L.5.2

RFD 449

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

October 29, 1963

Problems in Japan's Current Economic Upswing

9 pages

Richard H. Kaufman

October 29, 1963.

Richard H. Kaufman.

Problems in Japan's Current Economic Upswing

The performance of the Japanese economy has increasingly intrigued Western economists. From 1953 through 1962, the economy experienced an average annual growth in real GNP of 9.2 per cent, a rate unmatched by any other industrial country for which comparable statistics are available.

Many reasons have been given for the phenomenal expansion of the Japanese economy: the hard-working nature of the Japanese, a desire to emulate the higher living standards of Western countries, the limited power of trade unions, a high propensity to save, and a relatively stable political system. Some of these phenomena have undoubtedly been part of the underpinning for Japan's rapid economic growth. However, by themselves they would have been insufficient to effect the large-scale economic development which has occurred. Foundations must be built upon to be of use. It is Japan's adroitly handled economic policy which has provided the necessary material for building her showpiece among nations.

The Japanese economy is basically a free enterprise economy. However, governmental policy has exerted a strong influence whenever the economy becomes "overheated." The nature of the Japanese economy is such that the expansion of industrial production requires enlarged imports of raw materials and fuels. During cyclical upswings, strong domestic demand has siphoned off potential export growth and has also boosted the volume of imports. Thus cyclical economic expansion has been accompanied by a deterioration in the balance of payments.

The distinguishing feature of Japanese economic policy, especially since the early 1950's, has been the extensive use of monetary weapons to overcome balance-of-payments difficulties. When balance-of-payments problems have become serious, the authorities have tightened monetary policy, which has tended to retard industrial expansion and force the contraction of inventories. This has helped cut back import demand and promote export expansion.

The Japanese have been willing to subject themselves to temporary, mild cutbacks in industrial production in order to set their balance of payments aright. This has not affected adversely their long-run economic growth. In fact, it can be argued that the deflationary forces set in motion by the tighter monetary policy - as evidenced by the declines in wholesale prices which have accompanied production slowdowns - have contributed significantly to Japan's rapid growth by ensuring the competitiveness of her products.1/

1/ See Robert F. Emery, "The Japanese Measures to Restore Economic Equilibrium," Asian Survey, June 1962.

The current economic situation in Japan is clouded in uncertainties, and it still remains to be seen whether the authorities can once again perform the delicate feat of unravelling the difficulties threatening the economy without retarding its long-run growth. Unlike past periods of stress, the current situation is not entirely that of an "overheated economy." It is more the result of two main factors: the relative weakness of deflationary forces during the cooling-off period, and a monetary policy designed to stimulate the still quite warm economy. In addition, the U.S. proposed interest equalization tax may complicate Japan's efforts to rectify the economic situation.

Weakness of deflationary forces

From mid-1958 to the end of 1961, the Japanese economy experienced an uninterrupted expansion. The index of industrial production (seasonally adjusted) increased from a low of 65 in June 1958 (1960 = 100) to 70 at the end of that year. It proceeded to rise at an average annual rate of 21 per cent in the following three years, reaching 128 at the end of 1961. In the second quarter of 1961, the sustained expansion of industrial output again began to impinge upon the country's external balances. In that quarter, the trade deficit, seasonally adjusted, exceeded $1.6 billion (28 per cent of imports), as compared with a deficit of only $270 million (6 per cent of imports) in the corresponding period of 1960.2/ Enlarged imports accounted for almost all of the worsening trade deficit, especially those of textile materials, metal ores, mineral fuels, and machinery. These imports were required for the continuation of the industrial expansion. The trade deficit was reflected in a decline in Japanese gold and foreign exchange holdings of $84 million for the quarter.

The Japanese Government sought to check the economy by a series of monetary measures, beginning in July 1961. The basic discount rate was increased, penalty discount rates on borrowings in excess of quotas were raised, advance import deposit requirements were enlarged, and reserve requirements were doubled for the larger banks. In addition, a new export promotion program was instituted and the Government cut back on some of its expenditures.

