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The Japanese Measures to Restore  
Economic Equilibrium

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The Japanese Measures to Restore Economic Equilibrium

Robert F. Emery

Since mid-1961, the Japanese monetary and fiscal authorities have undertaken various measures to restore equilibrium to the economy. The necessity to impose economic restraints was clearly signaled by the substantial deficits in the international balance of payments beginning in May 1961 and the very high rate of investment in plant and equipment during 1961. The major question at this time is--will these measures be as successful in halting the drain in international reserves and restoring general economic equilibrium as those of 1953 and 1957? In attempting to answer this question, it might be helpful to examine the causes of disequilibrium in the last three booms and the nature of the corrective measures taken.

Past causes of disequilibrium

During 1952-53, significant increases in domestic consumption and investment demand contributed to substantial price rises which led to a worsening in the balance of payments. In 1953, personal consumption expenditures rose 19 per cent over the previous year and gross private investment increased 18 per cent compared to a year earlier. Tax cuts contributed to this increased demand in 1953, and at the same time, the lowest rice crop in eight years served to raise rice prices. As a result of these developments, wholesale prices in 1953 rose 5.4 per cent.

A very wide gap between imports and exports had opened up during 1952, as exports plunged precipitously and imports rose. This was narrowed a little in the first half of 1953 because of a decline in imports combined with some recovery in exports. However, in the latter half of the year exports levelled off, and imports, spurred by rising demand, rose steeply. Lessened interest on the part of businessmen in pushing exports was noted, as domestic markets offered easier and more attractive prospects than foreign markets. By September 1953, it had become apparent that action to reduce the trade deficit would have to be taken, and it was concluded that what was required was deflationary action to dampen down the domestic boom.

The main factors causing disequilibrium during the 1956-57 boom were inventory speculation and capital investment. Exports rose substantially in 1954 and 1955, increasing domestic incomes. This in turn stimulated domestic spending, particularly capital investment. Gross private domestic capital formation as a proportion of GNP rose from 16 and 17 per cent in fiscal 1954 and fiscal 1955, respectively, to 24 per cent in fiscal 1956. 1/ The increase in private domestic capital formation from fiscal 1955 to fiscal 1956 was 63 per cent. The increase in business inventories during the same period was 53 per cent. Inventory accumulation, some of it speculative, caused a sharp rise in imports, especially raw materials. Thus in the 1956-57 boom, the key disequilibrating forces were the high rate of inventory accumulation

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1/ The Japanese fiscal year ends on March 31. Fiscal year 1956-57 is normally referred to as fiscal 1956.

and increased investment demand for plant and equipment. International reserves began to decline early in the year and the authorities instituted their strongest restraints in May of 1957.

Probably the major factor contributing to imbalance in the 1961 boom was the very high rate of capital investment. Consumption demand increased, but only about half as much as investment in plant and equipment, and inventory investment was not of major importance. Reflecting these developments, imports rose sharply in 1961 reinforced by a proportionately steep rise in machinery imports. High levels of investment and consumption demand also appear to have discouraged exports, which remained relatively stagnant in 1961 despite economic recovery in the U.S. and relatively strong demand conditions in Europe.

Various data can be cited in support of the generalizations regarding 1960-61. It is estimated that GNP for fiscal 1961 will rise 14 per cent at current market prices over fiscal 1960. Consumption demand is expected to increase 14 per cent, and plant and equipment investment 25 per cent, with little net change in inventories. Trade data indicate that total commodity imports in the first nine months of 1961 were up 26 per cent from the same period a year earlier. Most import groups were up one-fourth to one-third, but machinery imports rose 51 per cent. Of the \$893 million rise in imports, machinery accounted for one-sixth of the rise.

One possible explanation for the sharp increase in capital investment is that with the slow rate of import liberalization, businessmen have not been under strong pressure to pass on productivity gains to buyers by way of lower prices. In recent years, there have been marked gains in productivity which have swelled profits. Real wages have lagged behind productivity gains and prices have not been lowered. The high profits have been plowed back into plant and equipment investment. It is possible that with more price competition from abroad as a result of increased liberalization, the productivity gains might have been reflected more in lower prices and less in increased investment in plant and equipment.

