating rate regime where capital restrictions were almost absent and information flows were substantial. To reduce the current account surplus, some appreciation would become necessary. He wondered whether, even at the current rate of ¥ 180 = US$1, Japan's relative competitive position was greatly eroded. Japan's relative normalized unit labor costs had been on the decline since about 1980, as demonstrated in Chart 23 in the report on recent economic developments. He asked the staff for its views on the appropriateness of the value of the yen vis-à-vis other major currencies, especially the U.S. dollar.

In fact, he wondered whether it was necessary to reduce Japan's current account surplus, Mr. Sengupta added. At an OECD seminar in 1985 he had described the Japanese current account surplus as structural: a reflection of the high savings rate and historically declining unit cost of exportables. An attempt to reduce that surplus would only lower the growth rate, which would not be helpful either for Japan or the rest of the world. It was difficult to imagine that a highly industrialized economy would be able to absorb a 27 percent rate of savings by increasing the rate of domestic investment and reducing the current account surplus. A mechanism should be found to enable Japan to sustain a high level of current account surplus. The problem had become almost similar to that of recycling the oil surplus of the mid-1970s.

Recently that surplus had been sustained by the large capital outflow, mainly to the United States, which was now acknowledged as unsustainable in the medium term, Mr. Sengupta noted. In a sense, it was also undesirable that so much of Japanese savings should flow to the United States, not only because of the implications for the U.S. dollar and mounting interest burden of the United States, as well as the risk of loss of confidence in that economy in liability financing, but also because of a growing gap in the developing countries. At the OECD seminar he had suggested that a mechanism should be found by the international community to recycle the Japanese surplus by financing the large current account deficits of developing countries. A number of schemes might be suggested, and similar schemes had been considered during the OPEC surplus period. The Fund could play a major role in that exercise. Looking at the nature of Japanese capital outflows and foreign investment, it appeared that the main motivating force was capital security and not the market rate of return. Any recycling mechanism that had the guarantee of an international institution such as the Fund or the World Bank would meet the requirement.

He hoped that the Chairman and the authorities would give adequate thought to the working out of such a mechanism that would be helpful not only for the developing countries but also for Japan by maintaining its growth and exports to the industrial world and by allowing an expansion of its import market, Mr. Sengupta concluded. That expansion depended on Japan's growth and removal of trade barriers and on the international institutions allowing it to have control over its resources.

Mr. Almeida commented that Japan's actions in reducing restrictions on imports had been significant during the past years, but much remained to be done. It was particularly important as the country moved to the frontier of technological progress that its markets should become available to developing countries. However, the opposite had happened in the first three quarters of 1985 when imports from developing countries had declined by 9 percent.

The revised staff projections for Japan's balance of payments in 1986/87 indicated an additional $12 billion in the current account surplus with non-oil imports increasing by only $5 billion compared with previous estimates, Mr. Almeida continued. Clearly there was ample margin for import growth, particularly through increased imports from developing countries.

There was significant room for increasing the many components of domestic demand, particularly through an increase in consumption, Mr. Almeida said. The question then arose of the difficulties of decreasing the savings rate. The recent decline of the discount rate showed that the authorities were moving in the right direction, but some of Mrs. Ploix's suggestions regarding savings rate policies should be explored.

He welcomed the increase in Japanese official development assistance in 1984 to 0.35 percent of GDP and the recent announcement by the authorities that they had set a new target of doubling official development assistance in dollar terms over the next seven years, Mr. Almeida concluded.

Mr. de la Herrán commended the Japanese authorities for the impressive economic performance that they had been able to maintain one more year. The Japanese economy represented one of those cases where, owing to the deep and wide implications that their economic policies had on the rest of the international community, the exercise of surveillance had a special significance. The consequences of the current account surplus was the most dramatic example of the external impact of Japanese policies.

Japan had not escaped the economic illness affecting most developed economies in recent years--high public sector deficits, Mr. de la Herrán stated. Nevertheless, Japan's situation did not appear to be as pressing as others. Fiscal consolidation, although important, should stay, under present conditions, behind other targets such as the need to maintain growth rates as near as possible to potential levels. It was worrisome to learn from the staff report that the proposed budget had been strongly aimed toward the reduction of central government deficits. That indication of the authorities' priorities prompted him to join the staff in advising that a withdrawal of economic stimulus through the fiscal side would be clearly inappropriate. Apparently there was still some room to offset, to a certain degree, the tight stance originally planned. Mr. Fujino had stated that the authorities intended to secure a higher rate of growth in public works, as well as to give financial support to housing investment; he hoped that the authorities would be able to carry out their intentions.

