Fiscal and Monetary Policies of Japan

in

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Part 1: Fiscal and Monetary Policies in the Reconstruction Years

Preface

This book treats the postwar reconstruction period as beginning in the mid-1940s. Differences in terms of the objectives of fiscal and monetary policy, the stability of political and administrative systems, and economic growth rates mandate that this period be distinguished from the "high growth" period that followed it. For our purposes, we will use the year 1955 as a general dividing line. The postwar reconstruction period was marked by the devastation of the wealth and people of Japan by the war, the need to repatriate soldiers and colonists from former territories, and the economic democratization and industrial demilitarization policies of the Supreme Commander for the Allied Powers (SCAP).

We will begin our study by dividing the postwar reconstruction period into three sub-periods: the period from the surrender to the end of 1948; the years from the enactment of the Dodge Plan in 1949 to the San Francisco peace treaty; and the period extending from the peace treaty until the mid-1950s. Political and economic conditions during each of these sub-periods will be considered in light of the general concerns and trends outlined above.

The first sub-period is characterized by policies aimed at rebuilding the economy after the war, while at the same time combating a strong inflationary bias. The Priority Production Plan and lending by the Reconstruction Finance Bank enabled a priority on reconstruction to be maintained, but shortages led to rampant inflation.

The second period begins with the highly deflationary policies of the Dodge Plan and a shift in the objectives of fiscal and monetary policy to a stress on economic stability. During this period, Japan succeeded in quelling inflation, and turned its sights to expanding private-sector trade and rejoining the international economy as soon as a formal peace treaty was in place.

The third period marks the transition to both political independence and high economic growth. It was notable for both strained public finances (in the wake of the Korean War) and sustained economic stability.

In addition to the issues outlined above, the postwar reconstruction period was distinguished by policies designed to democratize and demilitarize the economy, which were given a strong push at the insistence of SCAP. These special postwar policies generally overlap two or more of the sub-periods we have defined.

Before exploring the fiscal and monetary policies during the postwar reconstruction period, let us first survey the economic circumstances in which Japan found itself at the end of the war, its cities devastated and its troops and colonists returning home. Following that, we will look briefly at economic trends in each of the periods under consideration, before moving on to a discussion of fiscal and monetary policies.

Chapter 1 Fiscal and Monetary Policies in the Environment of Postwar Inflation

1. Political and Economic Conditions during the Period of Postwar Inflation

Between air raids and offshore shelling, the Allied forces wrought enormous damage on Japan's manufacturing and port facilities in their quest to destroy its military bases and military productive capacity. Estimates indicate that by the time the war had ended, Japan had lost 25 percent of its total assets, 80 percent of its ships, 34 percent of its industrial machinery and 24 percent of its buildings. The damage was not limited to industry: social overhead capital - ports, communications and transportation infrastructure - were also severely damaged. To this we must add the human loss. The army lost 1.14 million men to battle or disease; the navy 410,000. Air raids killed another 300,000 people. Total casualties when the wounded and missing are factored in reached 2.53 million, and probably closer to 3 million if Japanese colonists and expatriates are included.

Those who did not lose their lives often lost their livelihoods. Demilitarization policies brought 7.61 million soldiers back into the civilian population and turned 4 million workers in military industries (including 750,000 women) out of their jobs. Added to this were another 1.5 million people repatriated from former colonies.

The loss of the colonies resulted in significant shifts in the population structure as well. In 1946, the total population of 75 million included about 1.3 million former soldiers, former military workers and former colonists who required jobs. Japan was faced with the prospect of having 17 percent of its employed population suddenly out of work. Besides finding them jobs, Japan had to supply itself with sufficient food from an agricultural sector whose productivity had sharply declined. The "termination-of-the-war expenses" budget found work for many of the jobless in the businesses serving the U.S. forces or in one of the many public corporations that sprang up to control the flow of goods. But this was only a drop in the ocean, and unemployment worsened. Still, the job market was not flooded with people

seeking work. Most of the former soldiers and colonists returned to their home villages and went to work on farms. Those that stayed in the cities often went into business by themselves.

Table 1-1 War Damage to National Wealth

(In millions of yen)

Assets	Total damage	National Wealth Existing at War's End	Damage Rate
	(A)	(B)	(A/(A+B))%
Asset national wealth	64,278	188,852	25.4
Buildings	22,220	68,215	24.6
Ports, harbors and canals	132	1,632	7.5
Bridges	101	2,773	3.5
Machine tools	7,994	15,352	34.2
Railways and tracks	884	11,618	7.1
Vehicles	639	2,274	21.9
Ships	7,359	1,766	80.6
Electricity and gas supply equipment	1,618	13,313	10.8
Telegraph, telephone and broadcasting facilities	293	1,683	14.8
Waterworks	366	1,814	16.8
Furniture and other treasures	17,493	63,448	21.6
Miscellaneous goods	1,243	4,964	20.0
Nonclassifiable	3,936		
Other national wealth	1,024		
Forest roads and trees	6		
Roads	243		
Historic and beaty spots	775		
Total	65,302		

Source: Ministry of Finance, "*Showa Zaiseishi--Shusen kara Kowa made*" , Vol. 19, pp. 14-15

A large infusion of money immediately after the surrender triggered high inflation during the early postwar years. The reason for this monetary infusion was high latent demand for money during the war, which erupted when the war ended in defeat. Among the direct causes of the increase in the money supply were extraordinary military expenditures (payments to returning soldiers, prepayments to war contractors) and expenditures to indemnify for losses stemming from the closing of businesses during the war, among others. After the surrender, the decision was apparently reached that the markets would need an infusion of cash if economic

activities were to be maintained. Later, the demand for cash remained high as reconstruction commenced. Since the authorities failed to take sufficiently strong measures to deal with it, the postwar inflation continued. In 1947, active lending by the Reconstruction Finance Bank was one of the strongest money supply factors, producing the so-called "reconstruction inflation." This period before the implementation of the Dodge Plan has occasionally been summed up with the phrase "Government in the red, companies in the red, and households in the red, too." Between 1944 and 1948, in the course of the postwar inflation, average outstanding Bank of Japan notes increased 20 fold. During the same period wholesale prices rose 55.1 fold.

Defeat produced major changes in Japan's political and economic systems, many of which would not have come about - at least not so quickly - had it not been for the unusual political circumstances presented by the Occupation. These were, indeed, the most sweeping changes in the Japanese system since the Meiji Restoration. The policy-making in the first half of the Occupation concentrated on the political system. After the surrender was signed on September 2, Allied forces, led by the Americans, moved into areas throughout Japan, with SCAP Headquarters issuing orders and instructions to the Japanese government. On November 3, 1946, a new Constitution was promulgated.

Faced with inflation and food shortages, the postwar government introduced its first comprehensive economic policy - the Emergency Economic Crisis Policy - on February 16, 1946. Designed to free Japan from the punishing postwar inflation, these measures included a freeze on bank deposits, mandatory conversion to new Bank of Japan notes, asset checks, emergency food provisions, searches for concealed goods, price restrictions, job programs, incentives for higher industrial production and controls on basic household goods. This was followed by the June 11, 1947 announcement of Emergency Economic Policy. The policy objectives were to secure food supplies, establish orderly distribution of goods, reform the entire wage/price system, restore fiscal and monetary health, boost production and enhance

efficiency in targeted industries, secure jobs and livelihoods for workers, and promote exports. A reduction of the fiscal deficit also resulted, and on July 5, Japan was able to adopt a new pricing system. Despite the fact that price controls were stricter during this period than at any time in postwar Japan, however, the policy was unable to suppress inflation.

Food programs were strongly emphasized during this period. As the holding of a "Food May Day" in May 1946 illustrates, maintaining food supplies was one of the most important challenges facing the government. It had begun using the Foodstuffs Control Special Account to manage virtually all foodstuffs in the country in 1942, and this system was held over in its entirety in the postwar period. With demand high and agricultural production in decline, the government embarked on broad land reforms in an effort to boost output by giving farmers their own land to work (rather than the sharecropping that was common prior to and during the war). Farm cultivation programs, which were enacted in part to provide jobs for returning soldiers and colonists, gave land of their own to those who wanted to cultivate it, and subsidized long-term loans if they worked it. These programs were not entirely successful, however. Agricultural production continued to decline, but the population of rural villages began to swell, which combined with inflation to squeeze the food supply further.

In the end, it was assistance from the United States that covered the shortages. In 1945 the U.S. Department of the Army began to provide Government and Relief in Occupied Areas - or GARIOA - assistance. Japan also received Economic Rehabilitation in Occupied Areas - or EROA - assistance in 1948 and 1949. The GARIOA funds were spent on food, fertilizer, oil, medical supplies and other basic necessities for survival, while the EROA funds were used for raw cotton, mining, raw materials, machinery and similar reconstruction purposes. At the time, Japan was forced to rely on imports for many of its needs, and the U.S. assistance went a long way toward alleviating the domestic shortages. By the U.S. 1951 fiscal year, Japan is estimated to have received $1,577 million in GARIOA aid and $285 million

in EROA aid: a total of $1,862 million. Other U.S. statistics indicate that the United States supplied Japan with $575 million in wheat and wheat flour, $440 million in other foodstuffs, $240 million in raw cotton, $158 million in fertilizer and $143 million in oil. Until 1948 almost all of Japan's trade was conducted by the state, and during this period most imports were assistance goods. Indeed, until 1949, it was U.S. GARIOA assistance that kept Japanese imports afloat. Private-sector trade resumed in that year, however, and the volume of commercial imports rose in 1950, reducing the share of assistance in the total imports. Still, Japan was able to defer payments on the large debts it had run up with the U.S., which was in turn a major factor in its postwar economic reconstruction.

Table 1-2 Trade and Aid Import

(In thousands of US dollar)

Calendar Year	Export	Import	
			US Aid
Sep. 1945 - Dec. 1946	103,292	305,493	192,893
1947	173,567	523,562	404,433
1948	258,271	683,082	461,004
1949	509,700	904,845	534,750
1950	820,055	974,339	361,293
1951	1,354,520	2,217,377	180,341
1952	1,272,915	2,028,193	5,426

Source: Ministry of Finance, "*Showa Zaiseishi--Shusen kara Kowa made* ", Vol. 19, pp. 106-07

2. Fiscal Policies during the Period of Postwar Inflation

1) Budgeting during the Postwar Inflation Years

As soon as the Occupation began, SCAP ordered Japan to cease all payments from the Provisional Military Expenditure Special Account. In the fiscal 1945 budget, this special account was larger than the General Account representing the ordinary budget. Indeed, it dwarfed the General Account in terms of both revenues

Table1-3 General Account Budget Breakdown by Ministry and Special Military Account Budget

(In millions of yen)

Ministry	FY 1944	FY 1945	FY 1946
	Budget	Budget	Budget
Imperial Household	5	5	5
Foreign Ministry	48	48	194
Interior Ministry	1,831	1,950	8,922
Finance Ministry	13,386	19,354	84,504
Army Ministry	1	—	—
Navy Ministry	1	—	—
First Ministry for the Demobilized	—	1	—
Second Ministry for the Demobilized	—	1	—
Justice Ministry	81	109	364
Education Ministry	487	648	2,192
Agriculture and Forestry Ministry	—	—	8,370
Commerce and Industry Ministry	—	—	4,114
Agriculture and Commerce Ministry	2,228	1,723	—
Communications Ministry	—	—	252
Health and Welfare Ministry	516	639	7,249
Greater East Asia Ministry	492	605	—
Munitions Ministry	1,944	3,265	—
Transport Ministry	819	811	2,821
Total	21,838	29,157	119,087
Special Military Account Budget	63,000	85,000	

Note: The budget for the Transport Ministry in FY 1944 was a budget after supplementation for the Transport and Communications Ministry.

Source: Ministry of Finance, Budget Statistics

(from bond issues and borrowings) and expenditures (for military purposes). Most of this represented revenue transferred from the General Account and expenses

incurred by the Ministry of Military Procurements to buy weapons and other supplies. This was all part of the standard wartime budget. When the war ended, it was anticipated that many of the military expenditures budgeted for would not be necessary, while new fiscal demand would emerge: programs for former soldiers and colonists, hikes in public servants' wages to keep pace with inflation, and spending to cover deficits from the railways and the telecommunication service. Since this new spending demand had not been provided for in the initial 1945 budget, a supplementary budget was put together and passed on December 18, providing an additional ¥205 million for each of the General Account and Special Account. Also during fiscal 1945, the provisions for "Emergency fiscal disbursements" in Article 70 of the Imperial Constitution were invoked in order to fund payments from surplus revenues. These disbursements were used to cover expenditures not provided for in the original fiscal 1945 budget.

The Diet was dissolved in December 1945, and a purge of government officials delayed the general election, making it impossible to pass a budget for 1946 by the end of March. Article 71 of the Imperial Constitution provided for such a situation, stating that failure to pass a new budget would result in the re-use of the previous year's budget. This entailed problems, because 70 percent of the 1945 budget was for war-related expenditures, leaving the government with only 30 percent that it could administer, most of which had to go for debt servicing and other non-discretionary items. The Ministry of Finance (MOF) initially provided for unbudgeted expenses by drawing down its reserves, but as expenses mounted, it was forced to resort to "emergency fiscal disbursements." There were still expenses that could not be covered, however - a situation which led to the creation of a "provisional budget." Note that this provisional budget was not the same as the provisional budget described in the Public Finance Law; it was merely a name of convenience adopted by the bureaucracy. For that part of the non-military budget that could be administered, the Ministry created a "revised budget" covering the period from April to August. The initial 1946 budget was submitted to the Diet on

July 24, and it was finally passed on September 12.

This revised budget included "Economic stability expenses," which came under MOF jurisdiction. Set up at the insistence of SCAP, this account was in reality money for public works. Other new accounts under MOF administration included more than one third of the "termination-of-the-war expenses" - primarily those concerned with labor, relief and use of private facilities - which, it was hoped, would contribute to employment programs. The job issue was of particularly high priority, and speeches by the Minister of Finance on fiscal policy had very Keynesian overtones.

Thus, budgeting and budget administration up to fiscal 1946 faced a plethora of problems. Japan were still required to function under the Imperial Constitution, which was not suited to dealing with the fiscal demands of the postwar period; the budget was an extension of the wartime budgets, which were slanted heavily in favor of the military; and as if these cracks in the system were not enough, there was an inflationary spiral as well. The revised 1946 General Account budget totaled ¥ 56,088 million. Lack of funding forced the government to divert ¥ 25,587 from the Capital Levy Revenue Special Account. The major spending items were termination-of-the-war expenses, public works, coal price adjustments and food price adjustments. The supplementary budget also included new compensation funds for the reconstruction and reorganization of financial institutions.

The new Constitution took effect in May 1947. The sections concerning fiscal policy endeavored to ensure that democracy would be respected. It gave the Diet responsibility for determining how national finances are administered, and required that it approve all Treasury spending and any debt undertaken. The fiscal policy provisions of the Constitution were extended into the Public Finance Law, which took effect on March 31, 1947. This law specified single-year budgets, required that taxes and public impositions have statutory grounding, placed limits on bond issues and borrowings, placed limits on Bank of Japan borrowings, required that a ceiling on government debt be determined in the general budget provisions, required that at

least half of any surplus on the settlement of accounts be directed toward bond and debt repayment, required that asset management and administration have statutory grounding, specified the nature of provisional and supplementary budgets, and laid out the rules governing the carryover of budget surpluses to the following year's budget. The law also contained regulations on the establishment of special accounts.

One of the main thrusts of the Public Finance Law was to eliminate expenditures not made with Diet approval, a somewhat common practice under the old Accounting Law. This was in keeping with the strong budgetary authority given to the Diet under the new postwar Constitution. Having learned its lesson from the large wartime bond issues, Japan treated the law as an opportunity to limit government bond issues and borrowings to public works spending, and to regulate government debt the Bank of Japan was permitted to underwrite and finance.

The budgetary principles determined for fiscal 1947 were to prevent inflation and to encourage industrial recovery whenever possible, while maintaining an overall balance and, to the extent possible, a fiscal balance. In order to prevent a deficit budget in fiscal 1947, the government was again forced to dip into the Capital Levy Revenue Special Accounts to provide adequate funding. The initial General Account expenditure budget for the year was ¥ 114,504 million. Major spending items included termination-of-the-war expenses, public works, price adjustments and allocations of tax revenue to local governments. There was considerable upward pressure on the budget, however, not the least of which was inflation. A total of 13 supplementary budgets were passed during the year for the General Account alone. As a result, final expenditures for the year, with all the supplements factored in, totaled ¥ 214,256 million. It was a distinguishing feature of budgets after fiscal 1947 that all public works expenditures were recorded under the budget of the Economic Stabilization Board, and that they were to be examined by the office itself. This system remained in place until the fiscal 1952 budget.

The fiscal 1948 budget was initially proposed by the Cabinet, but had to be revised by the ruling party and revised again by the bureaucracy, before it finally

passed on July 4. The "provisional budget" for the April-June period was created in line with the Public Finance Law regulations. The budgetary principles established for fiscal 1948 called for working toward mutual equilibrium between the budget and prices. In other words, the government hoped that the Revised Schedule of Official Prices implemented in June of that year would reduce the fiscal burden from price adjustment subsidies, while at the same time both restraining any spill-over effects on the budget from skyrocketing prices, and encouraging industrial production. The General Account budget totaled ¥ 414,462 million, with major spending items including termination-of-the-war expenses, price adjustments, public works, allocations of tax revenue to local governments and government enterprise rehabilitation. Rising prices necessitated two supplementary budgets during the year, however, in order to raise the salaries of public servants, and to provide more money for price adjustment subsidies.

2) The Termination-of-the-war Expenses

The U.S. forces stationed throughout Japan under the Occupation ran up expenses for base construction and civilian workers. At first, the U.S. proposed using "B military scrip" to cover the costs of the Occupation, just as it had done on Okinawa. Plans to use scrip on the Japanese mainland were abandoned, however, after strong protests from the government. In its place, the government of Japan agreed to shoulder the financial burden of the "Termination-of-the-war" expenses. During 1945, no termination-of-the-war expenses were included in the budget. Instead, ¥ 12,253 million was borrowed from the Bank of Japan's Temporary Account to cover the costs. A decision by the MOF on September 14, 1945, resulted in a system in which costs were paid in advance by the BOJ. When the government received a request for materials or buildings, it would spend the amount required from the BOJ Temporary Account and deliver the requested items in-kind. By the end of the fiscal year, the total had reached ¥ 2,114 million, of which ¥ 414 million went on wages, ¥ 323 million on construction costs and ¥ 124 million on the procurement of goods.

Beginning in fiscal 1946, termination-of-the-war expenses were included as a separate budget item. Nevertheless, the BOJ continued to advance the funds to the government until October of that year because of budget shortfalls. During the fiscal 1946 budgetary process, SCAP requested a large boost in spending on housing for troops and similar items. The amount of the proposed increase was eventually reduced, and the revised budget contained a ¥ 19,000 million appropriation for termination-of-the-war expenses under MOF administration. This appropriation allowed the government to pay back the BOJ Temporary Account. The resulting pressure on the remainder of the General Account convinced the government to ask SCAP to reduce the termination-of-the-war expenses, but a supplement to the fiscal 1946 budget ended up increasing them instead. The government was forced to rely for revenues on deficit bonds underwritten by the BOJ and on direct borrowings from the BOJ. With the supplements added in, the termination-of-the-war expenses accounted for ¥ 38,300 million, or 32 percent of the total budget.

Japan refused to post a deficit in its fiscal 1947 budget, a position which strained funding for the termination-of-the-war expenses, in which SCAP demanded another increase. The initial budget contained a provision of ¥ 25,188 million for termination-of-the-war expenses. Until the initial 1947 budget, this item included both war reparations and Occupation costs. The MOF was largely unsuccessful in negotiating a downward revision in SCAP's requests in the fiscal 1947 supplementary budget. Supplements passed on November 1 and November 29 both contained large increases in termination-of-the-war expenses, which totaled ¥ 64,121 million for the year, or 29 percent of the General Account, making them the largest single spending item in the budget. It was in these supplementary budgets that reparations were first separated from other termination-of-the-war expenses as an independent expenditure.

The initial 1948 budget contained only a slight increase, but as the supplementary budget was being drafted, there were again requests for large hikes in termination-of-the-war expenses. When it was approved on December 22, 1948, the

supplementary budget contained an additional ¥ 14,500 million appropriation for this item, bringing the total for the year to ¥ 103,300 million - 22 percent of the final General Account budget. As a percentage of the budget, termination-of-the-war expenses reached their peak in fiscal 1948, after which they declined steadily as the United States pulled out its troops. Beginning in fiscal 1948, termination-of-the-war expenses were no longer administered solely by the MOF. Each ministry had its own termination-of-the-war expenses budget.

Since Japan continued to pay termination-of-the-war expenses until fiscal 1951, it behooves us to say a word about the expenses after 1949. It was in fiscal 1949 that the Dodge Plan was introduced to restrain deficit spending. SCAP cooperated with this policy by reining in its budgetary demands, which, coupled with the significant draw-down of U.S. forces in Japan, reduced termination-of-the-war expenses to 16 percent of the final General Account budget for the year. What had been the largest spending item only a year earlier, was now even less than the price-adjustment expenditures. The fiscal austerity continued in 1950, and the account was reduced once again in 1951, dropping to ¥ 106,473 million in the initial budget for that year. Termination-of-the-war expenses now counted only fourth in terms of spending items. When the San Francisco peace treaty took effect in April 1952, the account was eliminated altogether and money for goods and facilities for the U.S. forces stationed in Japan was paid from the newly created defense expenditures.

3) Price Policies

Japan experienced its first price-adjustment policy during the war in 1940 with the inclusion of a price-adjustment subsidy for coal in the General Account. Subsidies were later extended to food, steel, nonferrous metals, electric power, oil and other items, but the largest went to coal and nonferrous metals. By 1945, the price subsidies had grown to 20 percent of the General Account. As it set about dismantling the wartime controls, SCAP demanded that these subsidies be eliminated. In addition, on November 20, 1945, the practice of publishing official prices for fresh foods was done away with as well. The elimination of price controls

coincided with an increase in the money supply immediately after the war, triggering a price spiral for fresh foods. The resulting inflation prompted the government to enact “postwar” price controls, but in light of the absolute shortages that existed, it was forced to resort to its former policy of control through official pricing.

The publication of the Price Control Order on March 3, 1946, marked the beginning of what would come to be known as the “3/3 Price System” (from the date on which it took effect). Besides endeavoring to minimize price adjustment subsidies, the 3/3 Price System eliminated subsidies to industry entirely. The coal industry's production subsidies were restored in fiscal 1948, however, with the implementation of the Priority Production Plan. The 3/3 Price System was followed on October 1, 1946, by the Provisional Supply-and-Demand Adjustment Law, which became the other basic law concerning price controls. SCAP required that Japan should create a public rationing mechanism for basic materials and daily necessities, thereby wresting the authority to control distribution out of the hands of private industrial concerns. Japan complied, establishing public corporations to control the distribution and rationing of various goods. The capital for these companies came entirely from the government and their operating funds from the Reconstruction Finance Bank. Beginning in April 1947, several new public corporations were created, each with its own governing law and a mandate to adjust prices. They had three main tools for accomplishing this: “price leveling” in which prices were “pooled”; “transportation leveling” for goods for which transportation made up a large portion of the price; and price differential subsidies. Unlike the other public corporations, which merely rationed the goods they were responsible for, the Price Adjustment Public Corporation adjusted prices by buying goods from producers and then selling them back to the same producers.

By autumn, inflation had effectively broken the 3/3 Price System. With the gap between the official and black-market prices widening, a new official price schedule was published on July 5, 1947. The new schedule used cost calculations to set prices

for mining and industrial goods and parity calculations to set prices for agriculture, forestry and fishing products. The July 1947 system contained wide discrepancies among goods, however, when viewed as a multiple of average prewar prices. To flatten these out, a limit, or “stability band,” of 65 times base-year prices was established for the consumer prices of priority industrial goods. Should producer prices rise above the stability band, price adjustment subsidies would be used to bring consumer prices back within limits.

Under this system, the range of items subject to price adjustments expanded dramatically. In 1947, stability band subsidies were paid for only three items - steel, coal and fertilizer - which received priority in the Priority Production Plan. The next year, the subsidies remained in place for these three items, but appropriations for the Foodstuffs Control Special Account and other special subsidies brought the total price adjustment budget to ¥ 22,511 million, or 10 percent of final General Account expenditures of fiscal 1947. Prices continued to climb, making it necessary to revise the official price schedules. In June 1948, Japan moved to yet another new price system that hiked national railway fares and communications charges, expanded the stability band to 110 times the base-year level, hiked the price of basic goods by 70 percent and consumer goods by 80 percent, and provided for ¥ 43,000 million in price adjustment subsidies for stability band goods.

On December 18, 1948, the Government of Japan was given the Nine-Point Economic Stabilization Plan by SCAP. On April 19, 1948, the government announced its Price Policy Guidelines, in conjunction with the implementation of the Nine-Point Economic Stabilization Plan, which formed its basic price policy guidelines under the single-rate foreign exchange market introduced with the Dodge Plan. These guidelines eliminated export subsidies, reduced import subsidies and mandated both a review of the items for which price adjustment subsidies were paid, and cuts in the amounts paid.

The price system was revised again in April 1949. The special subsidies were scrapped, but new import subsidies were provided, though this was because

subsidies that had been hidden in the Trade Funds Special Account until the end of fiscal 1948 were moved over to the General Account. This led to an initial

Table 1-4 Price Adjustment Subsidies

(In millions of yen)

	FY1946	FY1947	FY1948	FY1949
Food	6,480	—	—	—
Coal	2,531	—	—	—
Oil	25	—	—	—
Stability Band Subsidies	—	16,612	53,786	97,928
Coal	—	9,957	18,119	21,675
Steel	—	3,873	21,372	46,375
Nonferrous Metals	—	808	2,392	1,803
Fertilizer	—	1,814	10,470	25,625
Sodium Compound	—	158	1,433	2,450
Major Food	—	5,542	—	—
Special Subsidies	—	355	8,713	—
Fresh Food	—	128	714	—
Crude Oil	—	73	—	—
Fiber	—	153	—	—
Reinsurance for Agricultural Mutual Association	—	—	500	—
Subsidies for Livestock Farming Funds	—	—	810	—
Coal Special Subsidies	—	—	5,950	—
Subsidies for Metal Mining Funds	—	—	289	—
Fertilizer (Loss compensation)	—	—	450	—
Import Subsidies	—	—	—	68,586
Food and Fodder	—	—	—	45,349
Fertilizer	—	—	—	11,878
Industrial Material	—	—	—	4,716
Fiber, etc.	—	—	—	6,643
Salt Import Subsidies	—	—	—	3,700
Total	9,036	22,511	62,499	170,214

Source: Ministry of Finance, "*Showa Zaiseishi--Shusen kara kowa made*", Vol. 10, pp. 230, pp. 349, pp. 449, pp. 529

expansion in the size of subsidies on the General Account, but it was done with the understanding that the subsidies would soon be slashed. In September, the subsidies for coal, one of the stability band items, were eliminated, and in subsequent months subsidies for other items were removed as well. The fiscal 1950 budget contained sharp reductions in price adjustment subsidies, and by fiscal 1951 only the subsidies for imports remained. April 1, 1952, witnessed the lapsing of the Provisional Supply-and-Demand Adjustment Law, the cornerstone of Occupation price controls.

