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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

October 4, 1965

Recent Economic Developments in Japan,
July-September 1965

10 pages

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Summary

Japanese industrial production in the June-August period, seasonally adjusted, was at about the same level as the highs reached late last year. The gap in unused productive facilities tended to narrow slightly during the second quarter.

The rate of business sales and profits continued to slacken during the second and third quarter, according to preliminary estimates. Inventories have remained at high levels, and money wages have increased at a faster rate than productivity gains. New orders for machinery slowed down during the first half of the year. Bankruptcies in July and August, however, were down from earlier levels.

There has also been a slackening in the rate of credit and monetary expansion. Interest rates generally eased through early September, increasing the competitiveness of domestic financing with foreign sources of short-term credit.

Wholesale and consumer prices leveled-off during the summer. Beginning about mid-July, stock prices began to recover, rising 25 per cent by mid-September over the low for the year in July. Part of this recovery has been attributed to a stimulative fiscal program announced by the Government in late July.

Increasing surpluses on trade account, due to buoyant exports, helped offset part of the net outflows on capital account during

April-July, and in August and September international reserves began to rise again. Foreign borrowing plans were curtailed during the third quarter, largely because of the higher cost of borrowing in the United States and Germany.

Industrial Production Remains Relatively Level

Industrial production in recent months has remained at about the same level as late last year. The average for June-August was at about the same level as during the fourth quarter of last year and the first quarter of this year. According to preliminary data, industrial production fell 2 per cent in August, bringing the index to a level only 3 per cent above that of a year earlier. In contrast, production in August of 1964 was 14 per cent higher than the level a year earlier.

Compared to Japan's two previous economic cycles, economic recovery has been relatively slow in materializing since the relaxation of monetary policy beginning last December. In the last cycle in 1962-63, industrial production began to increase only three months after monetary policy was relaxed, and in 1958 the lag was only one month.

There was a slight narrowing in the gap in unused productive facilities in the second quarter of this year. The ratio of output to productive capacity rose very slightly (0.3 per cent) between the first and second quarters. This contrasts with a decline of 2.6 per cent in the ratio between the two previous quarters.

Business Continuing Process of Adjustment

Business operations in the second and third quarters this year lagged behind earlier levels. A survey of 340 major firms in all industries indicated that sales rose only 1 to 2 per cent during the April-September period this year over the previous six months, compared to a rise of 6 per cent in the October 1964-March 1965 period. Profits were off 7 per cent, in contrast to a drop of only 2 per cent in the previous six months. The ratios of profits to sales, and profits to paid-up capital, also declined in the April-September period compared to six months earlier.

Money wages continued to rise faster than productivity gains. In May, wages in the manufacturing field were up 9 per cent over a year earlier in contrast to a rise of only 6 per cent in labor productivity.

Business inventories have generally remained at high levels with only very mild adjustments in response to last year's tight money policy. Producers' inventories of finished goods reached a peak in January, dipped mildly through April, and by July were only 1 per cent below last January's peak. Inventories of raw materials eased moderately from a peak at mid-1964 to a low in March of this year, but by July had moved up 3 per cent.

In line with the slower rate of capital investment forecast for this year, new orders for machinery have been slackening. Official government forecasts indicate that investment in producers' durable goods will increase only 6 per cent during the current fiscal year

(April 1965-March 1966) in contrast to a rate of 12 per cent during the past fiscal year. New orders for machinery eased during the first half of this year, and in June the level of outstanding orders was down 4 per cent from last December's peak.

Business bankruptcies eased somewhat in July and August compared to the second quarter. For firms with debts exceeding ¥10 million ($27,778), the number of bankruptcies fell to 491 and 506 in July and August, respectively, compared to a monthly average of 520 in the second quarter, and a peak last December of 596.

Credit and Monetary Expansion Slacken

In spite of the relaxation in monetary policy early this year, bank credit expansion continued to slacken steadily through July. Seasonally adjusted loans and discounts in July were up 14 per cent over the level a year earlier, in contrast to a rate of 15 per cent in January and 19 per cent last October. During the last cycle in 1962-63, bank credit expansion increased from an annual rate of 16 per cent at the time of monetary relaxation to 23 per cent six months later.

After accelerating moderately in the first quarter of this year, monetary expansion slackened slightly in the second quarter. Compared to the level a year earlier, money supply in the second quarter rose at an annual rate of 15 per cent, in contrast to a rate of 16 per cent in the first quarter, and 13 per cent in the fourth quarter of last year.

Interest rates continued to ease during the third quarter following three reductions in the Bank of Japan's basic discount rate during the first half of the year. On June 26 the rate was lowered to 5.475 per cent, which is the lowest rate since 1951 and is 1.095 percentage points below the latest peak of 6.57 per cent effective prior to January 9 of this year. The average interest rate on bank loans and discounts continued to decline through July, reaching a level of 7.78 per cent in contrast to last December's peak of 7.99 per cent. Call loan rates have also declined steadily, and during September the average rate for unconditional call money (repayable at a day's notice) was 6.205 per cent, compared to 6.94 per cent in June and 11.315 per cent last December.

