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Recent Economic Developments in Japan:  
January-March 1966

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Recent Economic Developments in Japan, January-March 1966Summary

Industrial production rose substantially in December-January, and machinery orders, as well as producers' shipments, have continued to rise. Stock prices have increased about 50 per cent since the five-year low reached last July. But there has been relatively little downward adjustment in inventories or domestic prices. While consumer prices have been relatively level in recent months, wholesale prices have moved up rather sharply. This latter development may reflect an acceleration in monetary expansion. On the other hand, there has not been an acceleration in bank credit expansion in spite of lower interest rates and generally easy credit conditions. As a result of these developments, Japanese officials have now stated publicly that they believe economic recovery is underway.

The Government is relying heavily on its fiscal operations to sustain the recovery. The first national government bonds in 16 years were issued in January to finance the expected deficit in the general account budget. More bonds were issued in February and March, and still more are scheduled to be issued in fiscal 1966 which begins April 1, 1966. The government's budget for fiscal 1966 calls for the largest tax cut in the postwar period and an acceleration of government expenditures.

These, and other measures, are expected to contribute to an increase of 7 per cent in Japan's real GNP during fiscal 1966 in contrast to an estimated rise of 2.7 per cent in fiscal 1965. A rise of 8 per cent in industrial production is forecast for fiscal 1966 compared to an estimated increase of 2.4 per cent in the current fiscal year.

Developments have been favorable in the international sector, mainly because of the export boom last year. Slack demand conditions domestically helped to boost exports substantially. There are some signs, however, of a slackening in the rate of export expansion. International reserves have generally been rising since last July in spite of net capital outflows and heavy payments for services. Japanese borrowing in the United States, as reported by U.S. banks, declined during the last half of last year, the decrease in the level outstanding being 4.7 per cent. Although interest rate differentials have narrowed between Japan and the U.S., there has not yet been any significant shift toward increased domestic borrowing in Japan for financing international transactions.

Signs that Economic Recovery is Underway in Japan

On March 1 Japan's Minister of Finance stated publicly that "business is definitely on the way to recovery" and that the pick-up started in December. The Government's Economic Planning Agency also

made a similar announcement on the same date. The rise in economic activity is expected to be gradual, however, The Finance Minister stated that it would be several years before full recovery could be achieved.

A number of statistical indicators support the view that Japan may finally be experiencing the beginning of an upswing after a year of stagnation. Most importantly, industrial production (seasonally adjusted) rose 1 per cent in December and a further 3 per cent in January to a new postwar high. The January level is 4.5 per cent above the high reached in December 1964 just before industrial production leveled-off in 1965.

Other signs of recovery include a rise in machinery orders and producers' shipments.

The level of outstanding orders for machinery (seasonally adjusted) rose steadily from July through November, the latest month for which data are available. This indicator had declined during the first half of 1965.

Producers' shipments (seasonally adjusted) began to rise in September, after a year of little change. By the end of the year they were up 3.6 per cent over the August level.

Inventories of raw materials continued to remain relatively unchanged during the last half of 1965, but inventories of producers' finished goods rose 3.4 per cent in the April-December period last

year following a moderate dip in the first quarter.

The Government currently estimates that real GNP will have risen 2.7 per cent in the fiscal year ending March 31, 1966. This is the second lowest gain in the postwar period, and it is well below the 7.5 per cent predicted a year ago by the Economic Planning Agency. E.P.A. is again forecasting a gain of 7.5 per cent in real GNP in fiscal 1966, i.e. the year beginning April 1, 1966. Most of the gain will be in personal consumption and government spending. Virtually no increase in equipment investment is expected. Personal consumption is expected to rise 11 per cent, the same as in the previous year. Government expenditures and residential construction are slated to rise 15 and 26 per cent, respectively.

The Government forecast of an 8 per cent gain in industrial production in fiscal 1966 is relatively conservative if a recovery is really underway. The forecast on wholesale prices, however, may be too low. During fiscal 1966, the wholesale price index is expected to average 102.9 per cent, an annual gain of 0.7 per cent. However, the index was already up to 105.3, in February of this year, one month before the beginning of fiscal 1966.

#### Recent and Proposed Stimulative Measures

The Japanese Government has decided to abandon its policy of balanced budgets in an effort to stimulate economic recovery. The

general account budget, as approved by the cabinet, incorporates an 18 per cent boost in expenditures for fiscal 1966 (as against a 12 per cent increase a year earlier), and the investment budget a 25 per cent increase (compared to 21 per cent a year earlier). At the same time, the Government is proposing to institute in fiscal 1966 the largest tax cut in the postwar period. This is expected to reduce revenues by ¥206 billion in fiscal 1966 and ¥306 billion in the following years. The proposed reduction in the corporate income tax rate is from 37 to 35 per cent for income over ¥3 million and from 31 to 28 per cent for income under ¥3 billion. Personal income tax rates are also to be reduced.