4) Tax Reforms, War Indemnity Special Measures Tax and Assets Tax Law

During the war, the Special Account for Provisional Military Expenditures was funded by a combination of tax hikes (including higher rates for income taxes, among many others) and new taxes, which produced more General Account tax revenues for allocation to the military expenditure account. After the surrender, the wartime tax system came up for fundamental review. A rescript issued on July 21, 1945, had already abolished the special tax on dividend and interest income, special tax on foreign currency-denominated bonds, building tax, electric power and glass tax and advertising tax, as no longer necessary. The special activities tax was added to the list of unnecessary taxes, and Law No. 14 of August 1946 formalized the repeals. This was followed in July 1948 by the lifting of the special corporate tax. The reforms of the tax system and the elimination of the wartime taxes can be seen as part of the transition from a wartime to a peacetime tax structure. Rates were lowered concurrently for those taxes which had been subjected to the steepest hikes during the war.

An amendment to the Income Tax Law passed on March 31, 1946, avoided an increase of the tax burden by raising the basic deduction and the untaxed income cut-off point to correspond with revisions in wages, salaries and prices made under the 3/3 Price System. The tax reforms of fiscal 1946, however, passed at the same time as the extremely late budget that year, raised rates on the classified income tax (covering asset income and the like) and the liquor tax, in order to account for the rise in nominal incomes due to postwar inflation. Faced with the need to make further provision for subsequent rises in nominal income, the Diet passed a full revision of the Income Tax Law in March 1947, that eliminated the distinction between the classified income tax and the aggregate income tax, replacing it with a single progressive tax rate, imposing a tax on income from the transfer of securities and other assets, and establishing 12 tax brackets with rates increasing incrementally from 20 percent to 75 percent. In 1947, the system was changed from one assessing results to one assessing anticipated income, and a temporary gains tax

was levied on income from real estate, forest land, and transfers, in order to prevent a decline in taxes levied on income gains during 1946. A revision of the Income Tax Law on November 30 of that year hiked the maximum rate to 85 percent, in an effort to shift more of the burden to the high new-yen income groups, following the introduction of the emergency financial measures. This series of reforms led to steady growth of total income tax revenues, the number of income tax payers and income taxes per taxpayer.

The 1946 revisions divided corporate income for the purposes of corporate tax into “ordinary income” and “excess income.” The Corporate Tax Law was completely rewritten on March 31, 1947, to require all companies to file tax returns with “ordinary income” taxed at 35 percent and “excess income” taxed in three brackets ranging from 10 to 30 percent, depending on the capitalization. Additional amendments passed on July 7, 1948, eliminated the tax on corporate capital and reformed the “excess income” tax to a system of three brackets with a maximum rate of 20 percent for all income in excess of 100 percent of a company's capital. Total taxable corporate income, the number of tax paying companies and the amount of corporate taxes paid per company skyrocketed due to inflation.

The new Constitution and the revised Civil Code led to a review of the legal and tax treatment of families, which resulted, on April 1, 1947, in a full revision of the Inheritance Tax Law. The new law did away with the former system of different tax rates for succeeding heads of households and other heirs. A gift tax, making the gift-giver responsible for payment, was also imposed, and a self-assessment system was adopted for inheritance taxes. In December 1947, a special tax on those who did not suffer from the war was imposed in order to even out differences between those whose assets were damaged by the war and those whose assets were not.

Japan passed the Transactions Tax Law in the midst of the postwar inflation spiral on July 7, 1948, introducing its first comprehensive indirect tax. The transactions tax resembled a general consumption tax, in the sense that it was a cumulative, stepped tax imposed on a broad range of transactions in goods, services,

and even financial institution fees. As a result, the tax revenues rose to keep pace with inflation, which raised hopes that it would serve as a comprehensive indirect tax, precisely suited to the current economic conditions. Since income and corporate taxes were cut when the transactions tax was introduced, the tax was also expected to cover the revenue losses. It appears that the policy-makers, faced with high inflation, wanted to switch away from dependence on direct taxation in the system.

The transactions tax was levied at a rate of 1% on top of other indirect taxes such as the commodities tax. Thanks to its broad base, it yielded ¥ 20,813 million in revenues during fiscal 1948 and ¥ 33,707 million in fiscal 1949. There were also complaints that it was unfair, however, because the tax burden differed for integrated multi-level producers and single-level processors. The collection practices raised taxpayers' ire as well. Payment was to be made in the form of transactions tax stamps, and businesses were required to report their transaction values and tax assessments every three months. With no adequate

Table 1-5 Transaction Amount and Turnover Tax Amount

(In millions of yen)

	FY1948					FY1949		
	Taxable Transaction		Tax Amount			Taxable Transaction		Tax Amount
	Places of Business (in thousands)	Transaction Amount	Article 14	Article 17	Total	Places of Business (in thousands)	Transaction Amount	
Individual	5,395	1,038,935	10,328	60	11,381	6,990	1,003	10,378
Corporation	541	1,269,839	10,410	2,288	13,032	1,757	2,577	26,072
Total	5,936	2,308,774	20,738	2,348	24,412	8,748	3,581	36,450

Source: Ministry of Finance, "*Showa Zaiseishi: Shusen kara Kowa made* ", Vol. 19, pp. 291

collection organization in place at the time, faults began appearing in the way in which the tax was administered, and it was finally done away with altogether in December 1949 under the Shoup missions. Meanwhile, the commodities tax rate, which had been raised repeatedly during the war, was lowered in March 1946, despite the general rate hikes elsewhere, to bring the system in line with inflation. New reductions were introduced repeatedly in subsequent years.

In April 1947, the national government eliminated its business tax, land tax,

housing tax, mining rights tax and entertainment tax, transferring them to local governments in order to provide them with independent funding and to promote local development. In July 1948 the hunting license tax and admission tax were also transferred to local governments, again as part of a program to ensure independent funding and adequate tax bases for local governments' fiscal revenue.

As this period began, some large assets had been frozen. Most were for indemnities paid to defense companies or corporations scrapped during the war. The release of these assets and payments in the years immediately following the war accelerated inflation, and the liquidity it produced was a factor in expanding the money supply. The MOF proposed cutting off the war indemnity and introducing a high assets tax in order to rebuild public finances after the war. SCAP's agreement was secured, and the War Indemnity Special Measures Law was passed on October 19, 1946, introducing a “War indemnity special measures tax” that effectively put an end to the payments.

Under this law, war indemnity paid after the surrender became subject to taxation based on claims against the government as of August 15, 1945. Military supply companies retained the right to claim subsidies and indemnity for losses suffered during the war, the right to file for war insurance was maintained, and

Table 1-6 Special Tax on Wartime Compensation Claims (accumulative total for FY 1946-1951)

(In millions of yen)

	Total		Corporations		Individuals	
	Number of cases (in thousands)	Value	Number of cases (in thousands)	Value	Number of cases (in thousands)	Value
Value of wartime compensation claims existing upon implementation of relevant law	302	12,087	161	10,924	141	1,163
Value of claims settled on imlementation of relevant law	1,971	63,812	475	41,831	1,496	21,981
Value of claims offset with present or advanced cash payments	568	11,083	209	9,373	359	1,710
Value of claims settled with special government borrowings or deposits	1,656	52,732	320	32,461	1,335	20,271
Present value of special government borrowings and deposits, etc.	1,673	47,007	316	27,600	1,357	19,407
Value of claims sold on implementation of relevant law	44	3,922	29	3,474	16	447
Value of claims cancelled before implementation of relevant law	57	1,802	26	1,386	30	416
Value subject to tax	2,250	75,900	631	52,757	1,619	23,144
Deduction under Article 10 of relevant law		333		59		275
Tax amount	306	57,537	111	49,061	195	8,475

Source: Ministry of Finance, "*Showa Zaiseishi--Shusen kara Kowa made*", Vol. 19, pp. 280

claims for war indemnity (grants for business closings and the like, introduced in 1943) could still be filed. The tax rate for assets and claims against the government was set at 100 percent, with a deductible amount of between ¥ 10,000 and ¥ 50,000 per claim, depending on whether the party filing the claim was an individual or a company. Payment of the war indemnity special measures tax on war indemnity claims could be made by transfers: in other words, the credit and the tax were considered as offsetting each other. The taxes on special deposits were paid after withdrawing them from financial institutions. Taxes on other frozen deposits, securities and real estate could be paid either in kind or in cash, with a grace period of up to two years. Taxes were levied under the law on ¥ 52,757 million in corporate assets and ¥ 23,144 million in individual assets, bringing in revenues of ¥ 49,061 million from companies and ¥ 8,475 million from individuals. Most of the war indemnity special measures taxes were paid during the 1946 and 1947 fiscal years. Special deposits generated the largest revenues, followed by government special borrowings. The tax totaled ¥ 57,489 million by end of fiscal 1951. Payments in both cash and kind were seen, as were requests for extensions. Most payments in kind were made in the form of government bonds.

The Assets Tax Law of October 11, 1946, imposed a high, progressive tax on personal assets. Individuals and families living together were required to report the total all of their assets as of March 31, 1946, including chattels, real estate, mines, fishing rights, deposits and trusts, and to pay taxes on the amount less a deduction of ¥ 100,000. The tax was levied in fourteen brackets, ranging from 25 percent on assets in excess of ¥ 100,000, to a maximum of 90 percent for assets in excess of ¥ 15 million. Land and houses were valued as a multiple of rent, stocks and other investments at trading prices, adjusted for the company's asset position and profitability. The Financial Institutions Emergency Accounting Measures Ordinance provided for payment in kind of old-account deposits and other assets and gave extensions of up to two years where payment would cause hardship. Even the Imperial family was subject to the assets tax.

Table 1-7 Taxable Property Value (accumulative total for FY 1946-51)

(In millions of yen)

	Number of cases (in thousands)	Property value
Rice paddies	451	7,673
Dry fields	418	2,997
Residential land	567	13,570
Forests	238	2,900
Houses	570	24,372
Trees and bamboo	217	5,716
Government bonds	498	1,806
Shares and corporate investment	678	16,324
Bank and trust deposits	1,155	29,159
Postal savings, and other savings and deposits	1,250	9,451
Annuity insurances, etc.	771	3,574
Machines, equipments, instruments, tools, furniture	175	3,506
Goods, products, semifinished products and raw materials	131	3,327
Calligraphic works, paintings, antiques	39	1,102
Movable household properties	1,324	4,647
Others	155	1,189
Deductions	9,277	136,141
Taxes and public dues	359	5,082
Debt	234	7,007
Balance (including other deductions)	1,808	123,779
Other deductions	254	1,716
Net taxable property value	1,808	122,062

Source: Ministry of Finance, "*Showa Zaiseishi--Shusen kara Kowa made* ", Vol. 19, pp. 283

The largest taxed assets were bank and trust bank deposits, which amounted to ¥ 29,159 million. These were followed by houses at ¥ 24,372 million and residential land at ¥ 13,570 million. After the deduction of other tax liabilities and debts from the total of ¥ 136,141 million, ¥ 122.062 million in taxable assets remained. In

terms of tax brackets, the concentration was heaviest in the 55-65 percent range, which accounted for assets exceeding ¥ 16,000 million. A similar trend was seen in tax revenues. In all likelihood, the assets tax hit those with taxable assets between ¥ 300,000 and ¥ one million hardest. There were only 48 applications of the maximum rate of 90 percent, and these represented tax revenues of only ¥ 5,147 million. Most people paid their assets tax in kind.

To manage revenues and expenditures from the war indemnity special measures tax and the assets tax, the government created a Special Account for Revenues from the Assets Tax, etc., on November 28, 1946. This special account generated revenues by selling off assets paid in kind in forms other than by government bonds. Unsold assets were posted as special account assets, while most of the government bonds were moved to the National Debt Consolidation Fund Special Account and redeemed. During fiscal 1946 the special account recorded ¥ 15,447 million in cash revenues from the assets tax and ¥ 706 million from the wartime indemnity special measures tax. These revenues provided the main source of funding for a ¥ 28,563 million contribution to the General Account, an amount roughly equivalent to the total General Account tax revenues for the year. The special account made a similar contribution to the General Account in 1947 as well. Cash revenues from the special account began to decline in 1948, and the account was abolished at the end of fiscal 1951.

5) Government Bond Issues During the Reconstruction Years

The government ran up a large cumulative debt through wartime bond issues, and the issuing of bonds continued after the defeat, leaving ¥ 170,811 million in outstanding government bonds (including foreign issues) at the end of fiscal 1945. The government had also borrowed extensively to fund foreign military expenses from 1943, leaving it with a balance of ¥ 55,280 million in borrowings at the end of fiscal 1945. Foreign borrowings had been switched to the Foreign Finance Bank after its establishment in March 1945. After the war, this bank was designated for closure, and repayment of the funds borrowed from it, by far the largest of the

government's borrowings, was put on hold. Repayment would consequently not be an issue during the reconstruction period.

Table 1-8 Purpose of Government Bond Issuance

(In millions of yen)

Fiscal Year	Project Expense, Investment and Loans	Military expenditure	Revenue Covering	Gratuities and others	Deficit Covering	Total	Government Compensation Bonds
1945	1,057	22,353	4,700	61	0	28,173	62
1946	11,858	-	13,985	0	1,960	27,803	1,960
1947	10,625	-	-	△ 1	21,898	32,521	21,926
1948	26,135	-	-	0	44,397	70,533	44,397
1949	74,458	-	-	0	2,518	76,977	64,985
1950	-	-	-	0	879	879	879
1951	13,500	-	-	0	11,635	25,135	11,635
1952	16,038	-	-	65,452	6,277	87,768	87,768
1953	80,766	-	-	18,782	△ 3	99,545	85,375
1954	-	-	-	5,156	1	5,157	5,158
1955	-	-	-	2,583	△ 3	2,580	2,580

Source: Ministry of Finance, "*Showa Zaiseishi--Shusen kara Kowa made* ", Vol. 19, pp.315
Financial Bureau, Ministry of Finance, Annual Statistics of Government Bond

The growth in government debt after the war prompted SCAP to forbid any new bond issues or borrowing without its permission, effective January 21, 1946. While extraordinary military expenditure had ceased, however, there were new fiscal demands to be met in the form of termination-of-the-war expenses (primarily comprising Japan's contribution to the upkeep of the Allied forces), which forced the government to continue its reliance on bond issues. Domestic government bond issues proliferated. In fiscal 1945, the Deposit Bureau and Bank of Japan underwrote new bond issues to fund railways. Other bonds for railways and telecommunications were issued between fiscal 1946 and 1948. The Deposit Bureau and Bank of Japan underwrote the 1946 bonds, but the markets bought most of the 1947 issues, although the Bank of Japan underwrote some of these as well.

The Public Finance Law of April 1947 banned in principle the issue of government bonds to supplement revenues, Bank of Japan underwriting of government bonds, and government borrowings. Since the clauses on bond issues

did not take effect until fiscal 1948, however, the Bank of Japan continued to underwrite government bonds until July 1947. Public subscription by commercial banks replaced Bank of Japan underwriting two months later, in September. Because these were public offerings within the context of the priority industrial lending program, the government instructed institutions to use funds in excess of their allocated lending ceilings for the purchase of government bonds.

Other issues of debt securities during this period included a conversion of Bank of Japan borrowings to government bonds underwritten by commercial institutions in 1945, and conversions of BOJ-held food securities and loans from the BOJ to BOJ-held government bonds in 1946 and 1947, respectively. To encourage the market to buy bonds in 1947, the government offered special 4-percent reconstruction bonds, which pushed the interest on public bonds upward from the 3.4-percent face value and 3.65-percent real value at which it had long held steady, to a 4-percent nominal and 4.6-percent real value. The interest on government bonds rose again in 1948, with the issue of 5-percent reconstruction bonds. Another special category of government bonds from this period was the "telephone bonds" of 1948, and everyone applying for a telephone line was required to purchase a designated and equal amount of these. SCAP instructed the government to terminate these issues in March 1949, and no new telephone bonds were issued thereafter.

The issuing of various government grant bonds continued after the war, among them bonds for war insurance-related war indemnity, indemnity for wartime losses by the Imperial Mining Corporation, Industrial Development Public Corporation and National Welfare Corporation, indemnity for losses related to the reconstruction and reorganization of financial institutions, and indemnity for losses in the coal mining and electric power industries. As part of the process of land reform, the government also issued farmland securities, beginning in fiscal 1948, the issue of which eventually declined and ceased in fiscal 1952. Finally, the government issued grant bonds during the 1948-1951 period as payment for concealed and hoarded goods. These bonds carried punitive 2-percent yields.

To redeem the government bonds, the National Debt Consolidation Fund Special Account Law required that one-third of 116/10,000 of total debt be set aside. The Public Finance Law required that half of all surplus funds also be contributed, beginning in 1947. The largest contributions to government bond redemption between fiscal 1946 and fiscal 1948 came, however, from write-offs of government bonds paid in kind to the Special Account for Revenues from the Assets Tax, etc. During fiscal 1946, this special account was the only contributor to the bond-sinking fund. Contributions from the General Account would not begin until fiscal 1948, when the account began to set aside surpluses as required by the Finance Law.

Let us touch briefly on government bond issues during the Dodge Plan years, which began in 1949. The 1949 budget was required to achieve an aggregate balance for the General Account and special accounts. In 1949 and 1950 government bonds for the telecommunications enterprise were underwritten by the U.S. Counterpart Fund Special Account and Deposit Bureau funds, and by 1951 all domestic government bonds were grant bonds. In 1949, the Reconstruction Finance Bank issued ¥ 62,467 million in investment grant bonds, which were purchased with the U.S. Counterpart Fund, allowing the bank to pay off earlier bonds. The grant bonds were then moved to the National Debt Consolidation Fund and redeemed. Grant bonds issued in 1951 included fishing securities, which were used to compensate the fishing industry. The buy-back of farmland securities began in March 1950 and eventually expanded to general government bonds as well. In order to consolidate the government debt issues, 95 issues of under ¥ 100 million each were repaid ahead of schedule. The repayment of outstanding issues and restraints on new issues brought the unpaid balance of government bonds steadily down from its peak at the end of fiscal 1949. The decline continued after the peace treaty took effect. The balanced budget remained a policy goal, and no new long-term bonds were issued, except for grant bonds.

3. Monetary Policy During the Period of Postwar Inflation

1) Emergency Monetary Measures

In November 1945 the government began to consider a package of strong measures, including freezing bank deposits and issuing new Bank of Japan notes, in order to control inflation. The final policies were embodied in the Emergency Financial Measures Ordinance and the Bank of Japan Notes Deposit Ordinance, both issued on February 17, 1946, effective immediately. At the same time, the government issued the Emergency Foodstuffs Measures Ordinance to secure food supplies, the Emergency Hoarded Commodities Measures Ordinance to bring concealed oil and textile stockpiles into distribution and the Extraordinary Asset Investigation Ordinance to set up an assets tax and special tax on war indemnity. The result of these orders was to rein in excess liquidity, hold down price increases and secure needed supplies of food and other materials.

The government also began to survey the bank deposits of individuals and corporations at this time. Under the Emergency Financial Measures Ordinance, Bank of Japan Notes Deposit Ordinance and the Executive Orders for both ordinances, the bank deposits and designated money in trust accounts of all individuals and corporations, except those maintained in the name of the central government, local governments or financial institutions, were frozen as of a designated time on February 17, 1946. Henceforth, there would be restrictions on withdrawals, and business transactions were to be settled with transfers between frozen accounts. Old bank notes would be void except for deposits until March 2, and new notes would be issued. On March 3, the balance of old notes would be written off in a special account at the Bank of Japan that would segregate the assets and liabilities involved in their disposal.

Among the restrictions on withdrawals were a monthly ceiling of ¥ 300 for heads of households and ¥ 100 for each additional family member that could be withdrawn from frozen accounts to cover living expenses. Companies could withdraw no more than ¥ 500 per employee per month to pay wages, plus such money as was required

to pay communications and transportation expenses. In addition, the victims of wartime destruction could withdraw up to ¥ 1,000 per person or ¥ 5,000 per household for the purchase of necessary clothing and furnishings. Withdrawals were also permitted for the payment of medical bills (if a proper invoice was shown), to pay for weddings and funerals (up to ¥ 1,000 per person) and to meet educational expenses. After the accounts were frozen, savings in new BOJ notes were to be deposited in new "free deposit accounts." The freezing of the accounts and the switch to new BOJ notes brought the balance of outstanding BOJ notes down from ¥ 54,342 million at the end of February 1946 to ¥ 23,322 million at the end of March, severely squeezing the money supply.

The Financial Institutions Emergency Accounting Measures Ordinance and the Company Accounts Emergency Measures Ordinance introduced in August 1946 enabled institutions and companies to segregate old and new accounts, using the old accounts to write off assets and liabilities from the war and the new accounts to continue operating their businesses. On August 11, 1946, the Executive Orders for the Emergency Financial Measures Ordinance were amended to divide frozen deposits into two categories. Personal deposits made after August 11 1946 were designated "Class I frozen deposits." All other deposits, both "small" deposits under ¥ 3,000 and larger deposits, were grouped by household. Class I deposits also consisted of amounts up to the larger of ¥ 15,000 per household or ¥ 4,000 per household member, with a ceiling of ¥ 32,000. Anything in excess of this was classified as a "Class 2 frozen deposit." For corporations, deposits of between ¥ 3,000 and ¥ 15,000 were assigned to Class I and the remainder to Class 2. The withdrawal conditions for Class I were the same as before, but withdrawals from Class 2 deposits were limited to such uses as payment of taxes and public impositions, repayment of existing debts to financial institutions secured with Class 2 deposits and, settlement of checks on frozen accounts outstanding as of August 11. Payments to "special deposits", which were set up for settlement of business closings and improvement measures during the war to prevent government payments

to companies from adding to liquidity, were suspended after the war and had been treated separately from frozen deposits under the Emergency Financial Measures Ordinance. The government permitted payment of the war indemnity special measures tax from the special deposits, and then transferred the balance to a Class I frozen deposit, quickly reducing the balance of special deposits as a result.

Table 1-9 Free Deposit Account and Frozen Deposit Account in National Banks (Balance)

(In millions of yen)

	Total	Free Deposit Account	Class 1 Frozen Deposit Account	Class 2 Frozen Deposit Account	Special Deposit Account
March 1946	135,751	14,518	94,450	-	26,782
June 1946	141,217	18,072	89,587	-	33,557
July 1946	142,580	19,936	87,679	-	34,964
August 1946	142,422	21,944	53,372	31,255	35,851
December 1946	142,422	39,751	82,507	20,936	1,675
March 1947	148,644	59,140	69,619	19,515	369
June 1947	154,807	78,981	58,779	16,862	183
September 1947	184,467	115,288	52,360	16,706	112
December 1947	234,375	170,065	49,714	14,519	75
March 1948	257,075	220,020	31,695	5,349	10
June 1948	292,544	262,705	29,838	-	-

Source: Ministry of Finance, "*Showa Zaiseishi--Shusen kara Kowa made*", Vol. 19, pp.610

A comparison of frozen and free accounts at national banks shows a balance of ¥ 94,450 million in frozen accounts at the end of March 1946, as compared to ¥ 135,751 million in free accounts - figures which give some idea of the enormous impact the frozen deposits exerted in restraining the money supply. Since demand for reconstruction financing was also enormous, however, companies used frozen deposits to settle their bills, while individuals withdrew them for living expenses. The offsets caused by these withdrawals and business transactions gradually reduced the amount in the frozen accounts. In the meantime, the regulations on wage

payments from frozen accounts were first relaxed, and then eliminated entirely. Similarly, a phased liberalization of business payments began in July 1947, further reducing the amount in frozen accounts. By June 1948, the frozen accounts only held ¥ 29,838 million, as compared to ¥ 262,705 million in free accounts. The Enterprise Rehabilitation and Reorganization Law and the Financial Institutions Rehabilitation' Law of October 19, 1946, resulted in the erasure of part of the Class 2 deposits in February 1948. The erased portion was counted as losses for deposit-holders, and the remainder was factored into Class I deposits. On July 21, 1948, Class 1 deposits were liberalized, bringing the system of frozen deposits to an end. The inflationary bias in the market remained a problem, however.

2) Reconstruction and Reorganization of Companies and Financial Institutions

After the war, companies found it almost impossible to recover foreign credits for investments, loans, accounts receivable or product exports, because Japan had relinquished all rights to lay claims to investments and credits in its former colonies and territories. Assets held against closed institutions - including investments, underwritten bonds, loans and accounts receivable against closed national corporations, colonial corporations and wartime institutions - also generated large losses, although the provisions for liquidation of these institutions did permit some assets to be recovered. Other companies came up for intermediary reparation, and they expected large losses from it. Added to this were losses from the erasure of part of the Class 2 frozen deposits and the termination of war indemnity as part of the postwar anti-inflation policy. The Company Accounts Emergency Measures Ordinance and the Financial Institutions Emergency Accounting Measures Ordinance of August 15, 1946, were enacted to enable companies and institutions to prepare for the termination of war indemnity.

Under these laws, designated special-accounting companies and financial institutions were to perform a “cut-off settlement” on August 11, 1946, at which time they would segregate their assets and liabilities into old and new accounts. Assets required for the continuation of business operations in which the company

was actually engaged would be posted to the new accounts, while other assets would go into the old accounts. In principle, all income resulting from activities after the designated cut-off date would also be posted to the new accounts, while that from earlier activities would go to the old accounts. The companies would then nominate special custodians to oversee their assets in the old accounts. Special-accounting companies and financial institutions were defined as those which had already received war indemnity by the designated date, which had claims to indemnity or which had foreign assets. This was followed by passage of the War Indemnity Special Measures Law, legislation that provided for all wartime claims against the government to be abandoned as of August 15, 1945, and allowed the companies involved to record huge amounts of special losses arising therefrom.

By November, 1948, some 8,373 companies had come under the Company Accounts Emergency Measures Ordinance. Of these, 1,736 were approved for exclusion, and 1,523 were recognized as having suffered no special losses and allowed to merge their old and new accounts, leaving 5,114 special-accounting companies that would be required to submit corporate reorganization plans for approval. Some 47 percent (¥67,106 million) of the ¥ 142,422 million on national bank accounts, as of the end of August 1946, was shifted to the old accounts under the Financial Institutions Emergency Accounting Measures Ordinance. Roughly 25 percent of the total (¥ 35,851 million) was in the form of special deposits.

Both the special-accounting companies and financial institutions used the old accounts to write off abandoned credits. To make this possible, the Enterprise Rehabilitation and Reorganization Law and the Financial Institutions Rehabilitation Law, enacted on October 18, 1946, allowed the posting of special losses as of the designated date of August 11, 1946. Special losses included the war indemnity special measures tax, losses on foreign assets, Class 2 frozen deposit losses, write-offs of old credits and equities from the termination of the war or war indemnity special measures tax, losses on deferred assets, losses in the accounting year ending on the designated date, and aggregate losses in the old accounts. Profits to be

recorded included profits for the accounting year ended on the designated date, reserves, profits in the old accounts, and profits on the revaluation of assets. Any losses remaining after offsetting against profits were deemed “special losses.” The special losses were repaid from profits, capital or abandonment of old credits. After recalculation of the special losses, the custodians appointed for special-accounting companies capitalized at ¥ one million or more were required to submit detailed business reorganization plans for approval. These concerned special loss calculations; the continuation, liquidation, or merger of the company; the establishment of a second “successor” company; and the disposal of assets.