The decline in interest rates in recent months has increased the competitiveness of domestic acceptance financing vis-á-vis foreign sources of trade financing. Adjusting for differences in maturities between Japan and overseas, the Japanese rates of 6.94 to 7.30 per cent are at the same level as the 7.0 per cent rate on four-month foreign acceptances based on letters of credit. Bank of Japan officials have expressed some concern that if domestic sources of financing become increasingly attractive, the country may be subject to possible losses in foreign exchange reserves.

Prices have been relatively stable in recent months. Seasonally adjusted wholesale prices in August were at about the same level as in May, but up about 1 per cent from the level a year earlier. After rising fairly steadily in recent years, consumer prices leveled-off in the April-August period, but the August index was still 7 per cent above the level a year earlier.

In line with the earlier measures to relax monetary policy, the Bank of Japan on July 16 lowered commercial bank reserve requirements. Demand deposit requirements were reduced from 1.5 to either 1.0 or 0.5 per cent for large banks, and from .75 to .50 per cent for other financial institutions. Time deposit requirements were cut from .50 to .25 per cent, but only for small- and medium-sized banks. In addition to generally easing monetary restraints, this move was reportedly taken in order to help bolster bank earnings, particularly those of medium- and small-sized banks that have been hurt by the fall in interest rates.

Later in the month on July 27 the Government announced that new budgetary measures would be undertaken in order to boost lagging demand and to dispel some of the current "recession mood." These measures include:

1. Increasing the loan and investment budget for the current fiscal year by $556 million to $5.1 billion;

2. Restoring about 85 per cent of an earlier postponement of $278 million in budget expenditures;

3. Speeding up disbursements of certain expenditures during the current fiscal year;

4. Reducing the lending rate of three governmental financial institutions by 0.3 of a percentage point; and

5. Deciding to float bonds to finance a deficit in the general account budget (as distinct from the loans and investment budget) for the next fiscal year beginning in April of 1966.

The last step represents a major departure from the policy followed since 1949 of balancing the general account budget, and it will require special legislation.

After reaching a low for the year on July 12, the stock market staged a recovery in July, August and early September. The stock average rose from ¥1,020 on July 12 to ¥1,277 on September 9 or by 25 per cent. During the rest of September the average remained at a high level. The recent recovery in stock prices has been attributed to a series of stimulative fiscal measures announced by the Government and to the relative attractiveness of stocks and bonds in view of the decline in call loan money rates. Pre-maturity redemptions of investment trust shares eased after mid-year, falling from ¥66 billion in June--a high for the year--to ¥52 billion in July.

Rising Exports Partly Offset Capital Outflow

In spite of a very good trade performance, Japan lost international reserves during the April-July period. This stemmed mainly from substantial net payments on capital account and also a moderate, but steady, rise in net payments for services. During August-September, the downtrend in reserves was reversed with a rise of $19 million, largely due to an increased surplus on trade account.

Seasonally adjusted exports (customs basis) continued to rise substantially in the July-August period and were one-third higher than the level a year earlier. Imports, on the other hand, were up only 6 per cent for the same period. Measured on an exchange transactions basis, the trade surplus continued to increase, the monthly average being $163 million in July-August compared to $85 million in the second quarter. The deficit on services account also continued to rise through June and in the second quarter the average monthly deficit was $58 million. During the July-August period, however, the average monthly deficit eased slightly to $55 million. The monthly surplus on current account averaged $108 million in July-August, higher than the average monthly surplus of $27 million in the second quarter and the average surplus of $51 million in the fourth quarter of last year.

Net capital outflows continued high through August due to larger net payments of both long-term and short-term capital. Net long-term transactions have generally been negative since March of this year, reflecting both lower receipts and higher payments. Short-term capital transactions have generally been negative since February, partly as a result of rising export acceptance credits and slackening import credits. During July-August, net monthly capital payments averaged $93 million compared to $54 million in the second quarter. Some of the factors contributing to the capital outflow, in addition to the one mentioned above, include increasing caution overseas in extending credit to Japan, lower interest rates in Japan, tighter conditions in international capital markets, and the impact from the U.S. program for voluntary restraint of foreign credit.

As a result of these developments, international reserves fell from a peak of $2,053 million at the end of March to $1,950 million at the end of July. During August-September, reserves increased $19 million to a level of $1,969 million. The upturn in the last two months reflects mainly the increased surplus on trade account.

Japanese borrowing in the U.S. remained generally slack in recent months. Short-term claims on Japan reported by U.S. banks were $2,822 million (preliminary) at the end of July, off about $50 million from the peak at mid-year, but up only $20 million from the level at the end of 1964. Long-term claims increased $53 million in January-May of this year to $483 million and remained at that level through July. Japan floated two bond issues in the U.S. this year, one for $22.5 million in April and another for $20 million in June, but it now appears that Japan will not be able to issue the full $100 million in bonds which the U.S. has exempted from the Interest Equalization Tax. A proposed DM200 million ($50 million) bond issue in Germany has been postponed, reportedly because of the currently high rates of interest in the German market.

Japan suffered a moderate loss in Euro-dollars during the late spring, but by the end of August had regained part of this. Maximum authorized rates on Euro-dollar deposits have been reduced in recent months, and by mid-September were substantially below the previous highs at the end of May.

With the improved performance on trade account, Japanese authorities now expect a current account surplus of about $700 million which will more than offset an expected deficit of $400 million on capital account for the current fiscal year ending in March 1966. During the balance of 1966 it appears likely that a less buoyant trade account may be matched in part by a decrease in the net capital outflow.

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