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Recent Economic Developments in Japan,  
January-June 1968

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During the first half of 1968 Japan was remarkably successful in restoring virtual equilibrium in both the international and domestic sectors of the economy. During 1966-67 the trade account had deteriorated, leading the authorities to institute restrictive monetary and fiscal measures in September of 1967, and to tighten further these restraints in January of this year. Although the adjustment process is still continuing, the restrictive monetary policy was eased on August 7 when the Bank of Japan lowered its basic discount rate.

A Brief Pause in Industrial Production

During Japan's previous "tight money" period in 1965, industrial production leveled off with a gain of only 0.5 per cent (December-to-December) during the entire year. The pause this time will apparently be much shorter. Industrial production leveled off after December 1967 and rose only 0.7 per cent during the first quarter. In April-May, however, the seasonally adjusted index rose 5.8 per cent to a level 19 per cent higher than a year earlier.

The sharp upsurge in April-May was due both to strong final domestic demand and to a continued sharp rise in exports. Particularly substantial increases were registered in the output of durable consumer goods and construction materials. Production of fabricated metal products, rubber and leather products rose significantly.

Following a pause in mid-1967, the value of producers' inventories of finished goods this year rose less rapidly. During the January-May period the seasonally adjusted index was up 8.6 per cent as against 11.7 per cent in the previous five months. Inventories of raw materials have also been increasing less rapidly and rose 2.8 per cent in January-April as against 3.5 per cent in the previous four months. New domestic orders for machinery (excluding ships) were down 17 per cent in the first quarter of this year compared to the fourth quarter of last year, but by April-May, the volume of monthly orders was back to the fourth quarter level.

Since March there has been a decline in the number of firms with capital of ¥1.0 million (\$2,778) or more that have suspended business operations. There were 1,432 firms with liabilities outstanding of ¥47 billion that failed in March. In May the number was down to 1,274, about the same as the monthly average in the fourth quarter of last year, but the amount of liabilities had increased to ¥55 billion. During the January-May period this year, the number of business suspensions was up 12 per cent over the same period last year, but the amount of liabilities outstanding that were involved was up 66 per cent.

#### GNP Growth Rate Declines

Real GNP rose 13.3 per cent from fiscal 1966 to fiscal 1967 (year ending March 31, 1968), this increase being higher than the original forecast of 11.6 per cent. For fiscal 1968, however, the Government has forecast a rise of 8 per cent in real GNP.

A sharp rise of 33 per cent (nominal) in fixed investment (including private housing) in fiscal 1967 accounted for much of the growth. The Government has forecast an increase of only 10 per cent (in nominal terms) in plant and equipment investment in fiscal 1968.

Credit Conditions Remain Relatively Tight

Money and capital market conditions remained relatively tight during the first half of this year and interest rates tended to increase. After reaching a low of 7.28 per cent in August of 1967, the average interest rate charged by banks on loans and discounts rose steadily to 7.52 per cent in April of this year. In May the rate remained unchanged for the first time since last August's low.

Call loan rates have also increased and in June ranged from 7.67 to 9.13 per cent. Last August, just before the Bank of Japan increased its basic discount rate, the rates ranged from 6.21 to 7.30 per cent. The latest changes occurred in June when the rates for all maturities of call loans rose 0.365 percentage points.

Bank credit has been expanding at a slightly slower rate. In the fourth quarter of last year, bank loans and discounts outstanding were 15.7 per cent higher than in the same period a year earlier, but in the first quarter this year the rate fell to 14.7 per cent and in April-May it was 14.2 per cent.

The Bank of Japan increased its basic discount rate from 5.48 to 5.84 per cent on September 1, 1967, and from 5.84 to 6.21 per cent on January 6, 1968. It also imposed quarterly ceilings on the net credit

expansion of the larger banks in September of 1967. The banks in the fourth quarter of last year were limited to an aggregate expansion of only 85 per cent of the expansion which occurred in the fourth quarter of 1966. In the first quarter of this year the ratio was further reduced to 71 per cent of the expansion in the same quarter a year earlier, but for the second and third quarters this year it has been relaxed slightly to 75 per cent.