From this time onward, the business activities of designated companies were recorded in new accounts, with the time from the designated date to the merger of the new and old accounts counted as one accounting year. On the date their business reorganization plans were approved by the competent minister, the companies were expected to finalize their special losses and the special-account companies to merge the balances in their old and new accounts after special loss calculation. Financial institutions were required to seek approval of final treatment from the write-off of assets, following which their old and new accounts were to be eliminated. Those unable to cover their finalized losses by writing off assets were eligible for government compensation up to a ceiling of ¥ 10 billion, including loss guarantees from the Deposit Bureau Fund.

The submission of business reorganization plans was delayed, however, because a higher priority was placed on policies designed to eliminate the concentration of economic power. It was not until December 1951 that all 4,762 companies submitted their reorganization plans. Of this number, 4,695 were approved, and 3,921 of those fully executed their reorganization plans. Others who had not implemented reorganization plans required long periods of time for reorganization.

Meanwhile, the reorganized liabilities of the financial institutions were transferred on December 1, 1947, bringing the reorganized liabilities of 48 banks into the new accounts as an interim measure. In addition, an amendment to the law

made on March 27, 1948, gave institutions until the end of March to merge their old and new accounts. Under this amendment, all institutions were to collect unpaid capital. Those writing off capital were to increase their capital after merging their old and new accounts. Those writing off their entire capital were to continue with capital increases. The government would provide compensation for losses by moving institutional bank debenture holdings to old accounts retroactive to the designated date. New restrictions were placed on the establishment of adjustment accounts in order to finalize the institutions' accounting prior to corporate reconstruction and reorganization. And finally, the institutions were required to merge their old and new accounts at the end of March.

The results of the corporate reconstruction and reorganization show 3,637 companies continuing their business, as of the end of September 1952. The total losses added up to ¥ 46,339 million, with the largest coming from the war indemnity special measures tax, followed by losses from the old accounts. There were also profits from the old accounts, however, and from the revaluation of assets due to inflation. The final special losses for continuing companies consequently totaled only ¥ 6,194 million. The 1,058 liquidated companies registered old account losses of ¥ 44,977 million, primarily from the war indemnity special measures tax. Having little in the way of profits or revaluation profits, these companies recorded special losses of ¥ 23,729 million. To cover the finalized special losses, the shareholders of continuing companies paid ¥ 3,821 million, and former creditors paid a matching sum. Some 77 successor companies were created from continuing companies. The ¥ 23,729 million in special losses by the liquidated companies was written off with a charge of ¥ 7,838 million to the shareholders and ¥ 16,243 million to former creditors. Some 340 successor companies were created from the liquidated companies.

The Financial Institutions Rehabilitation Law was amended in July 1948 because of forecasts that government compensation for losses would exceed ¥ 10 billion.

Table 1-10 Special Losses of Special-accounting Companies and Disposal of Losses

(In millions of yen)

	Continuing Companies	Liquidated Companies	Total
Number of companies	3,637	1,058	4,695
Losses			
War Indemnity Special Measures Tax	21,527	16,083	37,610
Losses on Foreign Assets	3,543	5,069	8,612
Class 2 Frozen Deposit Losses	706	342	1,048
Losses of Old Credit, Equity, Reparations etc.	4,345	4,199	8,544
Deferred Assets	173	306	479
Current and Deferred Losses	3,278	3,202	6,480
Losses from the Old Account	9,773	10,790	20,563
Other Losses	2,118	4,903	7,021
Balance (Profit/Adjustment item)	876	83	959
TOTAL	46,339	44,977	91,316
Profits			
Current and Deferred Profits	1,493	259	1,752
Reserves	4,271	1,858	6,129
Profits from the Old Account	13,812	6,978	20,790
Other Profits	8,847	4,391	13,236
TOTAL	28,423	13,486	41,908
Revaluation Profits			
Fixed Assets Revaluation Profits	3,543	3,983	7,526
Liquid assets Revaluation Profits	8,179	3,778	11,957
TOTAL	11,722	7,762	19,484
Special Losses	6,194	23,729	29,923
Compensation for Special Losses			
Special Losses	6,194	23,729	29,923
Borne by Shareholders	3,821	7,338	11,159
Borne by Former Creditors	2,370	16,243	18,613
Total of Old Credits	43,804	32,153	75,957
Credits from Financial Institutions	26,662	16,762	43,424
Disposed Assets	7,453	8,124	15,577
Fixed Assets	6,285	5,969	12,254
Capital Increase or Decrease, Liquidation			
Official Capital	22,672	10,196	32,868
Paid-in Capital	19,089	8,703	27,792
Eventual Capital	68,665		68,665
Capital of the second "Successor" company		14,189	14,189
Capital Increase	49,472		49,472
Prior Capital Increase	24,971		24,971
Borne by Shareholders		7,338	7,338
Prior Capital Increase		1,820	1,820
Collected Unpaid Capital	2,822	1,019	3,841
Voluntary Collection	2,697	-	2,697
Special Losses Paid-in Capital Reduction	2,658	-	2,658
Capital Reduction	883	-	883
Merger	60	-	60

Source: Ministry of Finance, "*Showa Zaiseishi--Shusen kara Kowa made*", Vol. 13, pp.903, Vol. 19, pp. 618

The amendments boosted the ceiling for government compensation, including Deposit Bureau Fund loss guarantees, to ¥ 16.3 billion, and this figure was raised further to ¥ 16.5 billion by a December amendment. Much of the finalized loss of ¥ 44,659 million for the financial institutions (of which ¥ 27,490 million was accounted for by banks) was offset by finalized profits, reserves, capital, reorganized liabilities and designated liabilities in that order. The shortfall was made up with ¥ 12,192 million in government compensation. Banks received only ¥ 367 million of the government compensation, and even then, only savings banks and trust banks received funds. Most of the compensation went to credit associations, insurance companies and prefectural credit union federations: institutions which had little in the way of profits, reserves or capital with which to offset their losses.

Table 1-11 Final Settlement of Financial Institution Reconstruction (at end of March 1948)

(In millions of yen)

Financial institutions	Fixed loss	Fixed loss coverage breakdown						Adjustment account profit (at September-end, 1952)
		Fixed profit	Reversal of reserves	Capital write-off	Restructured debt write-off	Specified debt write-of	Government comensation	
Banks	27,490	6,205	1,308	1,581	17,997	30	367	8,345
Special banks	7,687	500	278	237	6,669	—	—	—
Ordinay banks	15,441	3,838	947	1,331	9,339	—	1	—
Savings banks	1,747	323	15	72	1,079	—	241	—
Trust banks	1,253	71	66	123	858	—	124	—
Mutual loan firms	625	75	10	36	43	1	455	126
Credit cooperatives	743	69	36	93	175	1	323	72
Credit associations	4,563	38	12	147	116	1	4,268	1,784
Insurers	8,370	1,533	436	60	2,547	—	3,863	2,280
Prefectural agricultual cooperatives	2,868	164	50	109	25	2	2,509	—
Municipal agricultural cooperatives	—	—	—	—	—	—	403	—
Total	44,659	8,084	1,852	2,026	20,903	35	12,188	12,607

Source: Ministry of Finance, "*Showa Zaiseishi--Shusen kara Kowa made*", Vol. 19, pp. 616

Financial institutions that had erased all or part of their reorganized liabilities and designated liabilities set up adjustment accounts on April 1, 1948. The purpose of these accounts was to repay written-off deposit liabilities and the like from future profits. Interim allocations of profits to the adjustment accounts were made from January to July 1953 by 56 of the 65 banks establishing accounts. The write-offs of foreign assets and liabilities and the repayment from the adjustment accounts of

written-off liabilities and the interest on them continued. The write-offs of war indemnity credits and defaulted foreign assets and liabilities enabled companies to carry only their sound assets and liabilities forward, thus laying the groundwork for high growth once the peace treaty was signed.

3) Priority Finance

The ravages of war and damage to production facilities resulted in serious shortages in the supply of manufactured goods, and these production shortages, in turn, spurred postwar inflation. The highest priority was placed on overcoming shortages in coal supplies, leading in December 1946 to a Cabinet decision on "priority production," a system under which increases in coal production would be used to increase steel production. This increased production would then be used to achieve further increases in coal production, hopefully triggering a recovery of the economy as a whole. The decision made priority production the primary government policy for overcoming the postwar shortages, and all the government's resources were marshalled behind it.

The Emergency Financial Measures Ordinance provided the basis for support of the policy from the monetary policy side. Under this order, the MOF published its "Rules for Financial Institution Lending" on March 1, 1947, an action which marked the start of priority finance. A "Table of Priorities in Industrial Lending" was annexed to these rules. The practice of directing lending by setting priorities was similar to the capital investment financing controls imposed during the war under the Extraordinary Funds Adjustment Law. Postwar controls made good use of the Bank of Japan's experience in administering wartime controls. The major difference between the Funds Adjustment Law and priority finance was that priority finance fell under lending rules published by the MOF that could be revised frequently as circumstances required, enabling the system to keep pace with economic trends during the period of postwar inflation.

The lending rules defined "financial institutions" as banks, trust banks, insurance companies, the Central Cooperative Bank for Agriculture and Forestry

(Norinchukin Bank) and the Central Bank for Commercial and Industrial Cooperatives (Shoko Chukin Bank). The institutions were to restrain their lending voluntarily and to make an effort to absorb deposits, eliminate dependence on BOJ lending and manage their money as efficiently as possible to contribute to the rebuilding of the economy. The BOJ would set ceilings on increases in their outstanding lending, which they would be expected to obey strictly. In addition, the financial institutions were required to follow the priority table in their loans, lending top priority industries all the money they needed, then providing funding for other "urgent" industries, while deliberately minimizing lending in other areas. The rules applied to both capital investment funding and operating funds.

Four priority categories were identified in the rules A-1, A-2, B and C. Other funds designated by the Minister of Finance and commercial bills eligible for BOJ rediscounting were to be handled in the same way as A-1 loans. The Table of Priorities in Industrial Lending divided the capital investment and operating funding requirements for 460 sectors in 11 industries into these four categories. Top priority A-1 designation was applied to capital investments and operating funds in nine fields: coal, lignite, vertically-integrated steel production, ordinary iron, flat-furnace steel, cold-rolling mills, superphosphate of lime, ammonium sulfate and coal nitrogen. The A-2 designation was applied to capital investment in 60 sectors and operating funds in 147. The priority on coal, steel and fertilizer was clearly apparent.

By voluntary agreement, the lending ceiling was set at 50 percent of the institutions' expected increase in ordinary deposits. In point of fact, lending by national banks during the March to May 1947 period fell considerably below the lending potential. If potential lending is defined as the total of 50 percent of the expected increase in ordinary deposits, increases in bond issues, increases in financial institution borrowing, recovery of loans from old accounts and potential lending carried over from the previous month, then lending amounted to only 82 percent of the potential in March, 26 percent in April, and 32 percent in May. It would have thus been the exception rather than the rule for institutions to apply for

permission to engage in "extra" lending (loans to cover assets taxes or underwriting of Reconstruction Finance Bank bonds).

Monthly lending growth figures indicate that lending to the top-priority A-1 sectors began to increase in August 1947. Lending to quasi-A-1 and A-2 sectors was also significant, suggesting preferential financing of other priority sectors outside the A-1 group. A reorganization of the public rationing system produced a gap between the Table of Priorities and actual circumstances, resulting in a

Table 1-12 Monthly Change of Bank Lending by Industrial Classification

(In millions of yen)

Period	Class A-1	Class Quasi A-1	Class A-2	Local Government	Distributing Organ	Class B	Local Government	Construction Industry	Class C	Total
April 1947	48	151	1,476	116	636	1	35	△ 146	△ 161	1,515
May	△ 540	759	1,454	70	433	801	39	54	145	2,619
June	△ 17	474	3,393	136	184	1,532	△ 138	627	32	5,416
July	2	△ 1,574	350	24	△ 841	1,946	296	△ 140	24	747
August	352	640	1,310	68	△ 1,336	1,904	699	314	431	4,639
September	614	1,114	3,872	88	△ 407	1,424	△ 136	299	317	7,342
October	△ 626	1,482	5,057	107	681	1,255	△ 204	71	649	7,819
November	565	971	4,555	74	821	2,572	537	424	711	9,374
December	2,627	1,212	10,202	81	2,695	2,049	△ 10	△ 348	1,227	17,320
January 1948	199	175	5,125	56	1,846	1,685	11	257	488	7,675
Total	3,224	5,404	36,794	820	4,712	15,169	1,129	1,414	3,863	64,466

Source: Ministry of Finance, "Survey on Bank Lending (Monthly change)"

revision of the lending rules on June 13, 1947. The revised rules defined 517 industrial sectors, of which only eight received an A-1 designation, while an A-2 designation was given to capital investment financing in 72 sectors and operating funds in 188 sectors. The rules were amended again on October 6, 1947. Effective in the third quarter, the amendments eliminated ceilings on capital investment financing for A-1 sectors. The Shoko Chukin Bank was later allowed to lend up to 100 percent of its ceiling on outstanding loan increases in an effort to ensure adequate funding for smaller businesses. The lending rules produced an increase of ¥ 32,939 million in industrial lending by national banks, during the October to December quarter of 1947, of which ¥ 2,104 million went to A-1 sector industries and ¥ 1,665 million to loans guaranteed by the Reconstruction Finance Bank. Lending to the government during the period totaled ¥ 6,026 million, of which

¥ 2,401 million was used to purchase government bonds and ¥ 2,744 million to purchase Reconstruction Finance Bank bonds. The BOJ engaged in stricter supervision of banks that had not put at least 10 percent of their base level into government or Reconstruction Finance Bank bonds. Preferential financing did help to increase coal output, although production still fell far short of its levels during the war.

The preferential lending concentrated funding in priority industries and encouraged the repayment of BOJ loans, but this also impeded the market's ability to absorb government, municipal and Reconstruction Finance Bank bonds, with the result that government financial needs were not being sufficiently met. The lending rules were revised on July 21, 1948 (retroactive to July 1), to rectify this situation. The revisions changed the old system, under which 50 percent of regulated lending was considered the lending ceiling for ordinary companies, with anything in excess of that treated as "extra lending", to be earmarked for government funding and priority industries. Under the new system, the anticipated increase in operating funds, as determined by the Minister of Finance, was defined as regulated lending, a set percentage of which would be earmarked for government fund-raising, with any remaining funds to be used for loans to ordinary companies. The "extra lending" was abolished at this time.

The government's priority in financial institutional funding was on the purchase of central government, municipal and Reconstruction Finance Bank bonds, and also on loans guaranteed by the Reconstruction Finance Bank. The rules defined the anticipated increase in operating funds as the anticipated monthly increase in deposits, less those from public corporations and other financial institutions, plus anticipated repayments of government lending. In July the banks were required to spend 35 percent of their anticipated increase on government finance. The trust banks, meanwhile, were required to spend 20 percent, the Shoko Chukin 0 percent, and all other financial institutions 10 percent. The banks were further instructed to allocate 10 percent of their government financing to central government bonds, 10

percent to Reconstruction Finance Bank bonds, 5 percent to municipal bonds and 10 percent to Reconstruction Finance Bank-guaranteed loans.

Nevertheless, the Table of Priorities was at a variance with the conditions in the trading field and other industries, leading to demands for revision from the industrial community. The lending rules were changed again on January 10, 1949, partly to solve this problem and partly to bring them into line with the Five-Year Plan for Reconstruction. The revisions reduced the classifications to just A, B and C and significantly relaxed the preferential lending regulations. From January 1949 onward, category A businesses received the overwhelming majority of bank lending, over 90 percent of which was for operating funds. Even in capital investment funding, however, the tilt to category A was marked. The priority production and financing programs resulted in a substantial recovery for coal production during 1948. They remained in place until the implementation of the Dodge Plan. On July 22, 1963, the Emergency Financial Measures Order and the lending rules were both repealed.

4) The Reconstruction Finance Bank

After the Emergency Financial Measures Ordinance of February 1946, the need for a system to supply industrial funding became apparent. The government studied the possibility of establishing a reconstruction finance institution modeled on the American Reconstruction Finance Corporation and decided to use a special account to manage reconstruction lending. With the cut-off of war indemnity in August expected to make it more difficult for companies to raise funding, emergency funding would be necessary to rescue companies and enable them to return to production. The Cabinet decided on June 25, 1946, to have the Industrial Bank of Japan float special reconstruction loans and to create a Reconstruction Finance Committee to review lending proposals as interim measures until a reconstruction finance system could be established. The Industrial Bank of Japan's Reconstruction Finance Department consequently took over the responsibility for overseeing reconstruction lending as determined by the committee, making funds available and

drawing on loans from the BOJ when it was short of funds. The special lending began in August 1946. When it was terminated, the Industrial Bank of Japan's outstanding reconstruction loans totaled ¥ 4.1 billion, of which ¥ 1.25 billion was deficit lending to tide the coal industry over until government subsidies became available. Two-thirds of the lending was used for operating funds, which were in greater demand at the time than capital investment financing. Under the priority production system, over 40 percent of all lending went to the top-priority coal industry, primarily to cover deficits. The chemicals industry was next in line for funds, mainly for chemical fertilizer production. The Industrial Bank of Japan relied almost entirely on the BOJ for funding since postwar policy made bond flotation almost impossible.

The initial plan to provide reconstruction financing from a special account was eventually changed. Instead, a government finance institution was established for this purpose. The Reconstruction Finance Bank Law of October 7, 1946, provided for the institution to be established on January 24, 1947, with a government investment of ¥ 4 billion. In addition to employing capital underwritten by the government, the Reconstruction Finance Bank would also be allowed to issue bonds to raise funds. Once established, the Reconstruction Finance Bank took over the special reconstruction lending operations of the Industrial Bank of Japan.

The Reconstruction Finance Bank became the central institution in the priority finance system, and when it began full-fledged lending in fiscal 1947, it was swamped with requests from companies for both capital investment financing and operating funds. One reason for this was that private-sector institutions were still reconstructing and reorganizing and remained unable to lend as aggressively as they would have liked. The government continued to inject capital into the Reconstruction Finance Bank, but a lack of resources in the General Account forced it to rely mostly on bonds underwritten by the BOJ to finance its lending. The government capital was used to pay down those bonds as they matured. As the Reconstruction Finance Bank took the lead in priority finance, its lending, because

it was funded by bonds underwritten by the BOJ, became a factor in encouraging inflation; so much so that the inflation of this time was nicknamed “Reconstruction Finance Bank inflation.”

The reconstruction financing expanded rapidly, with most of the money going for general industrial capital investment, although some was also used to provide operating funds and cover deficits. Coal, electric power, fertilizer and steel were given a particularly high priority in the lending. The priority financing policies placed the highest priority on coal production, and the industry accounted for fully 33 percent of total lending as of the end of fiscal 1947 as a result. Chemicals placed second. Loans for operating funds exceeded capital investment finance during fiscal 1947. A considerable portion of the operating fund loans stemmed from government policies to put a cap on inflation and hold down prices. The Reconstruction Finance Bank propped up companies by lending them the funds they needed to cover deficits and reduced liquidity. Companies in the electric power, steel and fertilizer industries also received deficit financing.

One point of note with respect to Reconstruction Finance Bank activities in 1947 and beyond involves lending to public corporations. The demand for funds was so high at public corporations that it was expected to exceed the markets' capacity. The public corporations were consequently instructed to rely on the Reconstruction Finance Bank for all their fund-raising needs. The Reconstruction Finance Bank had dealings with eight rationing companies (those responsible for oil, coal, fertilizer, foodstuffs, processed foods, feed, edible oils and liquor) and three other public corporations (the industrial reconstruction, shipbuilding and price adjustment public corporations). The balance of loans to public corporations at the end of 1947 was ¥ 18,199 million, an enormous 30 percent of total lending. This declined as a proportion during fiscal 1948, after the system allowing public corporations to issue validated bills was introduced in March 1948. Because the bills were eligible for BOJ rediscounting, they enabled the public corporations to raise short-term funding from private-sector banks.

The large bias toward industrial capital investment and operating funds in the Reconstruction Finance Bank lending drove its balance of lending, as of the end of fiscal 1947, to ¥ 59.5 billion, an amount equal to 25 percent of the outstanding loans to national banks. Coal continued to garner the lion's share of the Reconstruction Finance Bank's lending in fiscal 1948, although electric power emerged in second place. Then, in November of that year, the deficit financing was discontinued. The amount of lending of operating funds to public corporations declined, but capital investment loans to the Shipbuilding Public Corporation surged under government shipbuilding plans designed to revive the marine transportation industry. Outstanding loans on the Reconstruction Finance Bank's books totaled ¥ 132 billion at fiscal year-end. During the latter half of the year, SCAP began to see a need for reorganizing the bank because it was not adequately recovering its loans. The

Table 1-13 Lending Outstanding of the Reconstruction Finance Bank

(In millions of yen)

	Mar. 1947	Mar. 1948	Mar. 1949	Mar. 1950	Mar. 1951	Dec. 1951
Mining Industry	1,589	21,941	51,485	38,312	35,153	33,372
Coal Industry	1,036	19,874	47,519	35,484	33,333	31,933
Metal Industry	349	2,122	4,390	3,773	3,209	2,630
Steel Industry	291	1,858	3,526	3,203	2,818	2,273
Chemical Industry	1,222	5,155	10,060	10,455	7,716	7,232
Fertilizer Industry	561	3,751	6,030	6,734	5,577	5,072
Electricity Supply Industry	302	2,807	22,400	18,641	17,162	16,258
Machinery Industry	835	2,806	6,522	6,400	5,141	4,311
Agriculture	4	48	229	66	30	22
Fishery	491	2,839	5,302	4,048	3,731	3,237
Fiber Industry	45	711	4,984	4,759	4,183	3,652
Public Corporations	-	18,199	18,182	-	-	-
Others	1,149	2,835	8,412	19,452	10,544	8,533
TOTAL	5,986	59,463	131,965	105,906	86,869	79,247

Source: Ministry of Finance, "*Showa Zaiseishi--Shusen kara Kowa made* ",Vol. 19, pp.571-3

Reconstruction Finance Bank lending virtually ceased in fiscal 1949 following the publication of the "Nine-Point Economic Stabilization Plan," in December 1948. The Bank subsequently concentrated on recovering its loans, after which it was disbanded.

4. The Handling of Postwar Economic Issues

1) Japanese Reparations payments

Japanese reparations were included in the Potsdam Declaration as an official policy of the United States government. After the Occupation began, the November 1, 1945 Basic Directive for Post-surrender Military Government in Japan Proper mandated reparations in kind and the creation of plans for the return of confiscated assets. Assets that Japan did not need and goods, factories and facilities not required by the peacetime Japanese economy or the Occupation forces were to be used for reparation. After Edwin Pauley, the U.S. delegate to the Trilateral Committee on German Reparations, completed his final report on German reparations in September, he was nominated to head the Japanese reparations mission. He arrived in Japan in November. A month later in December he completed the "Interim Pauley Report," which stated that the Japanese economy was not in such bad shape as people had thought.

In order to prevent a revival of Japanese militarism, Pauley recommended dismantling half of the country's machine tool production capacity, all its army and navy factories, 20 shipyards, its steel production capacity in excess of 2.5 million tons per year and half of all its coal-burning thermoelectric power plants. In addition, he wanted all foreign assets to be forfeited, all gold and precious metals sent to the United States for safe-keeping, and the assets of the zaibatsu to be moved to the fore among the reparations payments. Pauley's final report, containing much the same recommendations, was submitted to the President the following April. After some revisions, it was approved by the Far Eastern Commission in May 1946 and sent to the government of Japan in August in the form of a memorandum from

SCAP.

The armaments and military supply factories had already been designated for dismantlement on January 20, 1946, in line with the interim report. By August, another 1,005 industrial factories were also designated for reparations; the government of Japan was required to dismantle them and to remove and store the equipment. In terms of ministerial jurisdiction, this number included 851 factories to be overseen by the Ministry of Commerce and Industry, 134 military facilities with responsibility assigned to the MOF, 20 shipyards under the jurisdiction of the Ministry of Transport, and one research facility under the auspices of the Ministry of Education.

The Pauley Mission published its general report on November 17, adding new industries such as heavy electrical equipment, tools, copper and hydroelectric power, as well as railroad rolling stock and spinning equipment to the list in the interim report. Likewise, it called for a fuller dismantlement of the industries than the interim report.

The shock to Japan was enormous. One of the problems encountered at this time involved determining how to divide the assets slated for reparations payments in the interim report among the creditor countries. The countries concerned found the road to agreement to be rocky. A particularly sticky point was the Soviet Union's assertion that facilities removed from Manchuria were spoils of war, to which the United States replied that they ought to be counted in with the other facilities slated for reparations payments. The U.S. mulled over ways to enforce the provisions of the interim report, and, after negotiations between the Far Eastern Commission and the other countries, the U.S. government issued an order to SCAP in April 1947, instructing it to recognize claims to 30 percent of the assets confiscated for reparations under the interim report. China was to be granted 15 percent and the Philippines, the Netherlands and Britain 5 percent each.

After revaluation of the reparations assets to 1939 prices, the government of Japan was ordered to arrange the removal and shipment of the confiscated

equipment for interim reparations in November 1947. The first divestment consisted of machine tools, with 13,000 machines worth ¥ 301 million shipped to the four countries beginning in January 1948. Second and third divestments followed. It took until May 1950 for the final deliveries of machinery confiscated under the interim report to be made. A total of 110 tons of machinery valued at ¥ 165 million had gone to the four countries for reparations. This was carried out in parallel to the destruction of weaponry and other specialized machines.

SCAP, which was more concerned with rebuilding the Japanese economy, asked the U.S. Department of Army to relax the reparations demands in the Pauley interim report. In January 1947, a special task force on Japanese reparations (the Strike Mission) was organized and dispatched to Japan. It submitted its first report in February, agreeing with SCAP that a priority should be placed on rebuilding a disarmed Japan and proposing that the current reparations plan be scrapped in favor of a new one. The gaps between the Pauley and the Strike reports required some sort of coordination, a requirement which delayed the Far Eastern Commission's decision. The second Strike report of February 1947 noted that the high cost of removing assets designated for reparations payments was an impediment to recovery, and opposed divestiture of all except military facilities. The Johnston Mission of April 1948 concurred, finally swaying opinion in favor of relaxing the reparations demands. The U.S. delegate to the Far Eastern Commission announced the suspension of interim report divestments in May 1949. The confiscation of assets for reparations purposes under the Occupation had come to an end. The emerging structure of the Cold War had convinced the United States to shift from a policy of severe punishment to a more lenient stance, which greatly reduced the burden that would otherwise have been placed on Japan.