These measures, for the most part, had taken effect by January 1962. Throughout the whole of that year, there was little increase in the index of industrial production, as shown by the following table.

Table 1

Index of Industrial Activity
(Seasonally adjusted: 1960=100)

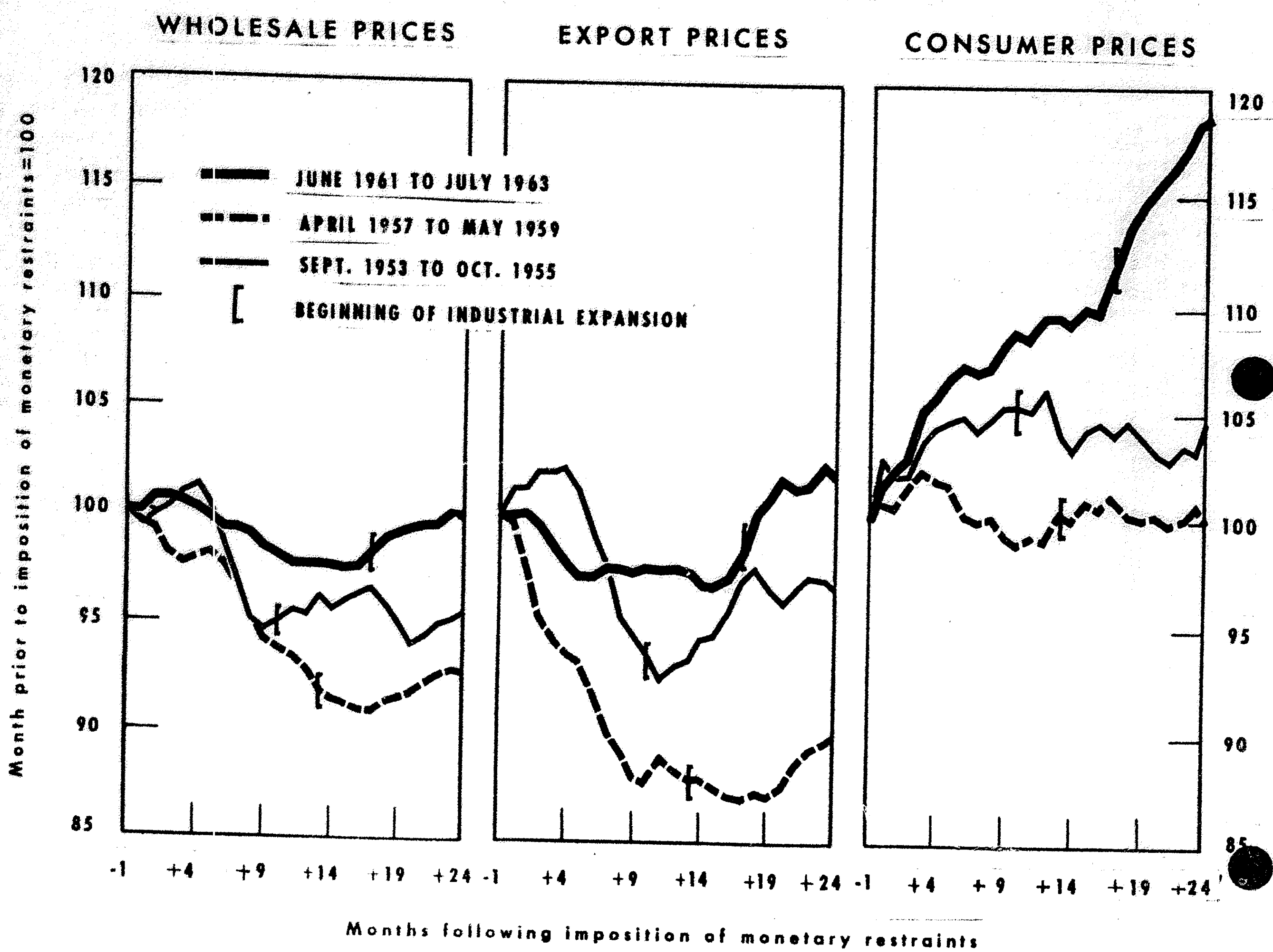
	1961	1962	1963
1st Quarter	111.5	128.9	130.2
2nd Quarter	116.6	129.8	136.9
3rd Quarter	122.5	128.8	
4th Quarter	126.6	128.4	