A clear move toward an easier monetary policy occurred on August 7 when the Bank of Japan reduced its basic discount rate to 5.84 per cent. At the time the Bank stated that the discount rate had been reduced because of the recent improvement in the balance of payments due mainly to an increase in exports.

#### Price Trends Mixed

In general, the monetary and fiscal restraints have slowed the increase in wholesale prices. Consumer prices in the first half of 1968, however, were rising at a slightly faster rate than in 1967.

In June wholesale prices were 1.2 per cent higher than a year earlier, while consumer prices were up 5.9 per cent. However, most of the increase in wholesale prices occurred in the last half of 1967. After reaching a peak in February, wholesale prices fell 0.8 per cent through May and then rose slightly in June. Some of the February-May decline, however, is probably seasonal.

Consumer prices have been rising steadily since mid-1967, except for a 1.5 per cent decline in June. This dip mainly reflected a seasonal decline in food prices.

### Stock Prices Recover

After declining sharply in the last half of 1967, stock prices on the Tokyo Stock Exchange began to rise in December and by July 31 had reached the highest level in five years. Between December 11, 1967, and July 31, 1968, stock prices rose 28 per cent. The Dow Jones average on July 31 was ¥1,603, which represented a new high for the year and was only slightly below the average of ¥1,504 reached on May 11, 1963.

The volume of sales on all stock exchanges rose steadily during January-May, and reached 7,012 million shares in May. This compares with an average monthly volume of 3,513 million in 1967.

One factor contributing to the upsurge in the stock market is increased purchases by foreigners. Following Japan's first step toward capital liberalization on July 1, 1967, foreigners--largely Europeans--have purchased an increasing volume of shares. In fiscal 1967 (year ending March 31, 1968), total foreign purchases were \$127 million, or almost double the amount in the preceding fiscal year. If the rate in April-May of this year is maintained, the total for fiscal 1968 may exceed the \$200 million mark. The price-earnings ratio for Japanese stocks has recently been about 10.5 to 1, making them attractive relative to the price-earnings ratios of 17 to 1 for the United States and 19 to 1 for West Germany.

With the upswing in the stock market, the Japan Securities Holding Association (a quasi-governmental stock-buying agency established in January of 1965) has used this opportunity to unload some of the shares it purchased in 1965 in a market support operation. During the second quarter at least ¥45 billion in shares were sold. This reduced the Association's holdings to

about ¥90 billion based on current prices. They had been as high as ¥230 billion in July of 1965. Indebtedness of the Association to the Bank of Japan has also been reduced to ¥80 billion, or approximately half of the original amount.

#### Balance-of-Payments Position Sharply Improved

As a result of several developments, Japan's international balance of payments registered a substantial improvement in the first half of this year compared to the first half of 1967. Although the services deficit increased, this was more than offset by a substantial improvement on trade account. A sharp improvement in the long-term capital account, stemming in part from bond issues in Europe, was matched by an approximately equal reduction in net short-term capital inflows; however, the "Errors and Omissions" item changed from a minus \$95 billion in the first half of 1967 to a plus \$115 million in the first half of this year. As a result, the overall deficit in the balance of payments was reduced from \$490 million to \$26 million between the first half of 1967 and the first half of 1968.

A major factor contributing to the improvement in the balance of payments has been the sharp rise in exports. In the first half of 1968 seasonally adjusted exports were 20 per cent higher than a year earlier and 15 per cent higher than in the second half of 1967. Exports to the United States have risen even faster, particularly exports of steel products. Japanese exports to the United States during January-April of this year, as a proportion of total exports, were 31.1 per cent as against only 27.9 per cent in the same period last year.

Seasonally adjusted imports have approximately leveled off. In the first half of this year they were only 1 per cent higher than in the last half of 1967. On a quarterly basis they have been declining slightly since the fourth quarter of last year. However, compared to the first half of 1967, imports in the first half of this year were up 12 per cent.