2) The Dissolution of the Zaibatsu, Elimination of Economic Concentration and Land Reform

The “United States Initial Post-Surrender Policy for Japan,” a document compiled early in the Occupation and published on September 22, 1945, mandated

the dismantlement of the zaibatsu. On November 6, 1945, SCAP issued a memorandum ordering the dissolution of holding companies, an order marking the beginnings of dismantlement. On November 24, a rescript on “Regulations on the Dissolution of Companies” forbade the zaibatsu scheduled for dissolution from attempting to liquidate themselves beforehand. A task force on the Japanese zaibatsu dissolution (the Edwards Mission) was sent in January 1946 to advise SCAP. It issued a report on March 14 asserting that any corporate grouping not in the form of a “family concern” should be considered a zaibatsu and dissolved. This led to the Holding Company Liquidation Commission (HCLO Order of April 20, 1946), that provided for the democratization of corporate ownership and management by requiring stocks owned by holding companies to be ceded to the HCLC. The HCLC would pay for the securities with registered government bonds with a maturity of 10 years or more to be distributed after all the shares had been sold off. It would also oversee the entire process until the holding companies themselves were disbanded. A rescript of November 25, 1946 on Limitations on Corporate Stock Ownership gave the commission all voting rights in the designated companies, their subsidiaries and their affiliates during the time in which the shares were being sold off.

The first round of company designations under the HCLC Order went forward on September 6, 1946. Mitsui, Mitsubishi, Sumitomo, Yasuda Hozen and Fuji Industries were named. The first four were the flagships of the major zaibatsu, while Fuji Industries was a military zaibatsu better known as Nakajima Aircraft. During the second round on December 7, a total of 40 companies were defined as medium-size or new zaibatsu and designated for dissolution, including Kawasaki Heavy Industries, Nissan, Asano, Furukawa Mining, Shibuzawa, Okura Mining and the Nomura Partnership. Round three on December 28 named 20 zaibatsu affiliates which were also deemed to have holding-company functions, among them Mitsui Mining, Mitsui Bussan (trading), Mitsubishi Heavy Industry and Mitsubishi Mining. On March 15, 1947, round four named two monopolies which had been set up for

national policy reasons. Round five on September 26 designated 16 holding companies as smaller zaibatsu. On December 3, 1946, the commission designated 56 zaibatsu families and barred them from corporate management or principal ownership.

The HCLC's priority in disposing of the holding-company assets was to sell them. This was particularly true of shares in subsidiaries and to a lesser extent, of securities concerned with foreign assets or with closed institutions. A Securities Coordinating Liquidation Committee (SCLO) was established in June 1947 to oversee and encourage the disposal of securities. The Law Barring Zaibatsu Families from Corporate Control, of January 7, 1948, attempted to cut the personal ties that had forged the zaibatsu. An amendment to the HCLC Order implemented on August 19 prohibited holding companies and their subsidiaries from using the same trade names. On September 21, 1949, the government ordered 346 Mitsui companies, 205 Mitsubishi companies, and 160 Sumitomo companies to change their names and trademarks and barred them from using the old names for a period of seven years beginning in July 1951.

In light of the operations of the Mitsui and Mitsubishi trading houses overseas and the central role they had played among the zaibatsu, a government order on November 21, 1950, placed restrictions on the employment of their former directors. The HCLC did not have jurisdiction over the zaibatsu financial institutions, however. These were rebuilt under a different program. Many of the holding companies were also designated special-accounting companies under the corporate reconstruction and reorganization program, which meant that long periods of time were often required before they could be dismantled. The committee placed a priority on employee stock-holding plans when selling off shares. Some were also sold by open tender. By the end of March 1950, shares with a face value of ¥ 4,085 million had been disposed of for ¥ 6,802 million. Employee stock-holding plans accounted for 38 percent of the sales, followed by market sales with 27 percent. As of December 1, 1950, however, the HCLC still had shares with a face value of ¥ 2,668 million on its

books waiting to be disposed of. The commission continued disposal.

An antimonopoly policy was embodied in the Law Banning Private Monopolies and Assuring Fair Trade of April 14, 1947 (generally referred to as the "Antimonopoly Law"). The Fair Trade Commission, established in July of that year, had responsibility for enforcing the law. In addition, the Law for the Elimination of Economic Excessive Concentration (usually referred to as the Deconcentration Law) of December 18, 1947, gave the HCLC jurisdiction over deconcentration measures. Under this law, the committee designated 257 companies in the mining and industrial sectors as having an excessive concentration of economic power, as of February 8, 1948. On February 22, it designated another 68 companies in the distribution and service sectors. The 325 companies thus designated included almost every major company in Japan, accounting among them for 65 percent of the paid-in capital of all joint-stock companies in the country, as of the end of 1947.

In May, 50 firms were taken off the list because no excessive concentration could be identified. There were other companies that were found to have a concentration of economic power but that were not thought to require reorganization. The total taken off the list, in fact or in practice, reached 225, leaving 100 companies subject to the Deconcentration Law. The "Four Principles for Eliminating Concentration" contained in a report submitted to SCAP on August 28 by the Deconcentration Review Board (DRB) which came to Japan in May 1948, resulted in an immediate and widespread relaxation of the deconcentration policies. More companies were taken off the list, and only 18 were actually reorganized in the end. These included Nippon Steel, Oji Paper, Mitsubishi Heavy Industries and Dai-Nippon Beer, among others. Six of the 18 were split up, and 12 were allowed to continue, after selling off some factories and stock (some also had to change their names). The enforcement of the deconcentration policy came to an end in April 1953, by order of the Fair Trade Commission. The dissolution of the zaibatsu was also winding down, and the HCLC was disbanded in July 11, 1951.

Landed interests, which had been expanding their property since the Meiji

Restoration, had come to own a considerable portion of Japanese farmland. Giant landlords were often in control of areas devoted exclusively to rice production. One of the goals of the Occupation was to eliminate this system. The government passed the "Law Amending the Agricultural Land Adjustment Law," on December 29, 1945. This measure became known as the "First Land Reform." Since it was not as far-reaching or thorough as SCAP would have liked, however, SCAP sent out a memorandum on December 9, before it took effect, ordering the government to submit a new reform plan that included buying out the lands of absentee landlords and returning the rents paid by sharecroppers via a long-term installment plan. The Allied Council for Japan also roundly criticized Japan's land reform policies. The Agricultural Land Adjustment Law was again revised on October 21, 1946, and with it were promulgated the Special Measures Law for the Establishment of Owner-Cultivators and the Special Account for Measures for the Establishment of Owner-Cultivators. The Special Account for Measures for the Establishment of Owner-Cultivators became operative on December 29.

The Special Measures Law for the Establishment of Owner-Cultivators provided a system under which the central government purchased land from landlords, and sold it to sharecroppers. It mandated the central government to purchase all share-cropped land owned by absentee landlords directly and any agricultural land in excess of a certain area owned by landlords residing in the same village. Landlords were to be compensated for their land with "farmland securities." Those purchasing the land were permitted to pay in annual installments, and the land was, in principle, sold off as soon as it was purchased. The government also bought uncleared land and pasture land. Purchases of land from the government came with a clause requiring that it be sold back should the buyers quit farming it themselves. Direct administration was ceded to municipal "Farmland Committees."

This program was referred to as the "Second Land Reform." Land purchases did not take place during fiscal 1946, but they did begin in 1947, during which year the government sold 255,000 hectares of land to sharecroppers; it sold an additional

1,473,000 in 1948 and 136,000 in 1949. Although the land reforms were for the most part complete at this time, sales of agricultural and uncleared land that had yet to be acquired continued, as did sales of agricultural land transferred from other accounts. Land purchases cost the government ¥ 1,164 million during fiscal 1948 and ¥ 1,060 million in fiscal 1949. Payments to landlords for land and other compensation and incentives above a set amount took the form of farmland securities from fiscal 1948 (grant bonds which were nontransferable for two years and which offered 3 .65 percent interest with equal annual amortization of principal and interest).

Agricultural land in other accounts was also employed in the owner-cultivator farm program. Much of this land had been paid in kind in lieu of assets taxes and was posted as assets on the Special Account for Revenues from the Assets Tax, Etc. Its transfer to the Special Account for Measures for the Establishment of Owner-Cultivators brought in ¥ 617 million in revenues between fiscal 1949 and 1951. The Special Account for National Forests, set up in fiscal 1947, also held land needed for the owner-operated farm program. Its transfer brought in ¥ 38 million in fiscal 1949 and ¥ 927 thousand in fiscal 1951. A small amount of land from the General Account - former military bases or uncleared land owned by the government - was transferred as well. ¥ 314.9 million in assets taxes was paid in kind by former landlords in farmland securities to the government, which were written off in the National Debt Consolidation Fund Special Account.

The Special Measures Law for the Establishment of Owner-Cultivators was amended on July 25, 1952, at which time its name was changed to the Agricultural Land Law. The initial goal of creating owner-cultivator farms having been achieved, the emphasis was now turned to general agricultural land policy.

It is worth pointing out that Japan achieved its goal of creating small, owner-operated farms in only six years, a feat rarely seen in land reform or land redistribution programs. The program gave farmers undisputed title to their land, which contributed greatly to improvements in agricultural productivity during and

after the Occupation. Problems remained in the government land policies, however, the most significant of which was the lack of a system to conduct buy-backs of agricultural land when the owners decided to discontinue farming.

Chapter 2 Fiscal and Monetary Policies as the Economy Stabilized

1. Political and Economic Conditions

Although the reconstruction was advancing, inflation had not been staunched, which made it difficult for Japan to revive trade and foreign exchange under the fixed-rate market system. Anxious to stabilize the Japanese economy quickly, the U.S. government directed SCAP to implement a "Nine-Point Economic Stabilization Program" in December 1948. Joseph Dodge was brought in from the United States as an economic advisor to help make the transition to the Nine-Point Program, and Japan enacted the "Dodge Plan" in fiscal 1949. The fiscal and monetary policies of the Dodge Plan consisted of a sharp tightening of the money supply, which produced a sufficient deflationary effect to overcome inflation quickly and stabilize the economy. Meanwhile, the peace treaty was signed in San Francisco on September 8, 1951. It was scheduled to take effect on April 28, 1952, but political conditions elsewhere in the Far East were turbulent. In July 1950, armed conflict broke out on the Korean Peninsula. Though it was brought to an end with armistice talks the following July, the Korean War produced special procurement demand from the U.S. armed forces, giving Japan extraordinary dollar income amounting to 25 percent of its exports in 1951, and 35 percent in 1952. Special procurement demand from the war created large numbers of new jobs and proved a major stimulus for domestic production.

The period of reconstruction and postwar inflation featured extensive hidden unemployment. It was in many respects an exercise in creating a nominal expansion in economic activity, in the face of an absolute shortage of goods. The boom produced by the Korean War created stability, as income increased under the single exchange rate. What is more, the Dodge Plan brought significant relief to the postwar economic system by spurring economic growth, as the focus shifted to

market mechanism-based transactions. Finally, the extraordinary dollar income from the Korean War raised the ceiling on the foreign reserves Japan could import, rapidly enough to keep pace with booming demand for imported goods. Demand from the war more than made up for the cessation of GARIOA in 1951, and growth during the war helped the Japanese GNE (gross national expenditure) to continue to rise during the postwar reconstruction period. In terms of prewar prices (1934-1936), real GNE climbed from ¥ 14,211 million in 1948, the year before the Dodge Plan went into effect, to ¥ 18,207 million in 1951, exceeding the levels recorded during the base years of 1934-1936.

Table 2-1 Expenditure on Special Procurement Demand

(In thousands of yen)

Year	Total	Dollar-based Transaction	Yen-based transaction
1950	90,633	90,633	—
1951	341,599	341,599	—
1952	457,296	413,875	43,421
1953	594,575	434,717	159,858
1954	453,674	268,679	184,995
1955	345,443	223,654	121,789
1956	344,783	256,562	88,221
1957	320,443	237,384	83,059
1958	283,143	221,110	62,033
1959	225,211	186,556	38,655
1960	234,062	226,353	7,709
1961	242,801	242,801	—
1962	217,029	217,029	—

Source: Ministry of Finance, "*Showa Zaiseishi--Shusen kara Kowa made* ", Vol.19, pp.117

2. Dodge Plan Fiscal Policies

1) Budgetary Policies

The fiscal 1949 budget, the first to be prepared under the Dodge Plan guidelines, had three main targets to fulfill. First, it had to achieve an overall balance in the

General Account, special accounts and government-affiliated agencies budgets. Second, it had to impose austerity and frugality measures on the public in order to establish a long-term base for efficient production and capital accumulation. This included distinguishing clearly between the budget proper and U.S. aid, and using aid effectively in the cause of reconstruction. Finally, the budget had to prepare for Japan's return to the international economy, by such means as eliminating export subsidies.

The characteristic that set the Dodge Plan budgets apart more than anything else was the requirement for a real, comprehensive balance of the aggregate budgets for the General Account, special accounts and government-affiliated agencies (the budgets which became subject to Diet approval in fiscal 1949). Known at the time as "over balanced" budgets, the goal was to eradicate deficits.

The fiscal 1949 budget also attempted to reduce government debt. In an effort to enable the economy to break out of inflation, it held down increases in spending across the board. The initial budget went from ¥ 414.4 billion in fiscal 1948 to ¥ 704.9 billion in fiscal 1949 - a hefty 70.1 percent annual growth rate. But the reasons for the increase were, first, projected rises in nominal expenses due to the 1948 inflation and, second, increases in price adjustment subsidies. The latter, in particular, were the result of the transfer of a hidden subsidy for exports and imports that had been paid from trade funds to the General Account. As the 360 yen / dollar fixed exchange rate came into being, import subsidies soared during fiscal 1949. The result was to raise commodity and price adjustment expenditures for the final budget from ¥ 62,500 million the previous year (13.2 percent of total spending) to ¥ 179,200 million (24.1 percent), making the subsidy the fastest growing spending item in the General Account. The budget restrained growth in termination-of-the-war expenses and began to eliminate distribution controls, allowing the abolishment of the public corporations which had been set up for rationing purposes. During fiscal 1949 the Liquor Rationing Public Corporation and the Petroleum Rationing

Public Corporation closed their doors.

The fiscal 1950 budget maintained the austerity. Its guidelines were 1) to achieve a true balance in the aggregate budget; 2) to cut spending; 3) to make significant reforms in the tax system to coincide with the spending cuts; and 4) to provide a large increase in funding for construction and other public works. The initial budget came in at ¥ 661.4 billion, down a sharp 6.2 percent from the previous year. The cuts in commodities and price adjustment expenditures were particularly large because of the relaxation of rationing. The final budget, after all the supplemental budgets were added, recorded a drop of ¥ 64 billion (9.6 percent) in commodity and price adjustment expenditures. Fiscal 1950 saw the creation of such public corporations as the Feed Ration Public Corporation, Foodstuffs Distribution Public Corporation, Coal Distribution Public Corporation and Ship Administration Public Corporation go out of business. The remaining seven public corporations would be liquidated during fiscal 1951. The only item in the fiscal 1950 General Account expenditure final budget that recorded significant growth was spending on local governments, which surged from ¥ 66.7 billion (9.0 percent) in fiscal 1949 to ¥ 108.5 billion (16.3 percent). The reason for this growth was the elimination of the Special Account for Local Allocations of Taxes and Revenues in 1949 and its replacement with Local Fiscal Resource Equalization System in 1950, under which General Account tax revenues would be transferred to local governments.

The 1949 and 1950 budgets had stabilized prices, while special procurement demand from the Korean War had triggered a boom among Japanese manufacturers, setting the stage for the budget of fiscal 1951. The guidelines that year called for 1) paying particular attention to the achievement of an aggregate balance encompassing the General Account, special accounts and government-affiliated agencies budgets; 2) reducing the size of the central government and bringing it into harmony with the national economy; 3) making another large tax cut; and 4) actively creating programs to promote stability, education and culture, and science

among the general public. The initial budget was set at ¥ 657.4 billion, a 0.2 percent decline from the previous year, but price increases triggered by the Korean War boom pushed the final budget up to ¥ 793.7 billion. There were again major cuts in price adjustment subsidies, bringing spending from this area down to 2.8 percent of the final budget, a relatively tiny portion. Spending on government projects - economic rebuilding investments - rose rapidly, reaching ¥ 157,841 million (19.8 percent) in the final budget. Another large spending item, the police reserves, was organized and granted ¥ 31,000 million (3.9 percent) in the final budget.

Dodge Plan budgeting enabled Japan to balance its fiscal spending, restrain government outlays, cut price subsidies and eliminate the rationing system. Postwar inflation died down, and the postwar controls were thrown off.

2) U.S. Counterpart Fund Special Account

As part of the Dodge Plan, SCAP issued a memorandum on counterpart funds on April 1, 1949, which resulted in the establishment of a “counterpart fund” system. This triggered a reform in the Trade Fund Special Account, which until fiscal 1948 had received aid supplies and sold them domestically at below their import price. In place of the Trade Fund Special Account, which treated the receipt and payment of aid goods as non-income/expenditure funds in order to control aid imports, a new Trade Special Account was established in April 1949, and an Aid Goods Sub-account set up under this. The Aid Goods Sub-account recorded aid imports at the newly fixed exchange rate of ¥ 360 to the dollar set up in April 1949, with the proceeds from their domestic sale posted to a newly established U.S. Counterpart Fund Special Account. Under the U.S. Counterpart Fund Special Account Law of April 30, 1949, funds collected in the account could be used to redeem debt or to fund investment, loans or spending, with surpluses carried over to the next year. With the decline of state-managed trade in 1950, the Aid Goods Sub-account was switched from the trade account, in which the proceeds were recorded, to a new U.S. Aid Goods Disposition Special Account.

Table 2-2 Revenue and Expenditure of Counterpart Fund (Actual)

(In millions of yen)

Fiscal Year	1949	1950	1951	1952	1953	Total
Revenue	129,329	162,971	54,267	42,970	11,277	400,815
Funds from the Special Account	127,867	130,851	45,527	2,261	-	306,506
Interest and Dividends	1,461	4,705	6,404	6,476	570	19,616
Collection of Invested Funds	-	27,415	2,335	4,661	1,887	36,298
Redemption and Sell-off of Bonds	-	-	-	29,557	8,820	38,378
Miscellaneous Receipts	-	-	1	14	-	15
Expenditure	114,070	79,956	122,508	59,053	17,808	393,395
Public Businesses	27,000	38,185	23,286	25,018	17,800	131,288
Telecommunication	12,000	12,000	-	-	-	24,000
National Railways	15,000	4,000	-	-	-	19,000
National Forestry	-	3,000	-	-	-	3,000
Housing Loan Corporation	-	8,640	1,360	-	-	10,000
Export-Import Bank of Japan	-	2,500	5,000	-	-	7,500
Agriculture, Forestry and Fisheries	-	-	4,000	3,000	-	7,000
Japan Development Bank	-	-	10,000	22,000	13,800	45,800
Electric Power Development Company	-	-	-	-	4,000	4,000
Public Works	-	8,045	2,926	17	-	10,987
Private/public Businesses	24,604	33,800	48,322	33,281	-	140,007
Electric Power	10,093	10,000	23,200	19,800	-	63,093
Maritime Traffic	8,343	12,872	21,469	11,953	-	54,637
Coal	3,858	2,362	205	-	-	6,425
Steel	1,417	791	-	-	-	2,208
Others	593	1,378	1,486	40	-	3,496
Small and Medium-sized Enterprises	300	1,197	1,962	737	-	4,196
Preferred Stock	-	5,200	-	750	-	5,950
Redemption of Debt	62,467	-	-	-	-	62,467
Others	-	7,972	50,901	754	8	59,635
Housing for the Allied Military	-	6,949	459	-	-	7,408
Specific Education Projects	-	149	401	147	8	705
Balance	15,258	83,015	△ 68,242	△ 16,083	△ 6,531	7,418

Source: Ministry of Finance, "*Showa Zaiseishi--Shusen kara Kowa made*", Vol. 19, pp. 363

Between 1949 and 1952, receipt of the counterpart funds from the sale of aid goods brought in a total of ¥ 400,815 million. To meet the formal requirement for disbursing funds under a general consensus by the government of Japan, expenditures of the counterpart fund required a Cabinet decision, with detailed information on the particulars of each loan proposal, which then had to be submitted

to SCAP for permission for disbursement. A comprehensive plan drafted by Dodge went into effect at the beginning of the fiscal year. Expenditures for purposes that had been approved for disbursement were allowed to continue in subsequent fiscal years. The approved expenditures in fiscal 1949 included purchases of grant bonds from the Reconstruction Finance Bank. The bank then used the money to redeem the Reconstruction Finance Bank bonds on the open market. This produced counterpart fund expenditures of ¥ 62,467 million for the year, one of the largest outlays in fiscal 1949. Other uses of counterpart funds included capital formation for state enterprises, primarily purchases of bonds floated by the Telecommunications Special Account and loans to the Japan National Railways. Counterpart funds were also invested in the government-operated Housing Loan Corporation and lent in the private sector to the fertilizer and coal industries beginning in December 1949. Lending by the Reconstruction Finance Bank was suspended in principle in fiscal 1949, and corporate borrowings for capital investment concentrated on the counterpart funds as a result. The receipt of the counterpart funds from the Aid Sub-account of the Trade Special Account was far larger than the amount spent during the year on investments, loans and debt redemption, and it took a fairly long time after the counterpart funds were received until permission .was granted for their disbursement. This would have led to a strong deflationary impact from the revenue and expenditure of the counterpart funds, but the idle funds were invested instead in foodstuffs bills, in order to relieve some of the excessive surplus in the Treasury.

During fiscal 1950 counterpart funds were used for capital formation with allocations to the Telecommunications Special Account and National Forests Special Account, as well as grants to the national railways. The telecommunications bonds and national railway loans of fiscal 1949 were, however, taken over by the Deposits Bureau. Some spending on public works was also seen, as were investments in the Export-Import Bank of Japan, which was established in February 1951. The increase in lending to the private sector that began in 1950 made electric

power and marine transportation the largest recipients of funds, which they used to pay for capital investment. Other sectors receiving loans from counterpart funds included steel, fertilizer, agriculture, forestry, fishing, small businesses and transportation and tourism. In the financial sector, counterpart funds underwrote preferred shares issued by the Industrial Bank of Japan, Central Cooperative Bank for Agriculture and Forestry (Norinchukin Bank), and three other financial institutions approved for issues of financial securities, enabling them to issue bank debentures with a value 20 times that of the new capital. (Preferred shares were equities that had no voting rights but that could receive dividends. They could be retired by the institution as it saw fit.)

The bank debentures issued on the basis of investments of counterpart funds enabled the institutions in question to take in long-term funding from the market. Some of the bank debentures were also underwritten by the Deposit Bureau fund, providing a pipeline through which its money could be supplied to the private sector. Since it was inappropriate for the MOF, which had jurisdiction over counterpart funds, to be involved in reviewing loans to the private sector or managing credits, these responsibilities were entrusted to the Bank of Japan. Counterpart fund loans to private-sector companies took the form of co-lending with commercial banks. The rates on counterpart fund loans were set low in order to move market rates down.

In fiscal 1951, the Japan Development Bank was established with counterpart funds and assigned responsibility for lending to small businesses and new industries other than electric power and marine transportation. This resulted in a cessation of new counterpart fund lending, though counterpart funds continued to be invested in the Japan Development Bank as necessary. Counterpart funds were also lent to the Special Account for Loans to Agriculture, Forestry and Fisheries, which was established in fiscal 1951 and placed in charge of prior agriculture, forestry and fisheries lending, as well as new investment. In fiscal 1951, the counterpart fund balance turned to an excess of disbursement as the government tried to meet the

demand for funding stemming from the Korean War. During fiscal 1952, counterpart funds were used for new Japan Development Bank investments and in loans to the electric power and marine transportation industries, and a revision of the Japan Development Bank Law in March gave the bank control over all private-sector assets in the counterpart funds account (except those allotted to the agricultural, forestry and fishing sectors) by lending it the entire amount. Counterpart funds also underwrote preferred shares issued by the Long-term Credit Bank of Japan during the year, paving the way for issues of bank debentures. The U.S. Counterpart Fund Special Account was scheduled to be reorganized into the Industrial Investment Special Account beginning in fiscal 1953, but political difficulties forced the government to operate on provisional budgets for four months of the fiscal year. During this time, the account invested in the Electric Power Development Company. At the end of July 1958, the U.S. Counterpart Fund Special Account was superseded by the Industrial Investment Special Account.

3) The Deposit Bureau and Trust Fund Bureau

The history of the Deposit Bureau Fund dates back to the Deposit Bureau Fund Law and Ministry of Finance Deposit Bureau Special Account Law of March 8, 1925, which established it as a special account for the management of non-income/expenditure funds. When Japan lost the war, the Deposit Bureau Fund took large losses on loans to wartime institutions and overseas companies, and the cancellation of war indemnity threatened it with further losses. The law to treat the losses handled them in much the same way as the reconstruction and reorganization of financial institutions: part of the losses were covered with compensation funds from the General Account, and some of the Class Two frozen postal savings assets were written off. During the period of postwar inflation, there was a sharp rise in allocations to the Postal Service Special Account among the administrative expenses for postal savings, causing the Deposit Bureau Special Account to post deficits from fiscal 1947 to 1949. The decline in postal savings in fiscal 1947 and 1948 was the

major reason for the deficit. Accumulated reserve funds were to be used to cover the special losses of the Deposit Bureau Special Account, not to offset deficits. To cover the mounting red ink, laws were passed that provided for funding from the General Account for fiscal years 1947 to 1949, with the General Account to be repaid at a later date. Deposit Bureau Fund investments after September 1945 were mainly for government bonds, industrial bonds, bank debentures and loans to special banking companies. With postal savings funds declining, investments concentrated in fiscal 1946 on municipal bonds and loans to special accounts. Postal savings funds continued to drop in fiscal 1947, and investments again went to municipal bonds, loans to public corporations and purchases of government bonds. In fiscal 1948, the Bureau Fund purchased municipal bonds and Reconstruction Finance Bank bonds, repurchased government bonds, underwrote government bonds, and made loans to special accounts.

During the period of the Dodge Plan, Dodge established the investment types and ceilings for Deposit Bureau funds at the time the general budget was being drafted. Dodge took General Account investments and allocations and counterpart fund allocations into account in determining Deposit Bureau Fund investments. The Bureau Fund was first permitted to buy municipal bonds in fiscal 1949, and it purchased them consistently thereafter. In fiscal 1949 the Reconstruction Finance Bank ceased to issue new loans. The public corporations that had been dependent on it for their funding turned to the Deposit Bureau Fund instead. This was approved, and the bureau's records do, indeed, show some outstanding loans to five such public corporations at the end of fiscal 1949, but the liquidation of some public corporations reduced its lending to three public corporations as of the end of 1950. By the end of fiscal 1951 Deposit Bureau Fund lending to public corporations had ceased.