As might be expected, the primary causes of disequilibrium in the last three boom periods were different. In the 1952-53 boom, increases in domestic consumption and investment demand were important. In 1956-57, the high rate of inventory accumulation played an important role, probably more so than the increased capital investment. During the 1961 boom, the high rate of capital investment has been the main disequilibrating factor, with higher consumption demand also contributing to imbalance.

### Stabilizing measures and their effects

The 1953 boom--In the 1953 boom, the main tightening measures consisted of a raising of central bank penalty discount rates, a shortening of maximum maturity period for foreign exchange import bills, budgetary restraints, and an appeal to commercial bankers for voluntary restriction of credit. This combination of actions proved effective.

With regard to the details of these measures, the cost of credit accommodation from the Bank of Japan was raised by changing the level at which higher discount rates became effective. Commercial banks in Japan have complex credit quotas for borrowing from the Bank of Japan based on their previous borrowing, the amount of their capital and deposits, and other items. Prior to October 1, 1953, a discount rate ranging from 5.84 to 6.57 per cent was applied to banks borrowing up to 15 per cent of their quota; rates of 6.93 to 7.30 per cent applied to borrowing ranging from 15 to 100 per cent of quota; and for borrowing in excess of 100 per cent of quota, the rates ranged from 7.665 to 9.125 per cent. Effective October 1, 1953, the interest rates were left the same but the ceiling quota of each category was cut 60 per cent, e.g., borrowing in excess of 40 per cent rather than 100 per cent were charged the maximum rates of interest. On December 25, 1953, the top rates of 7.665 to 9.125 per cent were applied to borrowing in excess of 30 per cent of quota instead of 40 per cent. The acceptable types of collateral for central bank credit were also reduced in number. As a result of these steps, the average interest rate on Bank of Japan loans and discounts rose from 6.42 per cent in June 1953 to 7.90 per cent in June 1954.

Other measures of economic restraint included: (1) a shortening of the maturity period and an increase in the interest rate for certain import bills; (2) an elimination of the special low interest rate extended on foreign currency loans for key import materials; (3) an agreement by bankers to voluntarily restrict credit; and (4) a restriction of government operations. The latter included the transfer of government deposits to the Bank of Japan in September of 1953, a general cut-back in government expenditures near the end of 1953, a delaying of government outpayments in early 1954, and the introduction of an austerity budget in the spring of 1954.

The above measures affected soonest imports and prices, and more slowly, inventory trends and international reserves. Dating the measures of economic restraint from October 1953, seasonally adjusted imports began to decline three months later in January 1954 and wholesale prices also reached a peak in the same month. 2/ Exports also began a new upward surge in January which continued until mid-1957. The trade deficit was sharply reduced in the second quarter of 1954 and the international reserve drain stopped after May 1954, eight months after the October measures. Production, which had been rising in 1952 and 1953, reached a peak in March of 1954, five months after the October measures, and dropped only 7 per cent in the following five months before starting on a long uptrend beginning in September 1954. 3/ Raw materials inventories also reached a peak in April 1954, six months after the October measures, and declined until May 1955.

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2/ See the seasonally adjusted data in Chart Book of Financial and Business Statistics of Japanese Economic Indicators (In Japanese), published by the Bank of Japan in August 1961.

3/ Trends based on seasonally adjusted index for manufacturing, mining and utility sectors combined.

The 1956-57 boom--Beginning in the third quarter of 1956, there were indications of economic imbalance, but these signs did not lead to decisive action until about nine months later in May of 1957. Imports began to increase at a much faster rate than earlier, and the trade deficit, as measured by seasonally adjusted customs data, more than doubled. The deficits rose from about \$30-\$40 million monthly during 1955 and the first half of 1956, to \$80-\$100 million in the last half of 1956.

Despite these developments, the authorities delayed in taking strong restraining measures, even though international reserves had been declining sharply since the end of 1956. On March 20, 1957, the Bank of Japan raised its discount rate from 7.3 to 7.665 per cent and at the same time, the two penalty discount rates were consolidated into one (1.095 percentage points above the basic discount rate). However, the quota limits within which banks are allowed to borrow at the minimum discount rate, were raised, and this action substantially nullified the increase in the discount rate. It was not until May 8, 1957, that an effective increase in the Bank of Japan lending rates was adopted. On that date, the rate was increased to 8.395 per cent, the highest level since 1901. The Bank of Japan also restricted its credit accommodation to individual banks with a resultant rationing of credit. The discount rate for export bills was left unchanged. On May 13, the commercial banks also raised their effective lending rates. In June, the Bank of Japan asked commercial banks to reduce their new loans for the month to half of the amount planned and took steps to curtail the issuance of import letters of credit. In July, banks were asked to restrict their loans to the amounts repaid. Also in July, the interest rates on bank deposits and corporate debentures were raised, and the financial and business sectors were asked to reduce financing for non-essential construction.