The combination of increased expenditures and reduced revenues will produce an estimated budget deficit of ¥730 billion (\$2 billion), which is to be financed in large part by the flotation of seven-year bonds. The bond flotations were actually begun in January of this year.

National long-term bonds totaling ¥70 billion (\$194 million) were successfully offered late in January with the city and long-term credit banks underwriting 51.5 per cent of the total. Provincial banks subscribed to 20.5 per cent, securities companies to 10.0 per cent, and other financial institutions to the remaining 18 per cent. Only the ¥7 billion subscribed by the securities companies, however, will be offered to the general public. The seven-year bonds carried a coupon

rate of 6.5 per cent and were priced to yield 6.795 per cent to maturity. This is about 0.36 percentage points higher than the recently quoted average yields on other issues of national long-term government bonds.

Additional bonds were also successfully issued in February and March, but the amounts sold to private financial institutions were reduced about ¥10 billion below the originally scheduled figure because tax receipts were larger than expected. Of the ¥260 billion in total bond flotations originally scheduled for the first quarter of this year, ¥140 billion will be subscribed by the Government's Trust Fund Bureau. For fiscal 1966, an additional ¥700 billion in national bonds is expected to be offered.

#### Monetary Expansion Accelerates

There are signs that the stimulative measures, some taken as early as December 1964, are leading to a faster rate of monetary expansion. Money supply, seasonally adjusted, increased at a fairly steady rate of about 16 per cent over the level a year earlier through August of last year, but during the September-December period the rate increased to 18 per cent. Commercial bank credit grew by a steady 14 per cent per annum through December of 1965. Commercial bank reserve requirements were lowered in late 1964, and the Bank of Japan's basic discount rate was reduced three times in 1965, in January, April, and June.

Bank of Japan credit on a net basis was expansionary in 1965. Most of the expansion in 1965 was due to a large increase in loans and discounts, which was offset about 90 per cent by net sales of securities. In 1964 the Bank of Japan both reduced its loans and discounts, and sold securities.

Recently, in December-January, Bank of Japan credit expanded substantially, but was approximately offset by net treasury receipts and an increase in bank notes in circulation. In general, money and capital market conditions have remained easy as bank credit has continued to expand at a rapid rate.

The increased rate of monetary expansion last year may have contributed to the recent rise in wholesale prices. Consumer prices remained relatively stable from September 1965 through January 1966. For the twelve-month period through January, however, consumer prices rose 4.9 per cent compared to 6.4 per cent a year earlier. Domestic wholesale prices have been rising since a low in mid-1965 and in February were up 3.7 per cent. Most of the rise was due to increases in prices of foodstuffs, non-ferrous metals and timber products. Export prices in 1965 were down less than 1 per cent from the level a year earlier but import prices decreased 2.5 per cent.

#### Interest Rates Decline and Stock Market Rises

The policy of credit ease and monetary expansion has contributed to a decline in the general level of interest rates in

Japan. The average interest rate on commercial bank loans and advances declined during 1965, and in January was 7.58 per cent, in contrast to the previous peak of 7.99 per cent at the end of 1964. Call loan rates fell sharply during the January-September period last year, but have generally remained unchanged at a low level since last October. The average rate for long-term bank credits declined from about 9.0 per cent at the end of 1964 to 8.5 per cent in January of this year.

Following the increase in the Federal Reserve discount rate last December, Japanese foreign exchange banks increased the rate on dollar acceptance credits by a series of three steps from 7.0 to 7.5 per cent in the December-February period. Because of the relatively low domestic interest rates in Japan and the increasing cost of foreign credits, Japanese domestic sources of financing have become increasingly competitive with foreign sources. The Japanese authorities would like to avoid a sudden shift to domestic sources as this would create downward pressures on their international reserves and possibly result in the loss of certain foreign lines of credit. To discourage such switching, the Japanese authorities in January temporarily suspended the preferential arrangement for import financing known as the "import bill system." Under this arrangement import credit had been made available to Japanese foreign exchange banks by the Bank of Japan at 5.84 per cent with a maximum two-month maturity.

The lower level of interest rates appears to be one of the factors that has increased the relative attractiveness of stocks. Since a five-year low last July, the Dow-Jones stock average has risen substantially and on March 14 was 50 per cent higher than last year's low. As a result of the recovery in the stock market, some of the stock that was purchased in recent years by the special-support buying agencies has been unloaded in the market.