Table 2-3 Outstanding of Investment by Deposit Bureau and Trust Fund Bueau

(In millions of yen)

	FY 1945-end	FY 1946	FY 1947	FY 1948	FY 1949	FY 1950	FY 1951	FY 1952	FY 1953	FY 1954	FY 1955
Government bonds	45,481	44,827	48,358	70,741	77,439	87,386	178,877	204,082	244,910	42,176	44,566
General account loans	94	2,381	2,567	2,969	2,891	17,890	7,326	20,739	2,500	2,500	2,352
Special accounts	1,229	2,288	2,475	2,888	1,669	1,669	7,249	17,744	5,185	11,090	17,298
Government agencies	—	—	—	—	1,142	15,000	38,000	83,166	148,057	221,222	301,346
Local government bonds	1,404	1,337	1,171	923	522	405	610	533	451	294	295
Local government loans	1,815	3,507	6,691	40,010	79,285	103,340	156,851	226,832	287,479	334,590	364,583
Special bank debt	2,826	2,772	3,019	4,706	526	509	152	131	83	78	74
Special bank loans	1,424	1,482	1,464	811	411	305	233	143	111	93	87
Special company debt	2,439	2,373	2,189	909	907	712	598	515	363	288	93
Special company loans	960	678	668	384	289	123	120	112	111	110	110
Foreign bonds	1,606	1,606	1,606	—	—	—	—	—	—	—	—
Foreign loans	329	329	329	—	—	—	—	—	—	—	—
Public corporation loans	—	—	—	—	20,502	11,199	—	—	—	—	—
Special corporation debt	—	—	—	—	—	—	394	884	1,154	2,041	2,479
Special corporation loans	—	—	—	—	—	—	400	1,700	7,900	22,450	39,850
Bank dibentures	—	—	—	—	—	17,960	47,994	83,722	137,739	132,727	135,425
Financial institution deposits	—	—	—	—	13,976	—	—	—	—	—	—
Total	59,607	63,580	70,537	124,341	199,559	256,498	438,804	640,303	836,043	769,659	908,558

Source: Ministry of Finance, "*Showa Zaiseishi--Shusen kara Kowa made*", Vol. 19, pp. 360-61. Ministry of Finance, Budget Settlement

To cushion the deflationary impact of the Dodge Plan, “designated deposits” were held with private-sector financial institutions beginning in fiscal 1949, thus providing the private sector with short-term funds. By the end of the fiscal year, the Deposit Bureau Fund had ¥ 13,976 million in deposits with private institutions. In 1950, it had drawn down all of its designated deposits, but it was permitted to lend against bank debentures in order to supply the private sector with long-term funding, thus reintroducing its private-sector investment activities. The Central Cooperative Bank for Agriculture and Forestry (Norinchukin Bank) and four other institutions were entitled to issue bank debentures up to 20 times the value of-their preferred shares. During fiscal 1950 the Deposit Bureau Fund underwrote ¥ 180 million in such issues. The Deposit Bureau Fund took over a ¥ 15 billion loan to the national railways and a ¥ 12 billion bond issued by the Telecommunications Special Account that had originally been underwritten by counterpart funds in fiscal 1949.

The Trust Fund Bureau Fund Law and Trust Fund Bureau Funds Special Account Law of March 31, 1951, reorganized the Deposit Bureau. The new Trust Fund Bureau was an active investor of the funds entrusted to it. Thanks to the price stabilization achieved by the Dodge Plan, the postal savings funds that served as the bureau's main source of funding began to increase. During fiscal 1951 and 1952 the Trust Fund Bureau underwrote bank debentures. The fiscal 1952 underwriting was for bank debentures issued by the Long-term Credit Bank of Japan, which was entitled to issue them up to 20 times the value of preferred shares underwritten with counterpart funds. Bank debentures continued to be one of the Bureau's core investments. Government institutions made loans during fiscal 1951 to the People's Finance Corporation, the Special Account for Loans to the Agriculture, Forestry and Fisheries, and the Housing Loan Corporation as well as to the Teito Rapid Transit Authority. In fiscal 1952, Dodge merely provided a ceiling for Trust Fund Bureau investments, leaving it to the government to decide the specifics of investment after the peace treaty took effect. During fiscal 1952 the Trust Bureau Fund made loans to

the Electric Power Development Company and the Special Account for Designated Road Construction.

4) Foreign exchange and the fixed ¥ 360 rate

The Trade Fund Special Account Law of December 13, 1947 established the Trade Fund Special Account. This account handled trade funds as non-income/expenditure funds, providing a system for managing state trade. The revenues from the domestic sale of aid imports were counted among the trade fund, and a system of foreign exchange allocations closely resembling a multiple-rate system, with provisions for export promotion, import prevention and selective importing, went into operation. The legal rationale for foreign exchange control was based on the Foreign Exchange Control Law of 1941, which was held over without modification. At the time, the price of export items was set in dollars based on foreign market prices, while imports were sold at controlled Japanese prices. The foreign exchange market was thus for all intents and purposes a multiple rate market, with rates determined after the fact on a product-by-product basis depending on whether exports or imports were involved. In October 1948, the government adopted a price calculation system that fixed exchange rates for specific export products. In January 1949, the export foreign exchange market ranged from ¥ 160 to ¥ 600 to the dollar. The ceiling rate was reduced to ¥ 450 in February of that year and lowered to ¥ 425 in April. There were three rates in place for textiles, which accounted for 60 percent of exports: ¥ 420, ¥ 350 and ¥ 330 to the dollar. In April the import rate was changed from an after-the-fact multiple rate to a set rate of ¥ 330 to the dollar, paving the way for the transition to a fixed-rate market.

The publication of the Nine-Point Economic Stabilization Program made it necessary to use a single-rate market to adjust domestic prices to international levels. A single rate was also necessary if Japan wanted to join the International Bank for Reconstruction and Development after the peace treaty took effect. Part of the Dodge Plan price stabilization policy was an immediate move to a fixed-rate market.

Before settling on the rate of ¥ 360 to the dollar, SCAP floated several ideas, ¥ 300 or ¥ 400, among others. It decided on ¥ 360 with a fluctuation range of 10 percent on either side in March 1949. Japan agreed, and the rate was formalized with a SCAP memorandum dated April 23, 1949. It took effect on April 25.

In April 1949, the Trade Special Account was established to replace the Trade Fund Special Account. The Trade Special Account handled the foreign exchange fund which was established under the special account, in addition to managing aid imports and other state trade. The foreign exchange fund, provided a financial basis for government purchases of export exchange and sales of import exchange under the uniform rate. Foreign funds were used for centralized buying and selling of foreign exchange. When private-sector trade began again in fiscal 1949, the expected increases in foreign exchange trading led to the passage of the Foreign Exchange and Foreign Trade Control Law and the Foreign Exchange Special Account Law on December 1, 1949, establishing a framework for new foreign exchange controls through the special account. SCAP transferred foreign exchange controls to the Japanese government. The government implemented central control over foreign exchange positions only for dollar funds, to replace the original system of central control over all foreign exchange. The U.S. dollar funds (August 1951), British pounds (October 1951) and open accounts of other currencies (according to exchange-clearing agreement) were moved to the jurisdiction of the government of Japan.

The second main means of foreign exchange control was known as the “foreign exchange allocation system.” Beginning in January 1950, Japan created a foreign exchange budget each quarter that defined the foreign exchange payments to cover import and invisible payments and the transactions upon which these payments would be based for the period. These budgets permitted control of foreign payments in terms of the product and item imported, and the currency of payment. The underlying law imposed no obligation to publish the foreign exchange budget, but

Table 2-4 Foreign Exchange Budget

(In millions of yen)

Period	Budget for Import				Budget for Non-trade Payment
	US Dollar	Sterling Pound	Open Account	Total	
Jan.-Mar. 1950	37	46	40	123	14
Apr.-Jun.	78	48	48	174	22
Jul.-Sep.	237	158	133	528	29
Oct.-Dec.	233	127	165	525	29
Jan.-Mar. 1951	480	253	194	927	40
Apr.-Jun.	225	110	131	466	40
Jul.-Sep.	357	127	92	576	75
Oct.-Dec.	269	230	162	661	62
Jan.-Mar. 1952	244	307	199	751	89
1st Half of 1953	583	299	362	1,245	N.A.
2nd Half of 1953	872	299	373	1,545	N.A.
1st Half of 1954	595	219	268	1,100	163
2nd Half of 1954	540	250	204	1,090	N.A.

Notes : 1. The figure for the non-trade payment in the first half of 1954 is the amount of the whole FY1954. The figures for the second half of 1954 are the amounts of the budgets from July 1954 to January 1955.

2. The figures in the first and second half of 1954 do not add up to the resepective totals. The budgets for the whole year of 1952 are not available.

Source: Ministry of Finance, "*Showa Zaiseishi--Shusen kara Kowa made* ", Vol. 15, pp. 350-51, 354-55

Ministry of Finance, Reference Chart of Foreign Currency Funds, January and February in 1955

all the budgets were announced from April 1950 onward. Although the amount of foreign exchange allocated to each import product was defined in the budget, no budget ceilings were imposed on products qualified for automatic approval, under the automatic approval system initiated in August 1950. Rather, the foreign exchange control policies changed according to the country's reserve position. When it was appropriate to promote imports, the automatic approval system's ceiling was raised and more items and countries were added; when it was appropriate to restrain imports, the opposite policies were introduced. Import exchange makes up a large

portion of the foreign exchange budget, and following the surge in special procurement demand from the Korean War in late 1950, the ceiling on import exchange rose to keep pace with the increase in incoming foreign currency. This, in turn, prompted an increase in the foreign exchange allotted to the automatic approval system, although the ceilings were later lowered in order to restrain imports. There was also a foreign exchange budget for non-trade payments. After the July-September 1951 quarter, repayment of investment in Japan increased, a result, as will be discussed later, of looser regulations on capital imports.

A lack of adequate foreign exchange funds in the Trade Special Account made it impossible to allocate ¥ 5 billion from the Trade Special Account to the Foreign Exchange Special Account, as provided for in the budget. This resulted in a shortage of bought funds on the 1949 commercial foreign exchange market. Bought foreign exchange funds were raised with temporary borrowing, resulting in a borrowing balance of ¥ 19.7 billion at the end of the fiscal year. The initial fiscal 1950 budget provided for an allocation of ¥ 50 billion from trade funds. Dodge suggested that the Trade Special Account and General Account transfer capital to the Foreign Exchange Special Account, and such transfer be used to pay down the borrowings of the previous year. The issue of foreign exchange bills in August 1950 removed the issue of foreign exchange bought funds as a headache for the policy-makers. The surge in domestic and foreign prices and the increase in exports and imports resulting from the Korean War led to sharp growth of receipts and payments of foreign exchange by the Foreign Exchange Special Account. This account reported all buying and selling of foreign exchange by the private sector as revenues and expenditures. The budgeted figures and those in the settlement of accounts consequently vary considerably, depending on trade and economic conditions. The Foreign Exchange Fund Special Account Law passed on March 30, 1951, reorganized the Foreign Exchange Special Account into the Foreign Exchange Fund Special Account, which would treat foreign exchange funds as non-

income/expenditure funds. On May 10, 1950, the Law Concerning Foreign Capital was passed and the Foreign Capital Committee set up to administer it. This law regulated foreign investment in Japan by, for example, guaranteeing remittance of dividends but not of principal. Amendments to the Special Taxation Measures Law, enacted on May 2, 1950, created tax breaks for capital imports, and U.S. companies stepped up their investment in occupied Japan. Foreign equity investment in Japan rose from 76 deals valued at $3,150 thousand in fiscal 1950, to 502 deals valued at $10,123 thousand in fiscal 1951. Similarly, technology imports increased from 27 deals in fiscal 1950 to 101 in fiscal 1951.

3. The Shoup Mission

1) The Recommendations

Japan was in the process of rebuilding its tax system, but fundamental reforms were needed before the system could be stabilized. The considerations had to be both broad-based and long-term, and advice was sought from outside. In July 1948, the decision was made to invite a mission headed by Professor Carl Shoup of Columbia University to Japan to examine the tax system. With inflation rampant, the greatest problem at the time was finding ways to cut taxes without exacerbating the price increases. Later, in December 1948, the publication of the Nine-Point Economic Stabilization Program made economic stabilization a priority for the Occupation policies as well. Arriving in May 1949, the Shoup mission looked closely at Japan's tax revenues, taxes and collection system. A summation of its findings was released in August, and the first set of Shoup recommendations, the "Report of the Shoup Mission on the Japanese Tax System," followed in September. Having examined the way tax revenues were divided between central and local governments and having considered the details of the Japanese taxation structure, the mission recommended changes in each type of tax and enhancement of the administrative system. The most significant accomplishment of the Shoup Mission,

however, was introducing the principle of "fairness" to Japanese taxation. The first set of recommendations retained a relationship with the Dodge Plan austerity budgets and took care to fight inflation while providing revenues large enough to ensure that the budget would not slip into deficit.

The first set of recommendations tried to make the burdens on salaried workers and independent businessmen fairer, by lowering the maximum rate for the national income tax from 85 percent to 55 percent, a level at which rational administration would also be possible. It also reworked some of the deductions, deducting the allowance for dependents from income, for example, rather than from tax value. In the area of capital gains, the report advocated a 100-percent capital gains tax with a deduction for capital losses. It also noted the need to put some limits on the ability of investors to hold assets such as stocks anonymously, in order to maintain the principle of a comprehensive, progressive income tax. The idea of comprehensive taxation was deeply rooted in the idea of fairness. For the corporate tax, Shoup maintained the 85-percent flat rate then current, allowing a 25-percent dividend deduction for shareholders and adding a 1-percent interest surtax on retained earnings (higher for family-owned companies). In exchange for this, it did away with the existing excess income tax and liquidation income taxes, and advised eliminating the 20-percent withholding tax on dividends.

The inheritance and gift taxes were similar to those in the United States at the time and were subject to widespread evasion. The report advised integrating the two into a progressive "succession tax" or "acquisition tax" on the recipients of gifts and legacies. Another new direct tax it proposed was the revaluation tax. Asset prices had risen significantly during the postwar inflation, resulting in a large gap between prices as recorded on balance sheets and market prices. The new tax would revalue assets at prevailing prices and take 6 percent of tax to the revaluation profit. There was also a wealth tax on individuals. This tax on personal asset growth resulting from inflation was recommended because the reduction in the maximum income tax

rate had lowered the burden on people in the high-income brackets, and the inheritance tax was not considered sufficient taxation on the concentration of assets. The asset tax was apparently imbued with the idea of vertical fairness. Shoup recommended rates of 0.5 percent to 3.0 percent on all assets valued in excess of ¥ 5 million.

In the area of indirect taxation, the mission proposed a large hike in the liquor tax, since alcoholic beverages were considered luxury items. Shoup also recommended scrapping the transactions tax that had been introduced in September 1948. This tax was paid by purchasing revenue stamps, which irritated the taxpayers. Nor did it provide for any deductions of transactions taxes paid at previous stages of the production and marketing process, which led to complaints that it did not divide the burden fairly among companies that both produced and marketed their goods and those that specialized in manufacturing, wholesaling or retailing. The textiles consumption tax was another slated for elimination, since the mission did not think it proper to tax basic necessities. The Shoup Mission liked the commodities tax on luxury items, on the other hand, because it would be able to generate revenues. Its recommendation for the sugar consumption tax was to eliminate taxation of domestically produced sugar. The Shoup Mission placed particular emphasis on ensuring adequate funding for local authorities and recommended sweeping changes in local taxation. To replace the real estate acquisition tax, which it recommended scrapping, the report proposed an added-value business tax to be collected at the prefectural level. It suggested that taxation at the municipal level should consist primarily of a resident's tax, land tax and house tax. One of its objectives in this was to make a clear distinction between prefectural and municipal tax items. It is notable that the prefectural added-value tax marked the introduction of a very broadly based tax immediately after the elimination of the transactions tax.

The Shoup Mission had much to say about tax administration as well. Its primary recommendations were as follows: l) to eliminate the traditional “collection

target system" in favor of a self-assessment of expected tax liabilities based on the results of the previous year; 2) to simplify the income tax reporting system; 3) to publish the incomes of high-income earners; 4) to create a new "blue form" income tax assessment (for the self-employed and taxpayers with multiple sources of income); 5) to introduce a withholding tax for agricultural income; 6) to ban anonymous and assumed-name deposits; 7) to make registration and changes of title mandatory for stock and bonds; 8) to establish a tribunal system to hear complaints about taxation and conduct tax-related claim proceedings; and 9) to use certified public accountants in the tax assessment system and to improve the quality of tax attorneys.

Diet deliberations on the proposed changes coincided with the debate on the fiscal 1949 supplementary budget. As discussed below, the Income Tax Law was amended during fiscal 1949, and reforms began in other areas in fiscal 1950. As the "Shoup Tax System" was being put in place, measures were taken to strengthen the administrative systems as well. After his return home, Shoup worried about the kind of reception his advice would receive in Japan. He organized a second mission in July 1950 to follow up on its implementation and to finish off unresolved matters. The MOF asked Shoup to suggest tax cuts, particularly in the income tax. There were worries that the second report would insist on implementation of the local added-value tax, a ban on separate deposit and savings accounts and tax on interest income, and mandatory registration of stocks - all elements of the first report that had been delayed. The second report, the "Shoup Mission Report for Newspaper Publication" of September 21, did not include these points, however.

The second report's tax system advice was as follows: l) to agree to a 10-percent labor deduction from the income tax for farmers and fishermen to be administered according to the level of surplus funding resources; 2) to agree to hikes in the dependent allowance and basic deduction and to reductions in the rate for low-income taxpayers; 3) to recommend that local fiscal resources be secured with

municipal bond issues and higher Local Fiscal Resource Equalization payments from the General Account (which replaced the Special Account for Local Allocations of Taxes at the end of fiscal 1949) rather than through higher tax rates; 4) to instruct the municipalities to base their residents' taxes on annual income and to collect it as a withholding tax; 5) to unify rates for the added-value tax to be introduced at the prefectural level and to allow companies the option of including the total of net profits, labor costs, interest and rent in the amount of added value; and 6) to place the highest priority on the fixed assets tax as a taxed asset. In addition, the recommendations underscored the need for taxation administrative reforms, asking for enhancement of the blue-form system, allowing simplification of the bookkeeping procedures for farmers and small businessmen, pointing out the need to deal with taxpayers in cumulative arrears, and recommending a tax-payment savings system. The focus of the second set of recommendations was thus on local finances and income tax administration.

How much binding force the second recommendation had on tax law was a matter of debate in Japan. SCAP informed the government that the recommendation should be considered as guidelines. The second set of recommendations promised to explain the technical details in an appendix to be provided later. On October 30, SCAP delivered the appendix to the government, but it contained only a detailed technical discussion of tax administration.

2) The Shoup Reforms

The Shoup recommendations led to fundamental reform of the Japanese tax system. The beginning of deliberations coincided with the Diet debate on the fiscal 1949 supplementary budget, and many amendments to various tax laws were proposed. The reason for the amendments, according to the bill, was to reduce the withholding income tax for wage earners for an interim period in order to lighten and optimize the national tax burden as part of an upcoming full-scale reform of the tax system. In the area of indirect taxation, the bill proposed repealing the textile

consumption tax and transactions tax, implemented January 1950, amending the commodities tax as appropriate and integrating the soft drinks tax into the commodities tax. This led to the enactment of the Law on Temporary Exceptions to the Income Tax Law of December 15, 1949, the Law to Repeal the Textile Consumption Tax, Soft Drinks Tax and Transactions Tax of December 27, and an amendment to the Commodities Tax Law, all of which were implemented during fiscal 1949.

The reforms were extended into the fiscal 1950 budget process, where further amendments were proposed to the Diet. Again, the bill explains, the purpose was to reform the entire existing tax system in line with the general principles of the Shoup recommendations, with some modifications recognized as appropriate in light of current fiscal and economic conditions. On March 31, 1950, the Income Tax Law, Corporate Tax Law, Inheritance Tax Law, Liquor Tax Law were all amended, and the Securities Transfer Tax Law was invalidated. The National Tax Collection Law was also amended. These amendments were followed by implementation of the Asset Revaluation Law (April 25), Special Tax Measures Law (May 2) and Wealth Tax Law (May 11) and an amendment to the Inheritance Tax Law (May 20).

This series of modifications of Japanese tax law did not contain many of the recommendations of the first advisory, notably the measures aimed at reforming the securities tax system, the creation of a new social security tax, the revision of the tax attorney system or the modification of official "useful lives" for depreciable assets. All were to be subject to further consideration. On July 31, 1950, the Local Tax Law was amended to provide a new added-value tax to be collected by prefectures from businesses. Its enforcement was put on hold, however.

Let us now consider some of the differences between the recommendations and the actual laws. The amended Income Tax Law included a higher basic deduction than that recommended in the first advisory, in order to reduce the burden on low-income taxpayers. In addition, the maximum rate of 55 percent was applied to

income in excess of ¥ 500,000 rather than ¥ 300,000. Finally, the law was narrower in its application of profit-and-loss netting and carry-overs and back-charges for losses. Still, it was generally in line with the advisory. The securities capital gains tax was legalized, as was the wealth tax, as a supplement to the income tax which was set at the rates advised by Shoup. Taking effect in May 1950, the wealth tax brought in ¥ 516 million in revenues in fiscal 1950, and ¥ 962 million in fiscal 1951. Although not large amounts, the value of taxable assets was growing thanks to the Korean War boom. In fiscal 1950 taxable assets were worth ¥ 170.2 billion; in 1951, ¥ 227.0 billion; in 1952, ¥ 408.0 billion.

Table 2-5 Wealth Tax

(In millions of yen)

		Taxable property value	Debt	Net taxable property value	Wealth tax amount
FY 1950	Payers	26,081	14,225	26,081	26,081
	Value	170,264	32,772	137,491	653
FY 1951	Payers	31,225	18,910	31,224	31,050
	Value	227,095	41,088	186,005	957
Retrospective	Payers	14,599	7,282	14,559	14,526
	Value	41,773	5,661	36,111	172
FY 1952	Payers	48,025	31,416	48,019	47,929
	Value	408,031	61,367	346,661	2,272
Retrospective	Payers	22,343	9,717	22,383	22,401
	Value	53,124	8,740	44,392	328
FY 1953	Payers	38,272	18,956	38,258	38,276
	Value	98,710	14,159	84,548	732
FY 1954	Payers	1,731	739	1,737	1,771
	Value	11,188	1,274	9,913	156
FY 1955	Payers	571	252	574	588
	Value	5,206	643	4,563	71
FY 1956	Payers	270	90	270	281
	Value	4,292	499	3,793	78

Source: Ministry of Finance, "*Showa Zaiseishi--Shusen kara Kowa nade* ", Vol. 19, pp. 294

The Corporate Tax Law amendment raised the rate on reserves to 2 percent for ordinary companies and to 7 percent for family-owned companies. Like the income tax, it was narrower in its application of profit-and-loss netting and carry-overs and back-charges for losses than Shoup's recommendations. There was much concern over the asset revaluation tax, because of the potentially large impact it would have on corporate finances. The tax, as implemented, differed from the recommendations on several points, generally softening it. The revaluation base date was extended from July 1, 1949, to January 1, 1950; revaluation was made voluntary (the recommendations suggested that it be mandatory); the methods of payment were relaxed in an effort to encourage companies to revalue; and the ban on dipping into the revaluation reserve was relaxed for the first five years. Revaluation brought in ¥ 6,403 million in tax revenues during fiscal 1950 and ¥ 11,532 million in 1951. The administrators set ceilings on the revaluation amounts, and the difference between the revalued price and the book value was considered as revaluation profit and subjected to a 6-percent tax. Inflation resulted in large revaluation profits, bringing in ¥ 359.6 billion for companies in fiscal 1950 and ¥ 388.5 billion in fiscal 1951, mostly in terms of depreciable assets. The progress in revaluation, together with the economic stabilization of the Dodge Plan, led to a decline in revaluation profits, beginning in fiscal 1952. The modification of the inheritance tax followed the Shoup recommendations almost to the letter.

In the area of indirect taxation, the government followed the advisory's recommendations on the commodities tax faithfully. The soft drinks tax was repealed as part of the fiscal 1949 supplementary budget, and taxation on soft drinks was integrated in to the commodities tax. Japan hiked the liquor tax rate as recommended, but it did not follow the advice to put alcoholic beverages back under government control. Shoup recommended scrapping the 5-percent travel tax, but the government merely did away with the tax on ordinary fares and boosted rates on first- and second-class seats to 20 percent on the assumption that those buying the

seats could afford to pay more. The advisory's recommendations for elimination of the stamp tax, registration tax and sugar consumption tax were ignored.

Table 2-6 Asset Revaluation Tax

(In millions of yen)

	FY 1950		FY 1951		FY 1952		FY 1956	
	Total	Depreciated assets	Total	Depreciated assets	Total	Depreciated assets	Total	Depreciated assets
Corporate tax asset revaluation								
Number of corporations	30,901	30,077	7,597	7,298	502	479	3,186	2,838
Revaluation amount limit	647,057	611,581	544,200	540,634	208,459	208,064	290,255	263,886
Revaluation amount	432,626	414,993	465,806	457,079	178,194	177,905	262,594	242,095
Book value, others	72,987	70,431	77,270	75,627	100,667	100,647	146,113	141,136
Revaluation difference	359,640	344,562	388,536	381,452	77,526	77,258	116,481	100,959
Revaluation tax amount	21,578	20,674	23,312	22,887	4,652	4,635	6,989	6,058
Special declaration								
Number of corporations	142	140	256	250	221	206	63	42
Revaluation amount limit	15,443	14,909	332,198	339,555	103,871	103,550	12,309	11,978
Revaluation amount	11,613	11,401	296,818	294,968	81,895	81,633	6,995	6,717
Book value, others	1,909	1,887	18,138	18,058	28,566	28,547	279	256
Revaluation difference	9,704	9,514	278,680	276,910	53,329	53,086	6,716	6,461
Revaluation tax amount	582	571	16,721	16,615	3,200	3,185	403	388
Statutory personal revaluation								
Personnel	294,986		428,513		182,059			
Revaluation amount	32,112		56,744		39,883		47,738	
Revaluation difference	21,415		42,467		30,218		35,445	
Revaluation tax amount	1,284		2,546		1,377		1,464	
Voluntary personal revaluation								
Personnel	68,216		23,028		7		10,231	
Revaluation amount limit	41,368		15,051		48		13,428	
Revaluation amount	33,399		13,163		38		12,463	
Fiscal tax valuation amount or acquisition value	7,953		3,603		6		5,825	
Revaluation difference	25,446		9,560		32		6,897	
Revaluation tax amount	1,526		573		2		414	

Note: Special declarations were made by companies subjected to special accounting procedures.
Source: Ministry of Finance, "*Showa Zaiseishi--Shusen kara Kowa made*", Vol. 19, pp. 297-298

The second advisory was published in newspapers in September 1950. It was officially deemed "guidelines," but opinions differed even within SCAP on how to position it. Nevertheless, the amendments to tax laws that coincided with the fiscal

1950 supplementary budget generally conformed to the second advisory's recommendations. The government reduced the income tax by hiking deductions and lowered the rates for the liquor tax, commodities tax, gasoline tax and sugar consumption tax. The reduction in the gasoline tax was counter to the recommendations, which did not think reductions appropriate as long as gasoline was being rationed. The recommendations made no mention of the sugar consumption tax, but the government cut it anyway.

The amendments based on the Shoup recommendations put in place the main features of the postwar tax system, with its heavy dependence on income taxes, corporate taxes and other direct taxation. Gaps between the ideal and the reality meant that some aspects of the Shoup system were not necessarily suited to Japan, but the principle of fair taxation it articulated would underlie Japanese taxation for decades to come. Elements which would have a particular impact in later years included the progressive, comprehensive income tax, the reorganization of indirect taxes, the use of local taxes to allocate revenues to local governments and the administrative enhancements.