On the import side, the maximum maturity period for certain classes of import trade acceptances, including sterling usance credits, was shortened in May 1957 and the list of import items eligible for such credits was reduced. Early in June, advance import deposit requirements were increased, and it was required that the deposits be held by the Bank of Japan. To encourage an expansion of exports, the discount rate for export bills was lowered on June 19 and the scope of the foreign exchange retention quota system was also broadened. On June 20 the import deposit requirements were further tightened.

Beginning in May 1957, the Ministry of Finance began to transfer sizable amounts of its foreign exchange holdings in commercial banks to the Bank of Japan. Efforts were also made to convert the current budget deficit for fiscal 1957 to a budget surplus by cutting back public works expenditures 8.5 per cent and public investment lending 15 per cent. To further reduce liquidity in the economy, the Government Trust Fund sold ¥70 million in bonds.

Compared with 1953-1954, the 1957 measures of economic restraint appear, in general, to have taken effect sooner. Imports began a very sharp decline in June 1957, one month after the strong measures of restraint in May. Exports did not turn up until August of 1958, but imports fell so rapidly that the drain in international reserves was halted in four months in 1957 compared to seven months in the previous cycle. This, however, was due to seasonal

factors, the Japanese trade balance being seasonally stronger in the second half of the year. On a seasonally adjusted basis, it was not until November 1957, seven months after the tightening measures were adopted, that the trade deficit was cut back to the \$50 to \$60 million range that is tolerable for Japan. The index of industrial activity began to decline in the month following the May 1957 measures compared to a five-month period after the October 1953 measures. Wholesale prices, which began to decline three months after the October 1953 measures, turned down four months prior to the May 1957 measures. In both the 1953 and 1957 booms, inventories of raw materials began to decline six months after the measures of economic restraint.

The 1961 boom--Just as in the 1956-57 boom, the Japanese were slow to take strong corrective measures in the latest boom, even though there were strong indications of economic imbalance a half year or more before the measures. By early 1961, it was evident that the trade deficit was becoming unsustainably large. From an average monthly deficit of \$39 million in the last half of 1960, as calculated on a seasonally adjusted basis, the deficit rose to \$103 million in February of 1961. The deficit from the fourth quarter of 1960 to the first quarter of 1961, on a monthly basis, jumped from \$42 million to \$76 million and continued to worsen steadily thereafter to a rate of \$186 million in the fourth quarter of 1961. This deterioration on trade account was largely masked by a substantial net short-term capital inflow. After April 1961, even this sizable foreign borrowing was insufficient to cover the deficit on current account and international reserves began to decline.

In July 1961, the authorities attempted to tighten somewhat by asking commercial banks to cut back by 10 per cent their planned loans for plant and equipment investment during the current fiscal year, and by tightening the system of voluntary controls on commercial bank lending rates. Also, on July 22, the Bank of Japan's discount rate was increased from 6.570 to 6.935 per cent, and the rate on export trade bills was reduced from 4.745 to 4.380 per cent. Earlier on June 6 the maximum maturity period for export acceptance credits had been extended by two months.

By September 1961, it was clear that additional measures were needed and several steps were taken. On September 1, a new export promotion program was put into effect. On September 18, advance import deposit requirements were increased by various amounts up to 35 per cent of import value. The discount rate was raised again on September 29 to 7.3 per cent. The penalty discount rate system was changed, with banks being required to pay rates 1.5 and 2.2 percentage points above the basic rate, depending on the amount of borrowing, instead of the previous single penalty rate of 1.1 percentage points. Commercial bank reserve requirements, which are relatively low in Japan, were roughly doubled for the larger banks on the first of October. The Government also announced that it would restrict its outpayments by eliminating or slowing down some expenditures.