The Japanese current account surplus constituted a good example of the lack of coordination in the design and implementation of economic policy among the major countries, Mr. de la Herrán remarked. The effects of a surplus of that magnitude and duration were pervasive. The revised projections presented by the staff showed how acute the problem could become unless some policy changes took place to reverse that trend.

The measures being taken to liberalize trade--for which the authorities should be commended--had proved to be insufficient, Mr. de la Herrán commented. In fact, the value of imports in 1985 had declined by 5 percent and, more significant, imports from developing areas had fallen by 9 percent, against a 6 percent increase registered in 1984.

He recognized the difficulties of forecasting the evolution of the current account in a medium-term outlook, but it would be useful to build up, even tentatively, some scenarios under different sets of assumptions, Mr. de la Herrân suggested. The instability of exchange rate markets and oil prices made it even more difficult to obtain accurate projections, while those uncertainties made even more valuable any kind of medium-term outlook that could be offered. Many Fund papers on country matters included such projections. He did not know whether the case of Japan entailed special difficulties in offering such scenarios, but it would be particularly interesting to have them available in future.

The Japanese authorities' intention to strengthen their official development assistance and cooperation was commendable, Mr. de la Herrân said.

Notwithstanding the efforts announced by the authorities, Japan should contribute more substantially to balancing the international economy, Mr. de la Herrân concluded. Japan's potential was so important and its influence in the world economy so strong that the authorities should, in designing their policies, take into consideration the external by-products of such policies.

Mr. Agah said that Japan's economic and financial performance had been marked in 1985 by strong real GNP growth for the third consecutive year and further progress in controlling inflation and widening the external account surplus. Although net foreign demand had slackened somewhat--mainly as a result of lower economic expansion in the United States--and its contribution to GNP growth had been significantly lower than in 1983, Japan's overall economic growth had been stronger than in most industrial countries in 1985. As noted by the staff, that performance was considerably below both Japan's traditional growth rates and its current potential. It also had been accompanied by a number of weaknesses, including unemployment, which was high by Japanese standards although significantly below most industrial economies' rates.

Furthermore, as Japan's economic outlook seemed to indicate the maintenance of a strong external position in spite of more moderate GNP growth, and as the country's very success would continue to entail large current account imbalances among major industrial countries and a strong threat of trade protectionism against Japanese exports, the need for structural and balance of payments adjustments remained crucial, Mr. Agah continued. The authorities had demonstrated over the previous year, and particularly in the previous few months, their willingness to take the necessary action to deal with current imbalances. In that respect measures included the concerted and successful realignment of major currency exchange rates, a number of initiatives to promote private consumption, and a series of structural reforms aimed in particular at further opening of the economy, at the internationalization of financial markets, and, in general, at a closer integration of domestic and foreign markets.

While many of those measures would be implemented over the medium term, and while many would have little immediate impact on current imbalances, developments with respect to the exchange rate and oil prices since the circulation of the staff report had significantly altered staff projections and the urgency of further corrective action by the Japanese authorities, Mr. Agah remarked. Many of the required policies would obviously be implemented in consultation with, and parallel to, similar measures by other industrial economies.

Japan's contribution to the recent realignment of the exchange rates of the major currencies had been positive and crucial and had, to some extent, led to a welcome abatement of protectionist pressures among the industrial countries, Mr. Agah stated. It was obvious, however, that while Japan's financial policies and other industrial countries' supportive measures permitted a considerable appreciation of the yen and a remarkable shift in exchange market psychology, the policies that were at the source of exchange rate misalignment had not been corrected. That correction was essential not only for the recent improvement to endure but also to allay pressures on monetary policies in the management of exchange rates.

The withdrawal of stimulus induced by lower external demand and by the considerable appreciation of the yen over the past six months was even larger than expected in the staff's original appraisal and should, over the medium term, offset the positive impact of lower oil prices on investment and external accounts, Mr. Agah noted. Thus, the need to boost domestic demand appeared to be more urgent at present than during the previous Article IV consultation discussion. While the significant improvement in Japan's terms of trade and the recent reduction in interest rates should have a positive impact on private demand, they also should be partly offset by the weaker profits and stagnating exports resulting from the appreciation of the yen. Some degree of fiscal stimulus would therefore appear to be in order.