4. The Monetary Policies of the Dodge Plan

1) Money Supply

The announcement of the Nine-Point Economic Stabilization Program preceded a severe monetary tightening in 1949. The Dodge Plan put an end to the priority finance that had been the chief characteristic of monetary policy up to that time. Since the Bank of Japan was the supplier of funds, the Bank of Japan Law was amended on June 3, 1949, to create a Bank of Japan Policy Board empowered to make decisions on important monetary issues, including basic business guidelines for the BOJ and changes in the official discount rate. The amendments also made the BOJ independent of the government as far as monetary policy was concerned. They did not, however, change the various regulations in the BOJ Law that had been

imposed during the war. In the financial sector, the Dodge Plan did away with the "special bank system" that had allowed certain banks to issue bank debentures since the Meiji Era, replacing it with a law that provided for bank debenture issues up to 20 times the preferred shares underwritten with the counterpart funds, as described earlier in this chapter. It also made provisions for credit cooperatives. The Savings and Loan Law of June 15, 1951, converted the "business district credit cooperatives" to "savings and loans" (*shinyo kinko*). Mutual finance associations (*mujin*) were reorganized as mutual (*sogo*) banks by the Mutual Bank Law of June 5, 1951.

The system of higher applied rates for BOJ loans that had run parallel to priority financing continued. Under the applied rate system, the BOJ set lending levels for the financial institutions it dealt with. Any lending in excess of those levels was made at higher interest rates. The BOJ used high applied interest rates for lending to commercial banks, trust banks, the Central Cooperative Bank for Agriculture and Forestry (Norinchukin Bank) and the Central Bank for Commercial and Industrial Cooperatives (Shoko Chukin Bank). In April 1949, the applied rate system was strengthened as part of a general monetary tightening. The purpose of the higher rates was to wean the commercial banks from their dependence on BOJ funding, in conformance with Dodge Plan principles. The excess treasury fund combined with the cessation of new lending by the Reconstruction Finance Bank to put a strain on commercial funding, however, leading to a reduction in Class 2 higher applied rates on applicable bills on July 13, 1949; trade bills had already been exempted in a June 24 measure. When the deflationary effects of the Dodge Plan continued to accelerate, the BOJ moved to provide some relief by exempting bill discounts from higher applied rates on January 17, 1950. As a result, higher applied rates were maintained only for general loans among loans on bills, and the Class 2 rate was cut by 0.365-0.720 percent at the same time. This easing of higher applied rates enabled the BOJ to encourage lower market rates, bringing down the maximum lending rate of

commercial institutions and setting ceilings on interbank deposit rates so that overcompetition of deposits would not ensue.

Table 2-7 Higher Applied Rates Loans by the Bank of Japan

(In hundred millions of yen)

Perid	Loans Outstanding	Higher Applied Rates Loans	Secondary Higher Applied Rates Loans	Higher Rates Applied Banks
Mar. 1951	1,279	n.a.	238	n.a.
Jun.	1,913	n.a.	601	n.a.
Sep.	2,463	n.a.	1,158	n.a.
Dec.	2,230	n.a.	995	n.a.
Mar. 1952	2,278	n.a.	534	n.a.
Jun.	2,518	n.a.	419	n.a.
Sep.	2,959	n.a.	550	n.a.
Dec.	2,232	n.a.	45	n.a.
Mar. 1953	2,912	n.a.	380	n.a.
Jun.	3,262	n.a.	483	n.a.
Sep.	3,500	1,932	581	61
Dec.	2,987	1,433	883	49
Mar. 1954	4,173	2,545	2,034	59
Jun.	3,996	2,648	2,145	57
Sep.	3,898	2,824	2,253	57
Dec.	2,434	1,954	1,562	43
Mar. 1955	2,521	2,098	1,693	43
Jun.	2,118	1,521	1,159	45
Sep.	1,435	14	-	11
Dec.	319	-	-	-

Source: Ministry of Finance, "*Showa Zaiseishi--Shusen kara Kowa* ", Vol. 19, pp. 84

Another method used to supply funds to the private sector was the government designated deposit. The Treasury ran a fund excess in 1949, causing government deposits with the BOJ to grow. Designated deposits were a way to return that money to the market by entrusting banks with Deposit Bureau funds. The government deposited ¥ 6 billion with the Central Cooperative Bank for Agriculture and Forestry (Norinchukin Bank), which had cash-flow problems, in March 1949, enabling it to repay loans from the BOJ. Another ¥ 15 billion was added later, with

the money to be used to purchase short-term government securities. Deposits with commercial banks began shortly thereafter. The government entrusted a total of ¥ 16 billion to 14 institutions, including city banks, the Industrial Bank of Japan, Nippon Kangyo Bank and Hokkaido Takushoku Bank. Deposits in regional banks enabled them to repay BOJ loans. The government continued to increase designated deposits until about October. In July, it entrusted ¥ 10 billion in surplus funds to the BOJ. These deposits were made initially to avoid an expansion in credit, but as the deflationary effects became more widely felt, supplying credit emerged as the main policy objective. The government-designated deposits were of great significance for monetary policy. At the end of fiscal 1949, the government had ¥ 10,878 million in designated bank deposits and a total of ¥ 13,976 million, when other miscellaneous deposits were added in. During fiscal 1950, it withdrew the entire amount. Meanwhile, the Reconstruction Finance Bank quit lending to public corporations in fiscal 1949, causing agricultural public corporations to turn to the Deposit Bureau for funding instead. Year-end monetary policies for 1949 resulted in ¥ 9.9 billion in Deposit Bureau funds being placed in short-term deposits with private-sector financial institutions. A relaxation of the rules led to a surge in Deposit Bureau lending to local governments during the year, as well.

The BOJ began to purchase Reconstruction Finance Bank bonds during the June-August period of 1949, and buying operations of government bonds continued thereafter, developing into a powerful tool for supplying money to the markets. By the end of 1949, BOJ purchases of government bonds to counteract Dodge Plan funding shortages reached a cumulative total of ¥ 32.1 billion. SCAP approved of the BOJ credit supplies as a means of providing relief from the deflationary effects of the Dodge Plan. BOJ lending to commercial banks rose steadily through the end of 1950, climbing from ¥ 49,306 million at the end of 1948, to ¥ 84,213 million at the end of 1949, and to ¥ 255,573 million at the end of 1950. These funds prompted a corresponding rise in commercial lending. Outstanding loans on commercial bank

books were valued at ¥ 381,347 million at the end of 1948, rising to ¥ 679,051 million at the end of 1949, and ¥ 994,746 million at the end of 1950. This increase in lending by commercial institutions dependent on the BOJ money supply was the major factor in establishing the postwar excessive lending structure.

Even easier money policies came into being in 1950. Between February and April, excess funds of the Reconstruction Finance Bank were deposited with commercial banks, and the BOJ's higher applied rates were cut sharply in February. Bill discounts were exempted from higher applied rates as part of this easing, triggering an upsurge in industrial bill discounting. Beginning around March 1950, however, Dodge became critical of monetary policy, claiming that the effects of suspending public bond issues were being negated by excessive increases in bank credit. Japan had no choice but to implement policies to restrain the growth of bank credit, beginning in April. As part of these restraints, the rediscounting of industrial bills was suspended in May 1950. Instead, they were handled as stamp bills and subjected to higher applied rates. The attitude toward government bond purchases also became less enthusiastic in May, reducing BOJ credit facilitation. It should be noted, however, that there was no substantial real decline in bond buying operations. Lending by the BOJ continued to expand. The reason the BOJ's government bond holdings did not grow was that they were shifted to the special accounts and government mutual aid associations. The Korean War broke out in July, while these money supply policies were in force. The boom it triggered began causing the economy to heat up as early as December, bringing an end to the need for easy money policies to counteract Dodge Plan deflation.

The Dodge Plan exerted a strongly deflationary impact that stabilized prices. The deflation policies were pursued during fiscal 1950 as well, but the situation changed after the Korean War broke out. Prices for textiles, metals and internationally traded commodities skyrocketed in July and August, and import prices rose sharply in 1951. The rising prices brought profits to companies and

Table 2-8 Lending and Securities Holding of the Bank of Japan

(In millions of yen)

At year's end	1946	1947	1948	1949	1950	1951	1952	1953	1954
Lendings	58,030	85,502	135,410	188,649	332,039	400,918	356,150	402,619	266,531
Banks	47,908	30,686	49,306	84,213	225,573	343,229	301,229	371,550	251,986
Small Business Finance	2,522	1,615	2,595	4,432	13,452	18,065	16,532	19,556	13,262
Special Accounts of the government	7,600	53,201	83,509	100,004	63,014	39,624	38,389	11,513	1,283
Securities	34,741	145,866	247,718	188,900	136,787	126,044	286,140	314,379	483,573
National Bonds	34,741	113,496	211,484	188,900	136,787	126,044	286,140	314,379	483,573
Reconstruction Finance bank Bonds	-	32,370	36,234	-	-	-	-	-	-

Source: Ministry of Finance, "*Showa Zaiseishi--Shusen kara Kowa made*", Vol. 19, pp. 424-41

carried the economy out of the Dodge deflation into a boom. During the latter half of 1950, $240 million in foreign currency flooded into Japan, and as the hard currency supply mounted, a Foreign Currency Loan Program was established on September 25, 1950, to promote import finance. Under the program, the BOJ bought foreign currency from the Foreign Exchange Control Committee to lend to the foreign exchange banks, which in turn lent it to importers. The balance of lending reached ¥ 280,175 million in March 1951, after which it declined.

Fearing that the Korean War boom would cause the economy to overheat, the BOJ tightened its higher applied rate lending. It had exempted commercial bills from the higher applied rates in February 1950 as part of its easy money policy, but it reapplied the higher rates now, revising its lending ceilings to reflect the change. Some of the Class 2 rates were hiked to close the spread between commercial and general rates. These policies were expected to restrain demand for funds not based on real economic demand, and to normalize the commercial banks' dependence on the BOJ. Demand for funds remained high, however, leading to a further tightening of the higher applied rate system in March 1951. The requirements for higher applied rate lending were made stricter, the ceiling for Class 1 lending was lowered and the rates were hiked. Government bond buying operations during the summer of 1950 served as a powerful tool for supplying funds to the market, but money had been eased sufficiently, thanks to the Foreign Currency Loan Program. It was possible to reduce the purchasing operations for the supply of funds to 60 percent of the industrial bond issue value in September, 50 percent in October, and 30 percent in December. The bond purchasing operations continued to decline, and ceased entirely in October 1951. In January 1951, bank debentures were excluded from the list of bonds eligible for purchase, narrowing the focus to industrial bonds.

The armistice ending the Korean War came in July 1951. The price rises during the war had been high by international standards, prompting SCAP to implement anti-inflationary price-reduction policies. When prices continued to rise after the

Table 2-9 Lending Outstanding in Foreign Currency by the Bank of Japan

(In millions of yen)

Period	Old System		New System	Others	Total
	Type A	Type B			
Sep. 1950	10,175		-	-	10,175
Dec.	102,215	52,295	-	-	154,510
Mar. 1951	132,949	147,225	-	-	280,175
Jun.	57,910	158,735	-	-	216,645
Sep.	32,430	104,955	-	-	137,385
Dec.	25,803	93,609	18,845	-	138,257
Mar. 1952	7,570	59,112	30,352	-	97,034
Jun.	3,850	9,871	34,751	12,570	61,043
Sep.	2,807	1,608	28,334	39,497	72,247
Dec.	2,093	601	29,214	62,578	94,486
Mar. 1953	1,351	348	13,187	81,579	96,466
Jun.	1,039	290	1,467	90,966	93,762
Sep.	661	118	202	95,094	96,075
Dec.	313	35	50	91,923	92,321
Mar. 1954	0	17	12	68,442	68,471
Jun.	-	0.3		45,011	45,011
Sep.	-	-	-	26,068	26,068
Dec.	-	-	-	21,864	21,864
Mar. 1955	-	-	-	20,319	20,319
Jun.	-	-	-	18,843	18,843
Sep.	-	-	-	16,436	16,436
Dec.	-	-	-	12,738	12,738
Mar. 1956	-	-	-	9,790	9,790
Jun.	-	-	-	8,173	8,173
Sep.	-	-	-	5,762	5,762
Dec.	-	-	-	3,091	3,091
Mar. 1957	-	-	-	1,538	1,538
Jun.	-	-	-	763	763

Source: Ministry of Finance, "*Showa Zaiseishi--Shusen kara Kowa made*", Vol.12, pp. 499

armistice, the authorities had little choice but to adopt a tight money stance. The ODR was hiked 0.73 percent on October 1, 1951. The higher applied rate lending ceiling was reduced on October 15, and new rules for capital investment lending were announced on October 20. On November 15, the Foreign Currency Loan Program ceased to lend funds to settle import bills.

Other significant measures of the day included a decision to scrap the system of centralized settlement of domestic exchanges by the BOJ, effective April 1952. The system was introduced during World War II, as a means of conserving funds for commercial interbank settlements, but it required the BOJ to lend the difference for banks with payment surpluses, offsetting the effects of lending restraints in other areas. These measures reduced BOJ lending to commercial banks from ¥ 343,229 million at the end of 1951 to ¥ 301,229 million at the end of 1952. The growth in bank lending finally began to slow in 1952 as well. This tightening policy was effective in quelling the inflation triggered by the Korean War.

2) The Securities Markets

Speculative short sale trading dominated the Japanese stock market, while the bond market developed around government bond trading. With most of the shares in major corporations in the hands of the zaibatsu, the securities market was still in its infancy as a tool for corporate fund-raising. During the war, the stock market was controlled by the government under the Japan Stock Exchange Law of March 1943. The Japan Stock Exchange had been followed by some government investments and the integration of all the stock exchanges into a single stock exchange in August 1943. That stock exchange had closed its doors on August 10, 1945, and it had not yet reopened. The MOF and the securities brokers wanted the stock exchange reopened as quickly as possible, but SCAP refused, believing it still too early. Until the stock exchange reopened, stock trading had to be carried out elsewhere.

Large increases in government securities holdings were expected. The asset tax brought more securities into the Treasury, along with securities from the dissolution

of the zaibatsu and special liquidation of closed institutions, and the securities in the old accounts of special accounting corporations. The Coordinating Liquidation Committee was established in June 1947, to decide how to deal with them. A part of the program for the democratization of securities, this council functioned, for all intents and purposes, under instructions from SCAP. Shares that had belonged to the *zaibatsu* or liquidated institutions, or that had been paid in kind as asset taxes to the Treasury were disposed of by promoting employee stock-holding programs, public tenders and general sales. One result of these activities was to raise the share held by individual investors from 53 percent at the end of fiscal 1945, to 69 percent at the end of fiscal 1949.

The Securities and Exchange Law of March 27, 1947, established a new legal framework for securities trading and repealed the Japan Securities Exchange Law. The drafters of the Securities and Exchange Law had envisioned a U.S.-style Securities and Exchange Commission that would oversee the brokers, but the commission stipulated in the law was not an administrative council. SCAP wanted amendments that would define the nature of the commission. Among the revisions it called for was also a ban on participation in the securities business by ordinary and trust banks.

The revised Securities and Exchange Law was enacted on April 13, 1948, creating a Securities Exchange Commission as an administrative council and greater authority, switching from a licensing to an approval system for brokers and stock exchanges, and limiting securities underwriting to brokerages. Article 65 of the law also banned banks and securities companies from competing in each others' industries, as was the U.S. practice. The banks having been excluded, would-be brokers merely needed to seek government approval for their establishment, with the Securities Exchange Commission providing oversight and supervision.

In short, the U.S. systems for regulating the securities markets were imported wholesale into Japan. During this time, trading took the irregular form of group

trading, in which groups of designated brokers bought and sold shares over the counter. The reopening of the stock exchange was awaited impatiently. The postwar inflation had brought activity to the stock market, but the trading was speculative, and the trading groups were instructed to exercise “self-restraint” in January 1948. After the revised Securities and Exchange Law took effect and the Securities Exchange Commission was established in May of that year, the trading groups were subject to strict supervision.

The revised law and establishment of the commission brought new demands for the reopening of the stock exchanges, but they were again denied and the reopening delayed, while the economy was stabilized under the Nine-Point Economic Stabilization Plan published in December 1948, and the shares held by the Securities Coordinating Liquidation Committee were sold off. Approval for reopening of the stock exchanges finally came in January 1949, and stock exchanges were registered in Tokyo, Osaka and Nagoya that April. Before trading restarted, SCAP provided the Securities and Exchange Commission with a list of Three Principles of Trading: 1) All trading conducted on the stock exchanges would be recorded in chronological order; 2) the stock exchange members would be required to effect all trades in listed issues on the exchanges; and 3) no futures trading would be allowed. The result was to concentrate all trading of listed shares in the stock exchanges, with accurate records kept to prevent unfairness, and speculative short sales trading banned (only real demand trading in underlying shares was allowed). These instructions came as a shock to the Japanese brokers, who had grown accustomed over the years to speculative short sale trading, but they had to be accepted for the purpose of investor protection. The Tokyo, Osaka and Nagoya stock exchanges reopened on May 16, as members-only organizations. They were followed by stock exchanges in Kyoto, Kobe, Hiroshima, Fukuoka, Niigata and Sapporo.

Share prices, which had risen consistently during the group trading years, peaked about the time the stock exchanges reopened and declined under the Dodge

Plan policies. When they hit bottom in 1950, the prices were half what they had been when the stock exchanges reopened. Since the exchanges only allowed trading in actual shares, speculative trading off the exchange flourished, though the Securities Exchange Commission did try to clamp down on it. To prop up the market, the Securities Coordinating Liquidation Committee quit releasing shares, more securities financing was made available to brokers and general investors, short sales were banned and capital increases were regulated. As a result, in 1950, the amount of paid-up equity shares fell to 50 percent of year-before levels. The market bottomed out in December 1949, but it did not turn upwards. Most of the shares sold to individual investors and employee stock-holding programs under the securities democratization policy lost money during the Dodge Plan deflation, and those losses drove many individual investors out of the market. The percentage of stocks in institutional portfolios continued to rise, however. By the end of fiscal 1951, individual investor holdings were down to 56 percent, and they continued to decline. The MOF considered establishing securities holding institutions to bolster share prices, but the idea was never acted upon. Japan Securities Finance Co. was established in December 1949, to provide larger securities financing, and by May 1950 every exchange had its own securities finance company. The job of the securities finance companies was to facilitate trading by lending money and shares. Japan Securities Finance Co. could borrow directly from the BOJ, and it was active in supplying funds. Amendments to the Securities and Exchange Law, designed to protect investors while share prices slumped, imposed stricter capital requirements on the securities companies to strengthen their base of operations. The Korean War boom of 1951 turned the market upward, permitting the regulations on capital increases to be relaxed and the money raised through the sale of shares to be used for long-term capital investment.

One idea put forward to encourage more stock purchases during the slump involved the establishment of securities investment trust companies. The Securities

Investment Trust Law of June 4, 1951 was enacted, and the investment trust system revived. Within a month, the top four brokers had registered as trust companies, and by August, there were a total of seven registered companies soliciting subscriptions in investment trusts. Coming in the midst of the Korean War boom, the trusts won immediate popularity, and began raising and investing large amounts of money.

On the bond market, meanwhile, the Dodge Plan policies brought an end to the issue of Reconstruction Finance Bank bonds, making it necessary for companies to issue their own bonds to raise industrial funding. In fiscal 1949, the BOJ bought Reconstruction Finance Bank bonds from financial institutions and instructed them to use the money to buy industrial bonds and Industrial Bank of Japan bonds. To counteract the Dodge Plan deflation, BOJ credits were used to promote corporate bond issues as well. In June 1949, the BOJ began lending at favorable terms against corporate bond collateral, and since only bonds qualifying for BOJ lending were issued, the system strengthened the control and selection process on the new issues market. Corporate bond issues fell off between 1950 and 1951 as a result. Beginning in 1950, the Industrial Bank of Japan and four other institutions were allowed to issue bank debentures, which were bought by the markets. Since most of the purchases were by financial institutions, however, the bank debentures competed for funds directly with private-sector capital increases and bond issues. After the peace treaty took effect on August 1, 1952, the Securities and Exchange Commission was disbanded and its functions moved to the Financial Bureau of the MOF. Japan did not, however, revive the brokerage licensing system at that time.

Chapter 3 Fiscal and Monetary Policies after the Peace Treaty

1. Political and Economic Conditions After the Peace Treaty

The Treaty of San Francisco took effect on April 28, 1952, and with it Japan recovered its independence. An armistice in Korea followed in July 1953, that avoided a large-scale war on the peninsula. As the lines of the Cold War hardened, however, the Security Treaty and administrative agreement between Japan and the United States placed Japan firmly in the Western camp (whatever reductions there might be in the U.S. military presence). An October 1953 meeting between Hayato Ikeda and Walter S. Robertson, Assistant Secretary of State for Far Eastern Affairs, in Washington, D.C., produced an agreement on boosting Japan's self-defense capabilities. Japan also began to recover occupied territory, with an agreement to return the Amami islands signed in December of that year. America started to provide aid to Japan in the form of surplus agricultural products under a series of agreements signed in March 1954, including the U.S.-Japan Mutual Defense and Assistance Agreement, the Surplus Agricultural Commodity Purchasing Agreement, and the Economic Aid Fund Agreement. In June 1954 the Defense Agency Establishment Law and the Self-Defense Force Law were enacted, leading to a reorganization of the Civil Defense Forces into the Self Defense Forces and a strengthening of Japan's military preparations. The two leading conservative parties merged in December 1955, setting the stage for the government of Ichiro Hatoyama to take power. The left and right wings of the progressives had already merged to form the Socialist Party of Japan in October 1955, and the creation of a new conservative party completed what would be known as the “1955 System.” Having given the ruling party a stable majority of votes, the new political system would define the tenor of economic policy throughout the high-growth period, and would remain one of the hallmarks of Japanese politics for decades.

The end of the Korean conflict promised stagnation in fiscal 1952, but the general growth trend continued. By 1954 Japan had returned to the levels of 1939, the peak year for the prewar GNE. The period following the peace treaty was thus characterized by a transition to high growth. At the time, the markets were by no means brimming over with confidence that high growth could be achieved, but the political and economic systems established during the reconstruction period had laid a foundation for the growth to come. The economic reforms following the war created a society in which assets and incomes were for the most part standardized, with a progressive taxation system ensuring vertical fairness. In the business community, most of the monopolistic markets had been eliminated and the conditions for competition were in place, ensuring development of a vital, active market economy. These measures, more than anything else, provided the economic basis for the high growth of the late 1950s and 1960s. Bolstered by high import demand, the Japanese economy entered a new phase.

2. Fiscal Policy After the Peace Treaty

1) Budgeting After the Peace Treaty

During the months leading up to the signing of the peace treaty on September 8, 1951, budgets had to be drafted in spite of considerable uncertainty concerning the disposition of such peace-related expenditures as U.S. Forces maintenance expenses, police reserve expenses, and Allied asset compensation expenses. When Joseph Dodge visited Japan in November 1951, he asked that the budget include a large allocation for peace-related expenditures and that it forego any tax cuts, something SCAP was also demanding. Unfortunately, he returned home without having reached an agreement with the MOF on the general outlines for peace-related spending. The government budget draft therefore covered everything except the costs of peace, and the Cabinet approved it as such.

The budget guidelines recognized three major tasks facing Japan: the payment of

reparations and security expenses; domestic investment for economic development; and the stabilization of living standards. The drafters were told to limit the size of public finance to what the economy could bear, to stick to a balanced budget policy, and to seek an aggregate balance equilibrium between revenues and expenditures (with "aggregate" referring not only to the General Account but to the special accounts and government-affiliated agencies as well). The budget for 1952, drafted under these guidelines, is notable for including ¥ 203.4 billion in peace-related spending - 23 percent of the total budget of ¥ 852.7 billion. Peace-related expenses included debt payments, which were further broken down into Allied asset compensation and peace restoration costs (redemption of economic aid and foreign currency bonds), government security spending on the police reserves and Maritime Safety Agency, and defense spending. The latter included Japan's portion of the costs of U.S. troops stationed in the country (as defined in the United States-Japan Security Treaty) and miscellaneous defense spending. The Allied asset compensation expenses were defined in the Allied Asset Compensation Law of November 26, 1951. Japan's portion of U.S. forces maintenance was ¥ 6.5 billion, while spending on the police reserves reached ¥ 57,774 million.

Even though massive amounts were set aside for peace-related costs, the budget still managed to fund increases for food production programs, public works, social security and other items aimed at strengthening the economy and stabilizing living standards. The public works budget, which totaled ¥ 123,969 million, was administered under the General Development Plan, which placed a priority on disaster recovery, flood control, and electric power development. In the area of road construction, the Special Account for Designated Roads was established. For all this, the fiscal 1952 budget included a tax cut as well, and the resulting strain on the public purse resulted in ¥ 58,700 million in cuts in the special accounts for foreign exchange funds, foodstuffs control, and precious metals. The Special Account for Telecommunications, which had been treated in the accounting as a government

enterprise, was moved to the government-affiliated agency budget, with the establishment in July 1952 of the Nippon Telegraph and Telephone Public Corporation.

The budget requests for 1953 were enormous. A draft budget was submitted to the Diet, but it was not passed before the dissolution of the lower house in March, forcing the government to operate under a provisional budget until July. The government resubmitted the rejected budget to the Diet with minimal revisions. This budget was set apart by the fact that it maintained a balance in the General Account, while providing for some flexibility in administration, endeavoring to prioritize and make efficient use of expense allocations. Of particular note was the attempt to hold down administrative costs and cut defense spending, and to redirect the money saved toward economic growth and the stabilization of living standards. The lower house decided to revise the government draft, however, to include a two-tiered rice price structure, the cost of which would be borne by the General Account. It was this budget that finally passed on July 31, 1953.

Nevertheless, the fiscal 1953 budget is remarkable for having reined in the explosion of budget requests seen after the peace treaty. Its total value of ¥ 965.4 billion represented growth of only 8.5 percent over the previous year, a reflection of the slump that followed the end of the Korean War. The weight in the General Account was on public works, which received ¥ 101,867 million (10.5 percent). The defense spending of fiscal 1952 was absent. Among the primary issues in the drafting of the initial budget and the implementation of the provisional budget was the Law on Treasury Funding of Compulsory Education, implemented in April 1953, which mandated that the central government bear half the cost of compulsory education. The budget for fiscal 1953 consequently included ¥ 54,000 million in Treasury funding for compulsory education. Fiscal 1953 also saw several typhoons and other natural disasters, with resulting large allocations for disaster relief in the first supplementary budget. A result of the passage of the 1953 initial budget was

the reorganization of the U.S. Counterpart Fund Special Account into the Industrial Investment Special Account.

Not long after the fiscal 1953 budget was passed, the drafting of the fiscal 1954 budget began. Fiscal 1954 was to have an austerity budget because of the import surplus being recorded on the trade balance, and it was within this context that the MOF proposed its "One trillion yen budget." Having learned its lessons from postwar inflation, the MOF had been sticking to the principle of budget balancing, but it was still worried about overheating and inflation and so proposed imposing a ceiling of one trillion yen, which would provide a powerful tool for dampening budget growth. The total budget requests for the year, excluding defense and foreign spending, were in excess of ¥ 1.8 trillion. The budget drafting guidelines proposed restoring equilibrium to the balance of payments by promoting exports and blunting import demand. Monetary and other policies were to be actively employed to reduce prices, while fiscal policy was to be balanced and austere. The government narrowed down public works, foodstuffs, and Fiscal Investment and Loan Program (FILP) requests to arrive at a draft budget valued at ¥ 999.6 billion. When passed, the initial budget also held to the one trillion yen ceiling. We should note that the government resorted to some unusual measures in order to keep the budget under one trillion yen, including transferring a portion of the admissions tax allocated to local governments from the General Account to be recorded directly in a special account set up for that purpose. The fiscal 1954 budget brought an end to the trend toward consistent growth in spending witnessed since 1950, and the one trillion yen guideline was held over into the budget drafting of fiscal 1955.