#### An assessment of the 1961 measures

It is difficult to compare directly the degree of tightness of the latest measures with those in 1953 and 1957. This time a new measure has been used, namely reserve requirements. These requirements are very low, ranging up to only 3 per cent of deposit liabilities, but since the large city banks

are usually in debt to the Bank of Japan, the approximate doubling of the requirements probably caused a sizable increase in borrowing from the Bank of Japan. In other respects, the 1961 actions appear weaker than in 1957 since the maximum maturity period for import acceptance credits was not shortened as in 1957, and the basic discount rate was not increased to as high a level in 1961 as in 1957. Also, bank deposit and corporate debenture interest rates were not increased as in 1957.

From a structural viewpoint, the 1961 measures will undoubtedly tend to work more slowly than in 1957. This is because the basic causes of the current boom lie in high investment and consumer spending, rather than in a substantial buildup of inventories, the latter generally being more amenable to corrective measures.

Current data confirm that there has been a slower rate of adjustment than in the previous two cycles. Since November of 1961, the index of industrial activity, seasonally adjusted, has levelled off at best and through February there were no clear signs of a marked downtrend. The rate of bank note and commercial bank credit expansion has slowed somewhat, compared to a year earlier. Wholesale prices dropped mildly between September 1961 and January 1962, and the trade deficit has also narrowed. From a monthly rate of \$186 million in the fourth quarter of 1961, the deficit, seasonally adjusted, narrowed to a monthly rate of \$118 million in the first two months of 1962.

However, much more progress than this must be made if Japan is to restore equilibrium to its balance of payments. An essential element in the restoration of equilibrium and continued growth in the Japanese economy will be a sustained pickup in exports. Turning to fundamentals for a moment, Japan's export outlook depends basically upon the state of world markets, the competitiveness of Japanese prices, and the degree of effort put into exporting, as against selling in its domestic market. Measures of monetary and fiscal restraint are highly important in influencing the last two, namely the competitiveness and volume of exports.

Subsequent to the measures of economic restraint imposed in October of 1953, seasonally adjusted wholesale prices dropped 5 per cent between January 1954 and November 1955. Export prices declined 8 per cent from October 1953 to September 1954. These tightening measures undoubtedly dampened domestic demand and contributed to the sharp rise in exports which began in 1953 and continued for several years.

Similar downward adjustments also occurred during the 1957-58 recession. Wholesale prices dropped 9 per cent between January 1957 and October 1958 and export prices fell off 15 per cent between December 1956 and October 1958. The 1957-58 response in exports was less clear than in 1953-54, but compared to other exporting countries, and in view of the general slump in world trade in 1958, the Japanese performance was relatively good. Exports continued to rise rapidly in 1959 and 1960.

Price adjustments since the September 1961 measures of restraint have been relatively mild. From September 1961 to February 1962, wholesale prices declined only 1.5 per cent and from August 1961 (also a peak month), to January 1962, export prices dropped only 2.8 per cent. Seasonally adjusted exports were up 2.7 per cent in January-February of 1962 compared to the fourth quarter of 1961.

The narrowing in the trade deficit between October 1961 and February 1962 has been due primarily to a decline in imports. During this period, seasonally adjusted imports dropped 15 per cent. Beginning in January 1962, international reserves began to rise and in the first two months of the year were up \$28 million to \$1,514 million.

The primary element in the recent modest increase in reserves, however, has been Japan's substantial foreign short-term borrowing. In November, Japan arranged a \$200 million short-term credit from three American banks and in January an additional \$125 million credit was arranged with seven American banks. In the four months ending February 28, 1962, Japan had drawn \$213 million of these credits. Japan has also increased other foreign short-term liabilities in recent months, including Euro-dollar deposit liabilities and acceptance credits. Except for these credits, Japanese reserves would have continued to decline.

In conclusion, it can be said that Japan is moving in the right direction in restoring economic equilibrium. However, the pace is quite slow and it is by no means certain that the past measures have been strong enough to slow domestic production to the point where import demands will not continue to cause a wide gap in the trade balance. From the current annual rate of \$1.4 billion, the trade gap will have to be reduced to about \$600 million a year if fundamental balance is to be restored. If this goal is not approached in the coming months, further additional measures of restraint will be necessary.