2/ These calculations are based on customs data, which value imports c.i.f.

It is significant that not only did industrial production not increase during 1962, but also it failed to decline. After the boom of 1953, the index of industrial activity declined by 7 per cent. After the 1956-57 boom, it fell by 10 per cent. This time, industrial production remained relatively stationary. This indicates that the deflationary measures were not as strong as those in early cyclical downswings.

Another indication of the relative weakness of deflationary forces is the trend in prices between the time just prior to the institution of monetary tightness and the start of further industrial expansion. This time-span approximates the period during which restrictive measures were effective; i.e., during deflation. The following chart presents price movements over the 17 months of the recent deflationary period, as well as for the comparable periods of the two previous deflationary periods.

JAPANESE PRICE INDICES



This chart reveals that although the past deflationary period (June 1961 to December 1962) was of longer duration than that of the two previous downswings, it was not as strong. In comparison to these earlier cyclical downturns, the decline in wholesale and export prices was much less after the imposition of monetary restraints, and the level of consumer prices much higher. It must be noted, however, that part of the movements of some of these price indices as well as inter-period comparisons may have been influenced by statistical changes in the base period upon which the indices were computed.

If a comparison is made between the highest price level of each boom and the lowest level in the ensuing downswing, instead of the above comparison, the same results hold. Thus the wholesale price index, for example, shows a maximum decline of 3.2 per cent in 1961-62, as compared to declines of 9.4 and 6.5 per cent following the 1956-57 and 1953 booms, respectively. Furthermore, money supply increased by 38 per cent during the past deflationary period, as compared with practically no increase during the two previous deflationary periods.

A policy of monetary ease

The fact that deflationary forces have not been as strong as in previous post-boom periods has important significance for the current economic situation. It has meant that efforts to stimulate industrial production have been reflected in the balance of payments relatively quickly.

In the fall of 1962, the Japanese authorities decided that industrial production should be stimulated. The index of industrial activity had been stationary since the beginning of the year, and the authorities feared that a continued lack of expansion would seriously affect the ten-year economic plan. This plan called for a doubling of national income by FY 1970. This would require an annual increase of about 7.5 per cent. In fiscal year 1961, the first year of the plan, national income rose by 18.6 per cent, much in excess of the required annual average. In constant terms, gross national product rose by 16.1 per cent during calendar 1961.

Thus the rate of increase in national income could have been reduced considerably without putting the economy behind its planned targets. However, the authorities wanted to maintain a minimum increase during each year. In October 1962, the Bank of Japan reduced the discount rate from 7.3 to 6.94 per cent. It was reduced further to 6.57 per cent in November, to 6.21 per cent in March 1963 and to its present level of 5.84 per cent in April. This is the lowest the discount rate has been since July 1955. Other measures were also taken over this period to produce monetary ease.

Partly as a result of these measures, the index of industrial activity registered a 5.1 per cent increase in the second quarter of 1963, as compared to the first quarter (See Table 1). However, the trade deficit has also increased substantially, as the following table shows.