2) Revising the Shoup Tax System

The "Shoup Tax System" refers to the revisions of the tax system implemented in 1950 based on the Shoup Mission's recommendations, with its emphasis on fairness, direct taxation and the elimination, wherever possible, of tax measures designed to promote capital accumulation. Once the peace treaty took effect,

however, Japan was free to revise its tax system as it saw fit. Revisions implemented in fiscal 1952 reduced the income tax; established new deductions for gift income, extraordinary income and forestry income; created a new deduction for those filing "blue form" returns for the self-employed; and provided for the deduction of social security premiums as well. These new deductions meant reductions in taxable income that, when combined with hikes in other deductions, resulted in a decrease in income tax revenues. At the same time, the basic rate for the corporate tax was raised from 35 percent to 42 percent. The reason for hiking corporate taxes was that the Korean War had caused corporate income to surge. In addition, 1952 saw the imposition of a new transit tax.

The real revision of the Shoup Tax System came in 1953. The following were among the major revisions: 1) elimination of the income tax on capital gains from securities (segregated taxation introduced in the Securities Trading Tax Law enacted on July 31, 1953); 2) elimination of the wealth tax; 3) an increase in the maximum income tax rate from 55 percent to 65 percent, in order to raise taxation on the rich after the elimination of the wealth tax; 4) introduction of a segregated withholding tax of 10 percent on interest income; 5) introduction of more breaks and deductions as special measures in the corporate tax; and 6) elimination of the acquisition tax portion of the inheritance tax. The revisions were a major reworking of the income tax-based comprehensive taxation principle espoused by Shoup, as well as an expansion of the special tax measures to encourage capital accumulation. We should note, however, that the securities capital gains tax imposed under the Shoup Mission brought in only 0.45 percent of fiscal 1951 tax revenues. The tax administration system of the time was not capable of enforcing an effective tax on capital gains, and it was forced to retreat to segregated taxation. The switch to a segregated tax on the profits from securities transfers, on the other hand, also took into account the need for capital accumulation through stock market expansion. It represented an attempt to use the tax system to stimulate the stock market. One of the reasons for

abandoning the wealth tax was that it was difficult for the tax administrators to scrutinize all taxable assets.

The Shoup recommendations proposed that assets be revalued, and a reappraisal (the third since the war) took place in fiscal 1953, based on prices as of January 1, 1953, which had risen significantly since the Korean War. The growth in prices was not as sharp as it had been in the first postwar revaluation, however, and profits were consequently not as high. With the elimination of the securities capital gains tax, stocks and the like were exempted from the third revaluation. The system was designed to facilitate revaluation by providing for one revaluation in fiscal 1953 and another in fiscal 1954, as needed, as long as it was within the revaluation ceiling. Companies were allowed to claim nine-tenths of the difference between former prices and the revalued prices, less the revaluation profits tax, as net value, which helped improve corporate primary capital after the peace treaty. In addition, for the inheritance tax, Japan eliminated the progressive acquisition tax that had been introduced in 1950 by the Shoup Mission. Assets acquired through inheritances or bequests were subject only to the inheritance tax, while those acquired as gifts were to be taxed under the gift tax based on the total value received during the year. Essentially a return to the pre-Shoup system, this was implemented because of the administrative difficulties involved in the Shoup acquisition tax.

The Cabinet decided to establish a Tax Commission on August 7, 1953, and the commission issued a report on revisions to the tax system three months later, on November 12. The report's emphasis was on boosting external competitiveness. It consequently advocated reductions in the income and corporate taxes, higher indirect taxation (including the introduction of a textile consumption tax to restrain extravagant consumption), transfer of the admissions tax and entertainment tax to the National Tax, and imposition of new prefectural residential taxes and cigarette taxes. The idea behind this was to fund reductions in income and corporate taxes with increases in indirect taxation, including hikes in the commodities tax rate. A

bill introducing a textile consumption tax as a luxury tax came before the Diet but did not pass. The gasoline tax was hiked in order to fund road construction, and one-third of the revenues was earmarked for allocations to local governments to fund road construction in their localities. This led to a further expansion of the volume of road construction. The central government introduced a local roads tax in fiscal 1955. This was a local road transfer tax for regional funding.

These hikes in indirect taxation and reductions in direct taxation reveal the extent of the departure from the Shoup system's emphasis on direct taxation. The income tax was reduced further in fiscal 1954, through a large increase in the personal deduction. The result was to bring revenues from the income tax down from 38 percent of General Account tax revenues between fiscal 1951 and 1953, to 36 percent in fiscal 1954. The proportion of withholding tax revenues in the income tax revenues increased, attesting to a growing dependence on withholding taxes as the number of salaried workers rose. In 1954, the admissions tax, which had previously been ceded to local governments, was returned to the central government to be redisbursed as part of the local allocation tax. Strong opposition to the transfer of the entertainment tax to the central government and the proposed textile consumption tax (which bore too close a resemblance to the textile consumption tax that had been eliminated by the Shoup recommendations) led to the failure of either to be passed. The Shoup Mission called for the introduction of a value-added tax at the local tax to provide stable revenues for local governments, but its enforcement had been delayed by collection difficulties. The value-added tax was finally abandoned at this time, leaving the local governments with traditional business taxes levied on income.

Perhaps the most significant departure from Shoup Taxation System was the introduction of special tax measures to promote capital accumulation, in the form of tax waivers, new reserves and allowances, and special depreciation schedules. Among the special taxation measures enacted in or after fiscal 1952 were a measure

adding new tax-free items to the "tax waiver for manufacturers of vital products," a special deduction for export income, the disallowance of some corporate entertainment costs as expenses, and rationalization of the special deduction for export income. New reserves and allowances set up at this time included a hike in the permissible amount of reserves against bad debts; new reserves for retirement payments, losses stemming from drought, compensation for damages because of failure to honor contracts and cancellation of export contracts; and a revision of the reserve for price fluctuations. Special depreciation measures enacted at this time included an accelerated depreciation schedule for experimental research equipment and facilities, as well as an increase in the depreciation allowance for modern machinery and equipment. Those introduced in 1952 were to act as a counterbalance to the hike in corporate taxes. Most of the special tax measures were originally intended to last for only three to five years, but they were often extended. To the extent that they promoted corporate capital investment and exports, the measures provided support from the taxation side for the economic growth of the late 1950s and early 1960s. It was during this period that the tax system functioned most effectively as an aspect of industrial policy.

3) Establishment of the Fiscal Investment and Loan Program (FILP)

The Dodge Plan required that counterpart fund be used for investment and loans, primarily as a government financial system. Beginning in 1950 investment of Deposit Bureau funds became more active as well, leading to a reorganization of the system on March 31, 1951, under the newly promulgated Trust Fund Bureau Fund Law and Trust Fund Bureau Special Account Law. The Trust Fund Bureau began to invest the funds entrusted to it actively according to the Dodge guidelines, working in parallel to the counterpart funds. It was out of this that the Fiscal Investment and Loan Program, or FILP, would emerge. Money collected in the Postal Insurance and Postal Annuities Special Account (generally lumped together as "Postal Insurance funds") had been pooled with Deposit Bureau funds under the wartime policies to

attract funding, but an enactment on June 25, 1952, mandated that it be operated separately from the Trust Fund Bureau funds. Nevertheless, Postal Insurance funds provided part of the FILP funding under the "government funds integrated operation" system. In addition, the Trust Fund Bureau maintained control over the short-term investment of Postal Insurance funds.

In fiscal 1953, the FILP budget was submitted for the first time to the Diet with the budget draft to serve as a reference in its budget deliberations. The scale of the FILP had grown to such an extent that it was necessary to publish its methods of investing money. The FILP plan that the Diet received included funding for government institutions from the General Account, but it excluded construction investment, which was charged directly to the General Account, and allocations for the foodstuffs control and insurance accounts.

It was consequently the submission of the FILP to the Diet in 1953 that marked the establishment of the FILP as an official government program. There was no law providing comprehensive governance of the program. Funding allocations from the General Account were subject to Diet approval, as was the rest of the General Account budget. Revenue and expenditures from the Industrial Investment Special Account were approved as part of the Diet's decisions on the special account budget. And government-guaranteed bond issues were required to be within the ceiling defined in the general provisions of the budget. The Trust Fund Bureau Special Account treats Trust Fund Bureau funds as "non-revenue/expenditure funding," and Trust Fund Bureau operations were not subject to Diet approval as a result. The situation with respect to Postal Insurance funds was roughly the same as that of the Trust Fund Bureau funds.

The fiscal 1953 FILP plan was based on the idea of moving actively to secure industrial funding by utilizing fiscal funding, as well as by tapping private-sector funds through the issue, to the extent the market could absorb them, of "special tax reduction government bonds" and "public corporation bonds." The priority in Japan

Development Bank lending was placed on electric power, shipbuilding, steel, coal and other basic industries, and additional funding was allocated to financing for small businesses and agriculture, forestry and fisheries. The plan envisioned a total of ¥ 338.9 billion, which would come from the sale of government bond holdings, use of idle moneys, issuance of a ¥ 20 billion special tax reduction government bond on the Industrial Investment Special Account, issuance of ¥ 16 billion in government-guaranteed bonds for the Japan National Railways and Nippon Telegraph and Telephone Company, transfers from the General Account and increases in Postal Savings and Postal Insurance funds.

Of particular note was the decision to utilize public bonds (the special tax reduction government bonds and government-guaranteed bonds). The special tax reduction government bonds attempted to tap the private sector to fund the Industrial Investment Special Account, but the issue had to be scaled back to ¥ 14.2 billion. The lack of market interest in the bonds was the result of public opposition to the issuing of government bonds, and this experience effectively prevented the Industrial Investment Special Account from issuing domestic bonds as an independent funding source. It has not done so in subsequent years. The government-guaranteed bonds for the Japan National Railways and Nippon Telegraph and Telephone, meanwhile, were the first government-guaranteed bonds issued since the peace treaty. The Japan National Railways bond issue of 1953 was valued at ¥ 8 billion and the Nippon Telegraph and Telephone bond issue at ¥ 6.8 billion. The success of these public bonds in raising funds helped the FILP to expand rapidly. Outstanding investments held by the Trust Fund Bureau, the largest investor in these funds, also saw quick growth. Growth was particularly rapid for investments in government-affiliated agencies and financial debentures during fiscal 1953. Loans to local governments grew as well, becoming the FILP's largest single investment.

The expansion of the FILP also introduced inflationary pressures into the

economy. As a result, no special tax reduction government bonds were issued during fiscal 1954, and sales of government bond holdings were restrained, bringing the FILP fund for the year to ¥ 280.5 billion. Trust Fund Bureau loans to government-affiliated agencies and local governments expanded, but investments in financial debentures were reined in. Total investment in financial debentures declined from ¥ 812.0 billion at the end of fiscal 1953, to ¥ 769.6 billion at the end of fiscal 1954. Similarly, the FILP declined as a percentage of the General Account from 33 percent in fiscal 1953, to 28 percent in fiscal 1954. The program expanded in fiscal 1955, however, with a funding plan that exceeded fiscal 1953 levels. From fiscal 1952 on, the largest use of FILP funds was lending to local governments and underwriting municipal bonds. This was followed by loans to the Japan Development Bank, the Agriculture, Forestry and Fisheries Finance Corporation, and the Housing Loan Corporation; purchase of government-guaranteed bonds issued by the Japan National Railways and Nippon Telegraph and Telephone; investments in the Electric Power Development Company; and loans to the Special Account for Designated Road Construction. The underwriting of financial debentures by the FILP came to an end in fiscal 1955. Beginning in 1957, contributions from the General Account were not included in the FILP. The FILP is generally considered to have been an effective mechanism for supplying long-term funding during the high-growth period of the late 1950s and 1960s.

4) Allocations of Tax Revenues to Local Governments

The system for dividing funding between the central and local governments dates back to the creation in 1940 of the Special Account for Allotment of Local Allocations Tax and Transferred Tax, under which the land tax and housing tax, which were collected by the central government, were transferred to the local governments. This account was reorganized in 1948 as the Special Account for Local Tax Distribution, through which General Account distributed funds for the local governments. The Shoup Mission proposed establishing a system for adjusting

the funding to local governments, however, which resulted in the passage of the Law on Local Allocations of Fiscal Resources Equalization on May 30, 1950. In fiscal 1950, this law replaced the special account with a "Fiscal Resource Equalization System" that provided equalizing fund allocations from the General Account, as required by local demand for fiscal resources.

When the economy turned down after the peace treaty, the central government adopted an austerity budget. Local governments faced resource problems for several years. The solution came in a report submitted to the Cabinet by the Local System Research Council in October 1958. The commission proposed replacing the Fiscal Resource Equalization System with tax revenues earmarked for local governments, arguing that this would provide for better adjustment of funding between the central and local governments and also among individual local governments. Under the plan, the local governments would be given a set percentage of the revenues collected in the form of income taxes, corporate taxes and liquor taxes, which would be allocated to a special account. On May 15, 1954, a new Special Account for Local Allocation and Local Transfer Taxes was established. Under the original law for this special account, revenues for the account came from the General Account. These were mainly revenues from the allocations of three taxes and gasoline tax and revenues from the admissions tax (which had been reclaimed by the central government after having been a local tax for several years). Expenses incurred by the account were mainly allocations of tax revenues to local governments, admissions transfer tax, and payments to the General Account. The local governments had claim through the revenue allocation system to 19.66 percent of income and corporate tax revenues, and 20 percent of liquor tax revenues. The amount of the allocations of gasoline tax would consist of one-third of the revenues the tax brought in. The Law Concerning the Local Allocation of Tax mandated that tax revenue allocations gauge basic demand for fiscal resources and the revenues of local governments, and that it provide amounts to cover shortfalls or to deal with

extraordinary circumstances, such as disaster relief. Admissions transfer taxes were to be made to prefectures in proportion to their populations; allocations of gasoline tax transfers were to provide necessary funding for prefectural roads. The Special Account for Allotment of Local Allocation Tax and Transferred Tax was successful in dividing funding between the central and local governments and enhancing the resources of the local governments. It would play a significant role in later redistributions of tax revenues to local governments.

Table 3-1 Local Allocation and Transfer Tax Distribution Special Account

(In millions of yen)

	FY 1954		FY 1955	
	Budget	Settlement	Budget	Settlement
Total revenues	149,088	150,549	185,977	186,138
Transfer from general account	137,022	137,022	157,993	157,993
Transfer from Japan Monopoly Corporation	—	—	4,474	4,474
Borrowings	—	3,500	—	—
Transfer of previous year surplus	—	—	1,477	1,477
Miscellaneous revenues	16	—	15	9
Tax	12,050	10,027	22,018	22,184
Admission tax	12,050	10,027	14,743	14,447
Local road tax	—	—	7,275	7,737
Total expenditures	149,088	149,072	185,977	186,085
Local allocation tax distribution	125,600	125,600	139,493	139,493
Transfer to National Debt Consolidation Fund	11	—	3,512	3,503
Miscellaneous expenditures	—	—	478	477
Special local distribution of tobacco tax revenues	—	—	4,474	4,474
Extra local fiscal special distribution	—	—	16,000	16,000
Local transfer tax surplus	23,472	23,472	22,018	22,138
Admission tax transfer surplus	15,550	15,550	14,743	14,435
Gasoline tax transfer surplus	7,622	7,922	—	—
Local road transfer tax surplus	—	—	7,275	7,703
Reserves	5	—	3	0

Source: Ministry of Finance,Budget Settlement

Even with this new system in place, however, the local governments continued to face revenue shortages. In 1955, allocations of the three main national taxes (the income, corporate and liquor taxes) were hiked to 22 percent. A new earmarked "local roads tax," which was levied on gasoline consumption, was enacted the same year, with revenues going directly to the special account. This money was then

transferred as local road transfer tax to prefectures and designated cities in accordance with their road area. This reform of the local road transfer tax system went a long way toward stabilizing and strengthening the roadway funding for prefectures and designated cities. In 1956, the local portion of the three major national taxes was raised again, this time to 25 percent. Other hikes would follow. In 1957, the special account added a "special tonnage tax" on the revenue side and a "special tonnage transfer tax" on the expenditure side, with the money going to concerned prefectures. It was in this way that the number of taxes paid directly into the special accounts was increased.

3. The Financial System, Monetary Policy and External Finance After the Peace Treaty

1) Specialized Financial System

By this time Japan already had three government financial institutions providing long-term funding: the Japan Development Bank, the People's Finance Corporation and the Housing Loan Corporation. Their funding came directly from the government - in the form of either counterpart funds or Trust Fund Bureau funds - which enabled them to make long-term loans at relatively low interest rates. In the private financial sector, there were already "savings and loans" (*shinyo kinko*) and mutual (*sogo*) banks supplying small business financing. Agricultural finance, meanwhile, had been provided for in amendments to the Central Cooperative Bank for Agriculture and Forestry Law and a new Agricultural Cooperatives Law. Policy concentrated on fostering long-term financial institutions, which were what Japan lacked most.

The specialized banking system had already been scrapped, and issues of bank debentures were limited to cases in which they were linked to the underwriting of preferred shares with counterpart funds. Since the counterpart funds would be eliminated once the peace treaty took effect, however, a new system for bank

debenture issues was needed. One idea studied at this time was to establish new long-term credit institutions modeled on the U.S. investment banks. These institutions would be allowed to raise long-term funds with bank debenture issues, which they would then use to fund long-term lending. This "Japanese-style investment banking system" was embodied in the Long-term Credit Bank Law of June 12, 1952, under which long-term credit banks, able to issue bank debentures valued at up to 20 times their capitalization, could be established.

The first to take advantage of the new law was the Long-term Credit Bank of Japan, which was established in December 1952. It was followed shortly by the Industrial Bank of Japan with permission to issue bank debentures. As an interim measure, investment in the Long-term Credit Bank of Japan was permitted from the U.S. Counterpart Fund Special Account; the banks were also permitted to issue preferred shares. The Nippon Kangyo Bank and Hokkaido Takushoku Bank, on the other hand, ceased issuing bank debentures in 1955 and became ordinary banks. The new system produced a clear division between long-term and short-term lending in the banking sector. The Norinchukin Bank and the Shoko Chukin Bank, which had been issuing bank debentures all along, were allowed to continue doing so by making amendments to their respective governing laws.

With the advent of the long-term credit bank system, the amount of outstanding bank debentures soared from ¥ 171.3 billion at the end of 1952, to ¥ 361.4 billion at the end of 1955. The holders of these debentures were other financial institutions and the government (Trust Fund Bureau funds). For the former, the conversion of deposits of less than a year to long-term financial assets produced an expansion of long-term lending and, at the same time, enabled them to draw on government funds for private-sector lending. This led to an increase in long-term loans. Even after the peace treaty, Japan's securities markets did not develop to the same extent as its banking industry, with the result that long-term lending by banks and other private-sector institutions continued to hold a predominant position in the long-term funding

market.

The history of the trust banking sector dates back to the Trusts Law and Trust Business Law of 1922. The Law Concerning Concurrent Operation of Trusts and Ordinary Banks or Other Deposit-accepting Businesses of 1943 gave banks access to both the ordinary and trust sectors through mergers, and in the intervening years most of the "city" (large commercial) banks developed trust businesses. During the reconstruction and reorganization of the financial institutions after the war, the Banking Law provided for the conversion of specialized trust institutions into banks to enable them to operate in both sectors. Since that time, the trust business in Japan has been the domain of trust banks.

Most Japanese trust assets at the time were probably monetary trusts, dating back to the prewar years. The six institutions that converted to trust banks needed a stable trust system capable of replacing their former fund-raising resources, "independently-invested designated moneys in trust" accounts. After much deliberation, including a good deal of thought on how the trust banks could contribute to long-term industrial financing, the "Loan Trust Law" was enacted on June 14, 1952. Under this law, trust banks and banks conducting both ordinary and trust business were allowed to solicit funds for "loan trusts," which would then be used for long-term lending. After the law was implemented, it was required that loan trust beneficiary certificates be issued for a minimum of two years to avoid competition with ordinary bank deposits. Most of the incoming funds were concentrated in the maximum five-year trust assets. Loan trusts expanded from ¥ 9.1 billion at the end of 1952, to ¥ 115.6 billion at the end of 1955. Although the loan trusts did not achieve the size of the long-term credit banks, they did come to occupy an important position in long-term finance. This system was also an aspect of the division of the banking industry into long-term and short-term sectors. Long-term financing was left to specialized institutions, long-term credit banks or issuers of loan trusts, the importance of which would only increase during the high-growth

period.

The Foreign Exchange and Foreign Trade Control Law of December 1949 allowed the private sector to engage in foreign exchange, but the funds were to be pooled and controlled in a special government account. Private-sector trade expanded after the peace treaty. The foreign exchange banks were assigned to one of three categories, with the city banks in Class A, the trust banks and regional banks in Class B, and all other domestic and foreign banks in Class C. The Bank of Tokyo became the first foreign exchange bank to open a foreign office in September 1952, establishing an office in London. Prior to the war, the Yokohama Specie Bank had served as a specialized foreign exchange bank, but it was closed down and liquidated after the war. The Bank of Tokyo, founded in December 1946, took over its new assets only. After the peace treaty, the idea of providing for specialized foreign exchange banks within the realigned financial system became a subject of discussion. It was agreed to do so in light of the specialized nature of foreign exchange trading and the need for international credit-worthiness, and the Foreign Exchange Bank Law was enacted on April 10, 1954, in line with this decision.

Under this law, the Bank of Tokyo (a Class-A foreign exchange bank) became the only official “foreign exchange bank”; other Japanese banks that had been engaged in foreign exchange were known as “authorized foreign exchange banks.” As a specialist in foreign exchange, the Bank of Tokyo was given incentives to establish foreign offices and preferential treatment in foreign exchange handling, but it was restricted in its ability to develop a domestic branch network. Other new developments in the financial system during this period included the Agriculture, Forestry and Fisheries Finance Corporation Law of December 29, 1952; the Small Business Finance Corporation Law of August 1, 1953; the Labor Finance Corporation Law of August 17, 1953; and the Credit Guarantee Association Law of August 10, 1953. All helped to supplement the specialized financial institutions and round out the credit system.

It was at this time, therefore, that the specialized Japanese financial system came into being. Among the things that set this system apart were the segregation of short-term and long-term credit; the establishment of a specialized foreign exchange institution; the specialization of government financial institutions in long-term finance; special provisions for agriculture, forestry and fisheries lending, on the one hand, and for small business finance on the other; a division between city banks and regional banks; and provisions for credit unions and other mutual finance institutions. The system developed further in the late 1950s and early 1960s, as institutions in one sector were forbidden from doing business in other sectors. Though there were some distortions in fund raising during the high-growth period, specialized finance did serve as an effective means of supplying the private sector with needed funding.

2) Money Supply Policies of the Bank of Japan

The excessive lending which occurred after war continued throughout the postwar period, and the private-sector banks remained dependent on borrowings from the Bank of Japan, even after the peace treaty. A hike in October 1951 brought the ODR up to 5.84 percent per day, the level at which it remained until August 30, 1955. The nominally low interest rates were maintained, but the Bank of Japan had for all practical purposes ceased using ODR changes to administer money supply policy during this period. It would not be until 1957 that the ODR became the main tool of BOJ monetary policy. Prior to that point, monetary policy was administered through window guidance, higher applied rates, intervention on the call market and adjustments in bond issues. The low ODR rates were merely for show; the interest rates that actually dominated the financial markets at the time were higher applied rates and the prevailing call market rate.

The BOJ tightened the money supply in 1953 to bring the balance of payments back into equilibrium, and the tight money policy continued in force until 1955. The central bank adopted stricter window guidance in September 1953, and began

enforcing the higher applied rates more strictly in March 1954. We might note that the main tools at the BOJ's disposal during the tightening that lasted until 1955 were window guidance and higher applied rates. The BOJ's window guidance to private-sector banks was implemented by the Operation Bureau in July 1947. Prior to 1952, it functioned primarily as a tool for administering funding allocation policies. September 1953 was the first time window guidance was employed to restrain private-sector bank lending.

The reason the BOJ did not use the ODR was because the government was adverse to rises in domestic rates. Window guidance, which involved direct regulation of the private sector, was considered more effective in restraining lending than either the ODR or the call rate. Some scholars doubt that window guidance was really so effective, however. There were cases in which lending regulations were flaunted or circumvented, for example, and window guidance applied only to the long-term credit banks and city banks, not to small financial institutions. There might have been times when an increase in lending by the latter would offset the impact of the tightening. Nevertheless, with ODR policies on hold, window guidance did serve as an effective means of adjusting funding allocations. The BOJ brought window guidance to a halt in December 1955 as one of its moves toward financial deregulation, but it reimposed it in July 1956.

The other means of tightening money - higher applied rates - dates to January 1946. This system involved regulation of the money supply by adjusting the commercial banks' marginal cost of borrowing from the BOJ. The commercial banks had a system of ceilings on their borrowings from the BOJ, among them a minimum ODR borrowing ceiling, a Class I applied rate ceiling and Class 2 applied rate ceiling. The BOJ could adjust both the ceilings and the lending rates to regulate the commercial banks' access to high-powered money. At first, the ceiling for higher applied rates was calculated based on deposit levels, but beginning in 1953, calculations were conducted on a quarterly basis according to the banks' primary

capital and deposits during a specified time period. In March 1954, the BOJ tightened the money supply by hiking the Class 2 applied rate by 0.73 percent, which resulted in a reverse spread with market rates. The commercial banks could borrow up to 15 percent of their ceiling at the official discount rate, which was their "minimum ODR borrowing ceiling"; borrowings between 15 and 100 percent of the ceiling were subject to Class 1 applied rates; anything in excess of the ceiling was subject to Class 2 applied rates. As of March 1954, the Class 2 rate was 8.395 percent. The minimum ODR borrowing ceiling was adjusted according to the banks' primary capital and deposits.

At the same time, however, the BOJ also led call rates lower, which brought an increase in higher applied-rate borrowings. The total Class 1 and Class 2 lending expanded to exceed the BOJ's general lending. In March 1954, outstanding BOJ general lending stood at ¥ 417.3 billion compared to ¥ 254.5 billion in Class 1 lending and ¥ 203.4 billion in Class 2 lending. At that time, there were 59 banks borrowing at the higher applied rates. Higher applied-rate lending disappeared during the easing of 1955 and 1956, as the commercial banks became less dependent on the BOJ. When demand for funding boomed on the back of the high economic growth in 1957, the BOJ maintained its low interest rate policies and revived the higher applied rates as a tool for money supply control.

The BOJ's tools for regulating market-based funds were intervention in the call market and government bond operations. Since the interest rate regulation under the Temporary Interest Rate Adjustment Law was not necessarily valid on the call market, the effective call rates rose during the monetary tightening of 1954. Although the Bank of Japan did strengthen its intervention, the high call rates continued in force, in part because the call market switched to direct trading rather than going through money market brokers (*tanshi*). Attempts to tighten the interest-rate regulations proved ineffective, and on August 23, 1955, the call market was officially liberalized.