The authorities' concern in that regard was well taken, considering the relatively high level of Japan's fiscal deficit in terms of GNP and the medium-term target of fiscal consolidation, Mr. Agah commented. They had also shown in recent months some flexibility with respect to fiscal targets, as they had, parallel to restraint on expenditures, tolerated larger than budgeted deficits when those were induced by slower revenue growth. However, there seemed to be sufficient scope for stimulatory action for a number of reasons, including the virtual elimination of inflation, which was projected at 0.3 percent for 1986/87, and the possible implementation of stimulatory measures by other entities of the public sector, such as those at the local government level and by public enterprises.

In spite of the authorities' corrective actions, there remained considerable uncertainties with respect to growth and balance of payments developments, Mr. Agah remarked. Those uncertainties were linked not only to the adaptation of investment to the considerable changes in exchange rates and oil prices and to the strong structural reforms being implemented, but also to the actual impact of recent reforms and developments on Japan's high savings rate. The detailed staff analysis of the forces operating on savings was very illustrative and seemed to indicate that fiscal stimulus would tend to be partially offset by changes in private savings.

Notwithstanding the opening of the Japanese economy, its closer integration with foreign markets, the strong appreciation of the yen, and the repeated renewal of the so-called voluntary quotas on some of its exports, protectionism against its exports might have only temporarily abated, Mr. Agah observed. The measures implemented in that regard were impressive and indicative of the authorities' determination to dismantle many of the barriers to its own markets. While there was scope, however, for an acceleration of the reforms aimed at liberalizing imports and financial markets, Japan's case with respect to trade protectionism would be much stronger without the excessive trade barriers it imposed on developing countries' exports. In that connection, he welcomed the authorities' stance on the implementation of the Tokyo Round of tariff reductions for developing countries' agricultural produce. He also welcomed their intention to strive to facilitate imports from those countries by encouraging shifts from traditional sectors of Japanese industry toward higher value-added products. However, there remained multiple barriers against those products, including ad hoc trade limiting arrangements, quotas, and "check prices." Furthermore, the authorities had increased loans and subsidies to industries competing with the developing countries to shield them from the impact of the higher yen.

Japan's official development assistance had been raised by up to 15 percent in 1984, but it remained below the average of other Development Assistance Committee countries and far below the UN target, Mr. Agah said. He welcomed the authorities' commitment to double official development assistance in dollar terms over the next seven years, although its regional distribution could perhaps be made more representative of Japan's extensive trade and other economic relationships with developing countries, particularly those in Africa. Private capital flows to developing countries had also increased sharply. With the continuous fall in the price of oil, and the recovery in the economies of industrial countries--especially Japan--the balance of payments surpluses had now shifted from the OPEC countries to the surplus industrial countries. The OPEC countries, at the height of the oil price boom--and some even at present--had continued to donate generously to the development of needy countries. The gap that had now emerged as a result of the change in the oil equation should be logically filled by the new surplus countries.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/41 (3/7/86) and EBM/86/42 (3/10/86).

2. KIRIBATI - MEMBERSHIP - GOVERNORS' VOTE

The Executive Board approves the report of the Secretary (EBD/86/5, Sup. 1, 3/6/86) on the canvass of votes of the Governors on Resolution No. 41-2, with respect to membership for Kiribati, approved by the Executive Board for submission to the Board of Governors (EBM/86/17, 1/31/86). The Governors' vote on the Resolution is recorded as follows:

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| Total affirmative votes | | 862,304 |
| Total negative votes | | 0 |
| Total votes cast | | 862,304 |
| Abstentions recorded | 0 | |
| Other replies | 0 | |
| Total replies | | 862,304 |
| Votes of members that did not reply | | 67,996 |
| Total votes of members | | 930,300 |

Decision No. 8216-(86/42), adopted
March 10, 1986

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/54 (3/6/86) and by an Assistant to Executive Director as set forth in EBAP/86/53 (3/5/86) is approved.

APPROVED: November 12, 1986

LEO VAN HOUTVEN
Secretary