Table 3

Trade Data a/
(Seasonally adjusted -
millions of dollars)

		1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
1961	Imports	1,285	1,404	1,529	1,606
	Exports	1,043	1,048	1,062	1,082
	Balance	- 242	- 357	- 468	- 524
1962	Imports	1,482	1,405	1,355	1,393
	Exports	1,133	1,224	1,283	1,256
	Balance	- 349	- 181	- 72	- 137
1963	Imports	1,464	1,636	1,746 b/	
	Exports	1,245	1,326	1,387	
	Balance	- 220	- 310	- 359	

a/ These figures are computed on a customs basis, in which imports are valued c.i.f. and exports f.o.b. Balance of payments data, where imports are valued f.o.b., are not yet available for the first three quarters of 1963. Between 1960 and 1962, imports c.i.f. were 17-20 per cent higher than imports f.o.b. The following table shows the trade data in which imports and exports are both on an f.o.b. basis. It is seen that in 1962, there was a trade surplus instead of the deficit indicated above where insurance and freight charges are added to the import cost.

	Imports	Exports	Balance
	(In millions of dollars)		
1960	3,711	3,982	+271
1961	4,707	4,149	-559
1962	4,463	4,860	+397

b/ Preliminary.

During 1961, the trade deficit widened noticeably due to the rapid expansion of imports. This is associated with the expansion of industrial production and the accompanying build up of inventories. Imports declined during the first three-quarters of 1962 and the trade deficit narrowed considerably. However, with the resumption of the policy of ease and the ensuing spurt in domestic economic activity, import growth has outpaced exports. In the last quarter of 1962 and the first quarter of 1963, there was a relatively moderate increase in the value of imports which, in conjunction with falling exports, caused a widening of the trade deficit. In the second quarter of 1963, imports jumped to $1,636 million, 12 per cent more than the previous quarter. Even with a sizeable increase in exports, the trade deficit rose substantially. Latest data indicate a continuing of this trend, with the trade deficit in the third quarter, seasonally adjusted, at an annual rate of about $1.4 billion.

The trade deficit during the current expansionary period rose at a much faster rate than during the corresponding periods of the two previous cyclical upswings. By July 1963 - seven months after industrial production began to increase - it reached $145 million. This was nearly as high as the deficit in June 1961, the peak of the last boom. In contrast, in January 1959, seven months after the beginning of the recovery phase of the previous cycle, the trade deficit was only $11 million, compared with a $167 million deficit in April 1957, the peak of the 1957 boom. At a comparable point in the 1954-55 recovery, the deficit was $50 million, less than half the $115 million reached prior to the start of the deflationary period.

Price increases since the start of the current expansion have also been a factor behind the rapidly-growing trade deficit. Chart 1 reveals that six months after the beginning of the current industrial expansion, wholesale prices reached the level attained just prior to the imposition of monetary restraints. This is slightly less than their cyclical high. In contrast, during the corresponding period after the two previous downswings, wholesale prices were well below their former levels. Export and consumer prices also are rising much more rapidly during the current expansion than in previous ones. Thus it appears that both the level of prices at the start of the current upswing and the rate of price increase since then have contributed to the quickly mounting trade deficit.

The trade account, of course, is not the only factor affecting the balance of payments. There are the invisible and capital accounts. However, not much assistance can be expected from the former. Receipts from invisible exports have increased significantly in recent years. Since 1959, they have risen at an annual rate of about 9 per cent, mainly because of increased income from investment abroad and larger receipts from transport services. However, invisible imports (excluding payments for freight and insurance on commodity imports, which are included in imports valued c.i.f.) have risen even faster (an average annual rate of 20 per cent) due to increased payments for all services, especially income payments on foreign investments in Japan. As a result, the surplus on invisible accounts, so defined, has been sharply reduced from about one-quarter billion dollars in 1959 to under $100 million by 1962. There is little prospect at present that this trend can be halted and even less that it can be reversed and that the invisible accounts would become a significant source for financing the trade deficit.

This leaves the capital account as the major hope for providing the funds covering the growing deficits on trade as well as current accounts, and it is for this reason that the proposed U.S. interest equalization tax is especially significant for Japan.