The net result has been a dramatic improvement in the seasonally adjusted trade balance. During the first half of 1967 the trade deficit was \$426 million, and in the second half of 1967 there was a further deterioration to \$823 million. In the first half of 1968, however, the deficit was cut sharply to \$80 million, and the seasonally adjusted trade account was in surplus in May and June.

The Japanese balance of payments has continued to benefit from American military expenditures related in part to the war in Vietnam. Most government receipts in the services account reflect U. S. military transactions. Net receipts for this account reached a low of \$308 million in 1964 but then rose, reaching \$443 and \$475 million in 1966 and 1967, respectively. In the first quarter of this year, net receipts were \$122 million, or 6 per cent higher than a year earlier.

In the capital account, a reduction in net long-term capital outflow was approximately offset by a reduction in short-term capital inflow. The net outflow of long-term capital fell from \$364 million in the first half of 1967 to \$125 million in the first half of this year. This was partly due to a sharp increase in long-term liabilities as Japan floated a substantial amount of Euro-bonds earlier this year. During January-June

of this year, Japan floated \$95 million in external bonds. Net short-term capital inflows, however, fell from \$317 million in the first half of 1967 to \$81 million in the first half of this year, partly reflecting a decrease in the level of outstanding short-term liabilities to the United States. As a result, total net capital outflows were relatively unchanged, being \$47 million in the first half of 1967 and \$44 million in the first half of 1968.

Japanese banks increased their borrowings of Euro-dollars moderately during early 1968, but the net foreign liabilities of Japanese banks increased less rapidly than a year ago. The Japanese authorities have allowed the banks to use the proceeds of Euro-dollar borrowings to repay loans from the United States, but since February of this year the proceeds of new borrowings are not supposed to be converted into yen.

International reserves last year and this year have tended to fluctuate between \$1.9 billion and \$2.1 billion. After reaching a peak of \$2,110 million in April of 1967, reserves generally declined to \$2,005 million at the end of 1967, and reached a low of \$1,694 million at the end of April of this year. In the May-July period, however, reserves rose \$178 million to a level of \$2,072 million at the end of July.

Short-term borrowing in the United States has tapered off. In April, outstanding liabilities were \$3,223, or \$507 million higher than a year earlier, but only \$69 million higher than in December of 1967. In May, moreover, there was a sharp decline as the liabilities dropped \$119 million to \$3,104 million. Outstanding long-term bank loans from the United

States, as reported by U. S. banks, have generally declined and in May were \$154 million, or \$109 million lower than a year earlier, and \$26 million lower than at the end of 1967. These trends reflect in part not only a slackening in the rate of growth of Japanese imports, but also the impact of the Federal Reserve's balance-of-payments program.

### Conclusions

From all the evidence available, Japan has evidently corrected the sharp 1965-67 deterioration in its balance of payments and again regained a sound economic position both externally and domestically. This has been accomplished in a relatively short period of about ten months, without a serious drop in production or employment.

Several factors have contributed to the sharp improvement in the balance of payments. These include the upsurge in exports to Europe and the United States, stimulated in the case of the latter by domestic inflation and the threats of both a steel strike and an import surcharge and/or border tax. In acting forcefully to cool the domestic boom, the Japanese authorities successfully stimulated increased interest in exports on the part of Japanese business. With the higher capacity created by the heavy plant and equipment investment in recent years, Japanese industry has had the resources to mount a strong export drive. They have also had a strong incentive to do so, since traditional employment practices make it difficult for Japanese firms to cut costs by curtailing employment and output in periods of slack demand. Imports have leveled off in response

to reduced credit availabilities, restrictive fiscal measures, and the higher cost of maintaining inventories.

The decision to lower the basic discount rate early in August was partly taken in response to strong pressures from the business and financial community. The authorities were impressed by both the rapid improvement in the balance of payments and the increase in the level of official reserves. The decision was therefore made to lower the rate early in August, partly on the assumption that exports to the United States would not significantly slacken during the remainder of the year.

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