Despite the stock market recovery, the number of business failures of firms with debts in excess of ¥10 million increased in the fourth quarter of last year to 549. Although the figure represents a new quarterly high, the amount of debts involved (¥44 billion) was substantially below the peak reached in the same period a year earlier (¥64 billion).

#### Balance-of-Payments Performance Generally Favorable

Japanese balance-of-payments developments have been relatively favorable since mid-1965 because of an outstanding export performance. Since the end of July, international reserves have generally increased and at the end of February were up \$129 million to a level of \$2,109 million. Due to a 27 per cent rise in exports and a modest rise of 3 per cent in imports last year, Japan had a trade surplus of \$292 million (customs basis), the first such surplus in 23 years. In contrast, the trade deficit in 1964 was \$1,265 million.

Contrary to expectations, there was a large net outflow on long-term capital account last year. Measured on an exchange transactions basis, the net outflow was \$155 million, the first such net outflow since 1959. There was also a net outflow of short-term capital last year totaling \$392 million and, as usual, an increase in the net payments for services. Despite these three negative factors, the trade surplus was so large that the overall balance of payments registered a surplus of \$98 million in 1965.

The net long-term capital outflow continued in January, but seasonal developments strongly influenced the developments in other accounts, and international reserves fell \$25 million. The seasonal inflow of short-term capital was approximately offset by the seasonally heavy net payments on current account.

It appears unlikely that Japan will be able to repeat in 1966 the excellent export performance of 1965. During the last four months of 1965, exports (seasonally adjusted) declined. Exports rose sharply in January, partly due to the termination of a seaman's strike, but then receded to a lower level in February. The January-February average was 7 per cent above the peak level reached during the third quarter last year. Imports have edged up since last July and in January-February were 5 per cent above the high reached in the fourth quarter last year.

The Japanese Government is forecasting an 11 and 9 per cent rise in exports and imports in fiscal 1966, respectively. This is about the same forecast made a year ago, and it may be no more accurate. It appears that in fiscal 1965 exports actually rose 20 per cent and imports only 5 per cent.

Net payments for services are expected to rise by \$200 million, but the net capital outflow is slated to fall \$100 million to a total of \$500 million. Over-all, a gain in reserves of \$400 million in fiscal 1966 is forecast.

Since mid-1965 there has been a decline in Japanese borrowing from the United States. Short-term claims on Japan reported by U.S. banks fell \$125 million in the last half of 1965 to a level of \$2,746 million (preliminary). Long-term claims also decreased after May, and were down \$38 million by the end of the year to \$445 million. Japan issued \$62.5 million in new long-term bonds in the U.S. last year, not taking advantage of all of the \$100 million exemption from the Interest Equalization Tax that the U.S. agreed to allow for Japanese bond issues. The Japanese Government was concerned about the fact that the full \$100 million exemption was not used, but the cost of borrowing in New York was found to be too high to justify more flotations. Japan expects to place a \$15 million issue by the Nippon Telegraph and Telephone Public Corporation in March of this year. For fiscal 1966, Japan has scheduled \$130 million

in foreign bond flotations, but there may be difficulties in achieving this targeted amount.

Since mid-1964 Japan has been able to improve its net short-term foreign position. In mid-1964, foreign short-term liabilities of \$3,213 million exceeded short-term assets of \$2,191 million by \$1,022 million. At the end of 1965, liabilities had risen moderately to \$3,452 million, but assets had increased to \$3,015 million. As a result, the net liabilities were cut almost \$300 million. This improvement reflects primarily Japan's excellent export performance as well as the slow rate of increase in imports last year.

Although rising interest rates in the United States, and relatively low interest rates in Japan, have increased the attractiveness of domestic borrowing to Japanese foreign traders, there has so far been relatively little shifting of short-term borrowing from New York to Tokyo. The Japanese report that the shift has been inhibited mainly by two factors: (1) pressure from the Japanese authorities who are concerned about the adverse effect on the Japanese balance of payments of any reduction in short-term borrowing abroad; and (2) fear on the part of Japanese borrowers that U.S. banks would reduce their credit lines if they did not fully use them. They are said to be afraid that it would be difficult to get the credit lines raised again if their need for borrowing should rise.

The changing level of interest rates in the United States and Europe has not affected substantially Japanese holdings of Euro-dollars. Various reports indicate that there has not yet been a major reversal in the Euro-dollar flow and that Japan has been able to maintain at satisfactorily levels its holdings of Euro-dollars.

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