The U.S. Interest Equalization Tax

In 1961, Japan's balance of payments on current account (including transfer payments) was in deficit by $982 million. This was covered mainly by a net inflow of short-term capital and a $356 million drawing down of foreign exchange reserves. Continued dependence upon these two factors could have seriously undermined confidence in Japan's ability to service its outstanding external debt, public and private, which is over $2 billion. Short-term credits are potentially volatile and doubts about financial soundness could prompt large reverse capital flows. Declining reserves would focus attention upon a weakness in Japan's economic situation and, of course, the extent of the decline is limited by the amount of reserves and the need to meet foreign exchange liabilities.

For this reason, the Japanese authorities instituted the series of monetary measures mentioned above to brake the economy. We have already seen that, as regards production and prices, these measures were not as deflationary as those in previous booms. However, the balance of payments did improve during 1962, due to a 15 per cent rise in exports of goods and services and a 3 per cent decline in imports. The net result was a current account deficit in 1962 of only $3.8 million. A large capital inflow more than covered this deficit and enabled the country to add $339 million to its international reserves.

If present trends continue, the current account will revert to a large deficit in 1963. For the past few years, the Japanese have been attempting to strengthen their balance-of-payments position by seeking the inflow of long-term capital, especially from the United States. This represents a less volatile source of finance for their current account deficits than short-term credits. In 1961, the Japanese floated in the U.S. money market debentures and stocks (American Depository Receipts) totalling $57.7 million. In 1962, such placements rose sharply to $145.8 million. In the first seven months of 1963, the Japanese issued in the United States bonds and equities totalling $159.9 million, slightly more than the total amount issued in all of 1962. Further flotations of at least $90 million were planned to be made before March 1964, the end of the Japanese fiscal year. In addition, Japanese securities experts had estimated that foreign purchases - mainly U.S. - of Japanese stocks would increase substantially from the $165 million total reached during the past fiscal year.

On July 18, 1963, the President announced a series of measures, including the equalization tax, designed to help correct the U.S. balance of payments deficit. This tax is to be applied to purchases by United States interests of foreign securities sold by foreigners and is estimated to increase the cost of foreign borrowing in the United States by about 1 per cent. The tax is to be imposed at the rate of 15 per cent in the case of stock and in the case of debt securities at rates ranging from 2.75 to 15 per cent, depending upon the remaining period of maturity. The tax is to remain in effect through 1965. If enacted as proposed, the tax may curtail the amount of capital flowing from the U.S. to Japan. Opinions in Japan differ on this point. Japanese long-term rates are around 7.5 per cent for 7 year industrial bonds and the latest Japanese issues in this country have been sold to yield about 5.8 per cent. Some private Japanese borrowers have indicated that the tax would not deter them from borrowing in the U.S. market. On the other hand, the Government might be more hesitant about borrowing here, and it is agreed that the 15 per cent tax on equities would make further stock issues impossible.

Since there is still no obstacle to borrowing short-term, the Japanese may be inclined to increase their short-term liabilities to the U.S. if the banks are willing to accommodate them, but total Japanese short-term liabilities are already at a very high level.

The U.S. Government has indicated to the Japanese that the application of the interest equalization tax to Japan will be reconsidered if Japan runs into serious balance of payments difficulties. This assumes, of course, that Congress will be willing to provide the necessary authority to grant exemptions to such countries as Japan and Canada. If the current trade trends are allowed to continue, Japan may well have reason to call upon the U.S. for an exemption from the tax.

If Japan does again experience a fall in reserves in the near future, there may well be some disposition to blame the interest equalization tax proposals. However, as has been seen, the Japanese payments problem began building up before these proposals were conceived. Japan must decide whether to keep up the present rate of economic expansion and hope that sound ways can be found to finance the current account deficit or whether it might be better again to put on the brakes and seek a closer approach to equilibrium in the current account.