The government bond operations began in October 1954 when the BOJ sold repos on bills and long-term government bonds to the Central Cooperative Bank for Agriculture and Forestry (Norinchukin Bank) and private-sector institutions. Between that time and 1956, bond operations were conducted during the third quarter of every year, in order to absorb the excess disbursements of Treasury from purchases of rice by the Foodstuffs Control Special Account. The money from rice purchases was pooled into the Norinchukin Bank via the agricultural cooperatives, then lent by the bank through Class 2 lending to commercial banks. Commercial banks were able to repay the borrowing of the Class 2 higher applied rate. This system continued in force until 1953, when the dependence of the commercial banks on the BOJ declined. After that, the short-term funds in the market were taken up with sales of bills and government bonds held by BOJ to the Norinchukin. The short-term money markets were still too undeveloped for wholly market-based regulation to be possible, a situation which forced the BOJ to intervene directly.

In the late 1950s, ODR manipulation joined window guidance and higher applied rates as a regulatory tool, rounding out the BOJ's monetary policy tools for the high-growth period.

3) Foreign Financial Relations

Japan had had a uniform exchange rate, one of the conditions for International Monetary Fund (IMF) membership, in place since the Dodge Plan, and in August 1951 it applied formally for membership. Its applications for both the IMF and the International Bank for Reconstruction and Development (World Bank) were approved on May 29, 1952, after the peace treaty took effect. On June 14, Japan enacted the laws necessary for implementation, and it gave its official signature to the accession agreements for the two institutions on August 13. Japan's contribution was USD 250 million, a figure commensurate with its economic strength at the time.

When the peace treaty took effect on April 28, 1952, the authority for foreign currency controls reverted in full to the government of Japan. The Foreign Exchange

Control Committee that had been set up under the Prime Minister's office was disbanded on August l, 1952 and foreign exchange control returned to the MOF. The Treaty of Friendship, Commerce and Navigation between Japan and the United States was signed on April 2, 1953, and went into effect on October 30. The treaty promised an expansion in trade with the U.S. With the economy running a latent import surplus, the government's foreign exchange reserves peaked at USD 1,051 million at the end of 1952, then began to decline. By the end of 1953, its foreign exchange reserves were just USD 844 million. Lacking sufficient British pounds to settle the claims against it, Japan was permitted to buy GBP 5 million from the IMF in September 1953. It bought another GBP 22 million that December.

Under Article 14 of the IMF Agreement, Japan was allowed to maintain foreign exchange controls as a “country in transition from postwar reconstruction.” The Occupation-period foreign exchange allocations remained in place. The foreign exchange budget system that had gone into effect in January 1950 initially provided for budgets to be drawn up each quarter. This was changed to semiannual budgeting in April 1952, after it was no longer necessary to seek the approval of SCAP. With strong demand for foreign exchange on the import side, the allocations exerted a major impact on Japan's import policies. The MOF, which was responsible for foreign exchange control and the Ministry of International Trade and Industry, which had jurisdiction over trade, determined how the foreign exchange funds were to be allocated to import payments. The foreign exchange fund was categorized as a non-revenue/expenditure item in the account. The pressure from import demand was particularly strong following the peace treaty, which made the foreign exchange budget, drafted in consideration of the foreign exchange reserves, a powerful tool for restraining imports.

There were three different allocation systems for the import exchange-funds budget: automatic approval, first-come-first-served allocation, and prior allocation. The first-come-first-served system began to wither away after the peace treaty, and

was eventually scrapped in November 1956. During the late 1950s, the priority in foreign exchange allocations was placed on key industries and industries likely to promote exports. Japan signed the General Agreement on Tariffs and Trade (GATT) in June 1955, becoming a member effective September of that year, at which time it was obligated to harmonize its trading practices with international norms. The foreign exchange budget remained in place until Japan achieved IMF Article 8 status on April 1, 1964.

Prior to the war, Japan was an active issuer of foreign debt. Its last major prewar debt issue was a dollar-based bond issue for Taiwan Electric Power in 1931. Foreign bonds were floated by the central government, municipal governments (Tokyo, and three other cities) and various companies (electric power companies, and the like). Though Japan had continued to redeem the bonds, its outstanding government bonds were valued at USD 152 million, GBP 77 million, and FRF 415 million when the war broke out. The handling of these bonds during the war was described in the Law on Disposition of Foreign Bonds of March 1943. The government, municipal and corporate bonds held by domestic investors were exchanged for domestic government bonds and redeemed in a two-phased program. Payments on bonds in foreign hands were suspended.

After the war, the Ministry of Finance banned all transactions in foreign bonds, including the export and import of coupons and principal and interest payments, under a MOF order issued on October 15, 1945, in compliance with a memorandum from SCAP. An exception was granted to French franc bonds, however, which were paid in yen. On November 25, 1950, the Law on the Disposition of Foreign Bonds was repealed by MOF order. Under the measures, the foreign bonds held in the United States by Japanese nationals and Japanese companies were converted to domestic bonds, but during the asset freeze of July 1941, the U.S. Justice Department declared the conversions void. Disposition of foreign bonds was expected to be a major stumbling block in foreign economic negotiations when the

peace treaty was signed in September 1951 and after it took effect. At the request of the United States, Japan enacted a law on December 3, 1951, recognizing USD 4,448,000 in dollar-denominated government bonds and an additional USD 116,000 and GBP 4,000 in bonds carried over by the government.

Table 3-2 Outstanding of Unredeemed Foreign Bonds and Accrued Interest (As of June 1952)

Due for redemption

	Bonds	Currency	Unredeemed principal	Accrued interest
Pound denominated	4 cases	Sterling pound	29,584	16,028
Dollar denominated	3 cases	Dollar	2,994	2,242

Undue for redemption

	Bonds	Currency	Unredeemed principal	Accrued interest
Pound denominated	9 cases	Sterling pound	46,690	27,736
Dollar denominated	11 cases	Dollar	73,366	47,797
Franc denominated	1 cases	French Franc	47,797	54,178

Total

	Bonds	Currency	Unredeemed principal	Accrued interest
Pound denominated	13 cases	Sterling pound	76,275	43,764
Dollar denominated	14 cases	Dollar	76,361	50,039
Franc denominated	1 cases	French Franc	383,221	54,178
Total	Total amount in dollar		291,028	172,735
	Total amount in yen		104,770,197	62,184,608

Units: In thousands of Sterling pound, US dollar, French franc and Yen.
Source: Juichi Tsusima, "*Gaisai Shori no Tabi*", 1966, Appendix pp.1-6

As of the end of June 1952, GBP 45 million and USD 5 million in unpaid principal and interest had accumulated on bonds which had already reached their contractual maturities, and another GBP 46 million, USD 73 million, and FRF 383 million in unmatured principal remained. The interest on arrears for this debt came to GBP 27 million, USD 47 million, and FRF 54 million. In dollar terms, the

principal, interest and interest on arrears for the unredeemed debt totaled USD 463 million. The full amount would be needed immediately in order to honor the original contracts. The MOF determined that full repayment was impossible, given Japan's foreign exchange reserve situation. Instead, it asked that the wartime years be recognized as a "suspended period", with the original contracts extended and paid according to the terms therein. To show its sincerity with respect to repayment before the treaty took effect, Japan entrusted GBP 20 million to the Bank of England in March 1952 for a period of two years to use for payments on sterling-denominated debt; in April it entered into a two-year, USD 20 million trust agreement with the Federal Reserve Bank in New York to provide payments on its dollar debts. Between July and October 1952, a Foreign Debt Treatment Committee met in New York to decide the disposition of the prewar debt, negotiating with concerned parties from the United States, Britain and France. Agreements were reached with the United States and Britain on September 26, more or less along the lines proposed by Japan. These agreements revived the terms of the original contracts with 10-year extensions. For debt in sterling with a foreign-currency payment option, it was agreed that the equivalent value be paid in sterling and the contract extended for 15 years.

The Law Concerning Foreign Capital of May 10, 1950, was the basic law governing capital imports. When it was implemented, the Foreign Capital Committee was established to consider capital imports. Capital imports had begun during the Occupation as technology was brought into the country for the steel, chemical fibers and pharmaceuticals industries. The government considered capital imports necessary after the peace treaty and amended the law on July 1, 1952, to relax the regulations on remittance guarantees to two-year hold/five-year installment payments for the recovery of principal invested in stocks and equities. The deregulation helped to promote greater capital inflows. The Foreign Capital Committee was upgraded and renamed the Foreign Capital Council and charged

with reviewing proposed capital imports at this time.

Investment promotion brought in USD 9,778 thousand in new equity investment and USD 34,457 thousand in new loans and credits, for a total of USD 44,405 thousand in new capital during fiscal 1952. Equity investment declined slightly during fiscal 1953, but loans and credits increased, bringing total income investment to the year to USD 54,232 thousand. A sharp decline in new loans and credits in 1954 forced Japan to become more active in its search for foreign capital. Several loans from the World Bank in 1955 and subsequent years helped to put imports of private-sector capital back on the road to growth.

With the favorable conclusion to the negotiations on its foreign debt and confidence in Japan's loans recovering, the government began to consider raising long-term funds from the World Bank. Long-term, low-interest funding was vital to private-sector capital investment, which featured long depreciation schedules. Bringing in more foreign capital would also ease some of the tightness in Japan's foreign exchange reserve situation. Some government-affiliated agencies also borrowed from U.S. banks to raise long-term funds. These funds from outside countries were expected to boost the foreign exchange reserves in Japan's fragile Special Account for Foreign Exchange Funds.

But Japan's private companies did not have the credibility required to import foreign funding directly. They needed the government to guarantee their debts. From an administrative point of view, however, it would be problematic for the government to guarantee private companies directly. Instead, the government guaranteed the debts of the Japan Development Bank, which then borrowed from the World Bank and lent the funds to electric power and steel companies. Government guarantees on foreign capital in-take, particularly on loans from the World Bank, were embodied in law. The Japan Development Bank signed a contract for a loan in October 1953, with the money scheduled to begin arriving in December. The initial interest rate was 5 percent, with a maturity of 20 years beginning January 1957. The

Japan Development Bank lent the borrowed funds to the Chubu, Kansai and Kyushu electric power companies for construction of electric facilities, enabling the power industry to raise massive long-term funding of a kind that was not available in the Japanese market. This was the first of several government-guaranteed loans from the World Bank to the Japan Development Bank, which were then used for lending to fund domestic private-sector capital investment.

Part 2: Fiscal and Monetary Policies in the High-growth Period

Preface

The second part of this book covers the period from 1955 to 1971. There is no established chronological definition of the high-growth period. Some consider it as having lasted until about 1975, but we treat it as having ended when the United States took the dollar off the gold standard, since this demolished one of the major assumptions of Japanese economic management during the postwar growth years: the assumption that the yen would continue to be valued at ¥ 360 to the dollar. This historical change in the underlying conditions seems a suitable watershed with which to define the end.

Chapter 4 covers the years from 1955 to 1959, Chapter 5, the years from 1960 to 1964, and Chapter 6, the years from 1965 to 1971. Since the subject of this book is policy history, we focus on the long-term macroeconomic plans that have been the hallmarks of Japanese economic management since 1955, dividing the periods according to the nature of the plans and the factors that contributed to them. A key factor in this is the relationship - both actual and conceptual - between the Japanese economy and the international economy. During the late 1950s, the objective of policy was, in the words of the day, to achieve “economic independence.” Having completed reconstruction, the Japanese economy rejoined the international economy, albeit with many regulations and postwar systems remaining intact. During the early 1960s, the focus shifted to becoming a respected participant in the international economy, a goal which was accomplished through the liberalization of trade and foreign exchange. The Income-doubling Plan provided a policy framework to support rapid liberalization. Throughout the 1955-1964 period, the aim was to catch-up with the industrialized-West, and slogans such as “maximum growth” were the norm. In fact, the economy routinely achieved growth in excess of government

forecasts, and an underlying assumption held that there would be basic stability in the international economy and in the monetary system that mediated it, thanks to the overwhelming dominance of U.S. economic might.

After 1965, Japan too became an "industrialized country," and as it did so, the focus shifted to achieving the qualities of a leading country, in addition to the quantities. The external qualities, in this case, took the form of capital liberalization and the internal qualities the creation of a welfare state. It was at this time that the two primary thorns in the sides of the economic managers, the balance of payments deficit and foreign reserve shortages, finally disappeared. It was also at this time, however, that the international economic and monetary systems began to shake. While the Japanese economy had grown sufficiently to be an accepted part of the international economy, it was largely left to fend for itself when upheaval ensued. The realignment of the international monetary system brought an end to the ¥ 360 rate against the dollar.

That fixed rate had been the cord binding Japan to the international economy and the axiom underlying all the nation's economic activities. Because a structural trade outflow was inevitable for a long time, it was the greatest constraint on economic policy, which had to be conducted in such a manner as to avoid bankrupting the country under what were considered "given" conditions. Economic policy could only function within that framework, and the framework was supported either by direct controls or regulation. Once the framework was established, however, international factors became relative; economic policy could be, and in fact was, built around domestic factors within this overarching framework. During the late 1960s, conditions were percolating that would eventually make changes in both the systems and ways of thinking inevitable. The final blow from outside was Richard Nixon's announcement that the U.S. would suspend conversions of dollars for gold.

Each of the chapters in this section begins by outlining the economic plans for the period under discussion. This is not to suggest that the fiscal and monetary policies were based on long-term economic planning, or administered to achieve the

objectives of the plans. Rather, we should make it clear that the fiscal and monetary policies developed and operated based on their own logic and history. It is more realistic to think that their basic directions were taken into account in the drafting of economic plans than to view it the other way around. The purpose of this book is not, however, to argue the significance of long-term planning to the postwar Japanese economy. Our use of the plans is, rather, for convenience in defining periods and forms.

Chapter4 1955-1959: Fiscal and Monetary Policies for Independence and Expansion

1. Background and Economic Policies

Postwar Japanese economic growth was clearly dependent on an expansion of world trade. Economic policy during the late 1950s sought to build a framework which would allow smooth (albeit belated) entry into the international economy and maximize the existing international conditions.

In a speech on fiscal policy delivered on January 22, 1955, Minister of Finance Hisato Ichimada summarized the achievements of the reconstruction policies that had driven the economy during the first half of the decade. Noting that the postwar economy had been rebuilt rapidly and that production and the national income were now above their prewar levels, Ichimada described a situation in which “everyone has worked wholeheartedly toward the restoration of production and the improvement of consumptive activities, but this has resulted in only a superficial expansion of economic power, while structural weaknesses, including backwards technology, bloated management, disorderly industrial structures and extensive dependence on debt by corporations, have remained.” The Japanese economy could only achieve stable expansion within the context of international trade and interchange. With the world economy, led by Europe, moving in the direction of liberalization, Japan would have to make improvements in its economic structure if it wished to join the world economy in a manner commensurate with its station. During the postwar period and the subsequent years of special procurement demand resulting from the Korean War, Japan's economic structure was inward-looking, and its economic policy, guided by an awareness of the inflationary bias in the economy, sought to shift the weight in external affairs toward construction of a structure that would be in line with the basic international trends toward liberalization. In other words, the goal was to achieve a balance-of-payments equilibrium that was not dependent on “special procurement demand” from the Korean War. The name given

to this was "economic independence."

As far as the domestic economy was concerned, the objective of policy was to achieve the "economic soundness" (sometimes called "economic normalization") that would make these external goals possible. Given Japan's economic weakness, this meant that policies and programs would have to be developed and administered in a methodical and comprehensive manner. Policy in the past had lacked overall cohesiveness and was often little more than a collection of stop-gap efforts. This would now be changed. External liberalization was given the highest priority and made the standard to which all other policies were expected to conform. Domestic policies aimed at achieving "economic soundness" went by the respective names of "fiscal soundness" and "monetary soundness."

It was at this time that the first macroeconomic plans containing broad policy guidelines were announced. The first, published in July 1955, was the "Five-Year Economic Independence Plan." There were two reasons for the plan's introduction in 1955, the year in which the "postwar reconstruction" was generally deemed to have been completed. First, economic management was becoming better organized, and the conditions were in place for it to operate from a longer-term perspective; and second, "reconstruction," an obviously unifying slogan, had been achieved, and a new target was needed both for the administration of what was still a frail economy and for the effective allocation of limited resources.

The slogans for the Five-Year Economic Independence Plan were "economic independence" and "full employment." We might note that the latter would be a slogan for all macroeconomic planning up to and including the Income-doubling Plan of 1960. The unemployment rate was ostensibly not especially high, but there was a large "latent unemployed" population in rural agricultural communities, which was compounded by worries that jobs would become more difficult to find as the postwar baby-boomers began entering the workplace in the 1960s. Providing jobs for these segments of the population was equal to rejoining the international economy in terms of the emphasis placed on it in economic policy. An ability to

Table 4-1 Economic Plans

Economic Plans	Compilation	Cabinets	Period (Duration)	Goals (Catch line)	Growth Rate (%)		Industrial Production (%)		Consumer Price (%)		Current Account (100 million $)	
					Plan	Actual	Plan	Actual	Plan	Actual	Plan	Actual
Five-year Economic Independence Plan	July 1955	Hatoyama	1956-60 (Five years)	Economic Independence, Full Employment	5.0	9.1	7.4	15.6	-	2.0	0	-0.1
New Long-term Economic Plan	December 1957	Kishi	1958-62 (Five years)	Maximal Growth, Improvement of Living Standard, Full Employment	6.5	10.1	8.2	13.5	-	3.5	1.5	-0.2
Income-Doubling Plan	December 1960	Ikeda	1961-70 (Ten years)	(same as above)	7.2	10.9	10.5	13.8	-	5.7	1.8	23.6
Medium-term Economic Plan	January 1965	Sato	1964-68 (Five years)	Correction of Distortion	8.1	10.8	9.9	13.6	2.5	5.0	0	14.7
Economic and Social Development Plan	March 1967	Sato	1967-71 (Five years)	Balanced and Fulfilling Development of Society and Economy	8.2	10.9	10.2	13.2	around 3	5.7	14.5	63.2
New Economic and social Development Plan	May 1970	Sato	1970-75 (Six years)	Construction of Livable Nation through Balanced Economic Development	10.6	6.0	12.4	3.6	4.4	10.9	35	1.3
Basic Plan for Economy and Society	February 1973	Tanaka	1973-77 (Five years)	Simultaneous Realization of Fulfilling National Welfare and Promotion of International Cooperation	9.4		10.0		4 (avg.)		59	

Notice: Cabinets are the cabinets in charge of preparation.
Source: Isamu Miyazaki, "*Showa 50 nendai zennki Keizaikeikaku Kaisetsu*"

absorb a growing work force required a consistently expanding economy. The solution was consequently to be found in growth policy, and a policy framework was established that would permit achievement of this goal.

Rising exports produced a burst of economic activity in 1956 that served as proof that Japan had weaned itself of its dependence on "special procurement demand", and was ready to join the international economy. This news was immediately welcomed as a large step toward the achievement of "economic normalization" and a new phase of economic reconstruction. It quickly led to overheating and a deterioration in the balance of payments in the following year, 1957, however; once again underscoring the essential frailty of the economic structure and the need for "economic soundness." This was a pattern that would continue throughout the late 1950s. Strengthening the domestic economic structure was a long-term policy goal, but the defining near-term principle was to avoid overstimulating the economy, to keep currency values and economic conditions stable.

Table 4-2 Outline of Economic Growth (1953-59)

Year	Economic Growth Rate		Growth Rate of Private Capital Investment (%)	Corporate income / National Income (%)	National Gross Expenditure per capita (Real) (*in* thousands of[yen)
	Nominal (%)	Real (%)			
1953	12.6	5.7	15.7	9.1	128.1
1954	11.0	6.1	4.3	9.8	134.0
1955	10.1	9.1	△ 3.2	7.9	144.5
1956	12.8	8.0	39.0	8.7	154.5
1957	13.9	8.0	25.1	12.1	165.3
1958	4.9	5.4	△ 4.7	10.5	172.7
1959	12.2	9.2	16.9	10.6	186.8

When the Five-Year Economic Independence Plan began to advance, it became apparent that the Japanese economy had more growth potential than had originally been thought, but it was also hampered as expected by quick overheating during expansionary phases. The policy-makers recognized a need to make better

provisions for stability and structural reinforcement in light of the newly expanded economy, and they consequently revised the Independence Plan into the "New Long-term Economic Plan," which took effect in fiscal 1958. The slogan for the New Long-term Economic Plan was "maximum growth," a slogan that would be carried over into the Income-doubling Plan that succeeded it.

Industrial planning involving active governmental intervention in the resources and products of the private sector was a major component of both the Five-Year Economic Independence Plan and the New Long-term Economic Plan. The main tool employed was direct regulation, making use of the controls over goods and foreign exchange that were carried over from the reconstruction days. In this sense, the macroeconomic policy of the period was a continuation of the rigidly controlled structure (representing, in practice, the almost complete insulation of the domestic economy from international influences) of the initial postwar period.

2. Sound Fiscal and Monetary Policies

1) Fiscal and Monetary Policies under the Five-Year Economic Independence Plan and New Long-term Economic Plan

Under the Five-Year Economic Independence Plan, it was the role of sound fiscal policy to provide stable economic management that would, in turn, lead to the stability of the economy as a whole. Achieving "fiscal soundness," in this case, included holding fast to the idea that no bonds would be issued under the General Account, a taboo that had been maintained since the days of the Dodge Plan. The size of public finance had begun to contract with the "Trillion Yen Budget" of 1954. The conditions for fiscal soundness had therefore been achieved; they needed only to be maintained while spending programs provided the support required by economic policy. There were those who were of the opinion that a certain amount of expansion would be required to provide for post-reconstruction economic policy, but the official decision was to maintain current levels for the foreseeable future. This was done from the perspective of eliminating any fiscal factors that might lead

to a reignition of inflation. The ultimate goal was to achieve an “optimum scale” of public spending, but since current spending levels were roughly equal to the prewar levels as a percentage of national income, maintaining those levels was in reality basic to fiscal administration.

The tax burden was considered high in real terms. Although not necessarily high in comparison with other countries, it was high in comparison to prewar levels and to the standard of living, especially with the Engel coefficient taken into account. Each year, therefore, implementing tax cuts at either the central or local level became a major policy issue. On the other hand, new demands were also being made on the country's coffers and, of course, bond issues were out of the question. In practice, therefore, the tax burden was adjusted on an annual basis with the objective of maintaining it at current levels as a percentage of total revenues. In the figures of the day, the combined central and local tax burden was 19-20 percent. Though there were calls for large tax cuts, these were not incorporated in the near-term goals of economic policy.

The priority was thus on eliminating factors threatening disruption from a fiscal standpoint. The size of the General Account had to be strictly controlled in relation to the demand for funding, resulting in a prioritization and rationalization of expenditures. High-priority long-term spending areas included the following: 1) public works; 2) food production; 3) housing construction; and 4) social security. The FILP and private-sector funding helped to finance public works, housing construction and social security. Social security was given a special priority and identified as an area in which increases would be permitted, if necessary. Growth in spending on public works and food production was to be kept within the national income growth rate. At the same time, however, consumption expenditures were rationalized and reduced. The policy was to maintain defense spending at a level the economy could bear, but inasmuch as growth was envisioned for other spending areas, real declines were expected for the military.

The overall goal of the New Long-term Economic Plan was to sustain high

Table 4-3 Social Security Budget breakdown (1955-59, after Supplementation)

（In thousands of yen)

	FY1955	(%)	FY1956	(%)	FY1957	(%)	FY1958	(%)	FY1959	(%)
Welfare Benefit	37,280,598	37.5	39,460,617	33.1	36,696,371	31.2	39,614,070	30.4	45,387,825	28.9
Child-care and Others	7,371,124	7.4	7,539,572	6.9	9,089,570	7.8	9,584,391	7.4	10,272,086	6.6
Social Insurance	12,387,493	12.5	17,138,819	15.6	21,754,911	18.5	23,784,611	18.3	31,008,876	19.7
National Pension	-	-	-	-	-	-	-	-	11,047,909	7.1
Unemployment Relief	28,524,000	28.7	34,797,000	31.6	34,362,000	29.2	40,457,318	31.0	41,924,000	26.7
Tuberculosis Control and Mental Health	14,020,728	14.1	14,410,127	13.1	15,984,318	13.6	17,041,829	13.1	17,845,203	11.4
Total	99,583,943	100.0	110,346,135	100.0	117,887,170	100.0	130,482,219	100.0	157,485,899	100.0

Source: Ministry of Finance, Budget Statistics, FY1962, pp.138-39

growth rates, while stabilizing the economy. In achieving this, the government wanted to rely on the private sector and to avoid the need to resort to direct controls wherever possible. Private-sector firms, however, were thought by some as still lacking the capacity to make autonomous adjustments. The general perception was that the Japanese economy was frail, and burdened with a latent inflationary risk. The policy-makers consequently attempted to provide the maximum amount of funds that could safely be injected into the economy under those conditions, and the government left itself room to take appropriate measures should the interests of private companies and those of the country as a whole come into conflict.

The primary job of fiscal and monetary policy was to achieve the first half of the plan's goals: to stabilize currency values. In the achievement of the latter half, fiscal and monetary policy aimed at encouraging the flow of funds to basic industrial sectors, though in the relationship between fiscal policy and finance, the focus was to be on the growth of private-sector funds as the driving force behind economic development. Fiscal policy was to play the role of overall coordinator.

The switch to the New Long-term Economic Plan, with its slogan of “maximum growth,” did not therefore signal a change in the attitude of the policy-makers concerning the size of public finance or the need to achieve fiscal soundness. If anything, the bias was toward a relative shrinkage of the size of public finance in comparison to the national economy. A priority was placed on using tax breaks at both the central and local levels to encourage the accumulation of private-sector capital. In reality, new demands on the-country's coffers would keep the size of public spending vis-à-vis the economy more or less constant, again with no fundamental change in fiscal management. Achieving maximum growth, on the other hand, would increase the need for adjustment and coordination of economic management, and public spending was, indeed, forced to play a relatively large role in stabilization and coordination, since the normalization of finance (the financial structure was acknowledged as being abnormal and in need of reform to enable it to

provide proper monetary regulation) and the use of the financial sector to supply needed funding were the priorities in the policy structure.

With this larger role, however, came the need to neutralize disruptive factors on the fiscal side. The ideal official soundness was maintained, as was the taboo on bond issues under the General Account. The experiences of the 1958-56 period, when overlapping private and government investments exacerbated swings in the business cycle, reminded the policy-makers of the frailty of the economy and of the need for prudence in the administration of public finance. The New Long-term Economic Plan targeted a relative reduction of the tax burden, viewing the expansion achieved under the Five-Year Economic Independence Plan as justification for giving more space to the private sector. One of the policy issues raised by this involved finding ways to adjust the relative weightings of direct and indirect taxation to correspond to the changes in the expenditure structure.

2) The "One Trillion Yen Budget" and the "100 billion Yen in New Spending / 100 Billion Yen in Tax Cuts" Budget

Public finance (the General Account) grew at a rate of 9.6 percent during the late 1950s, far slower than the 12.8-percent rate recorded by (nominal) GNP and an indication of the fiscal conservatism that was maintained throughout this period. The late 1950s are notable for several policies, among them the continuation of the "Trillion Yen Budget," large tax cuts and the allocation of surplus funding to reserves. We should note, however, that the growth of Japanese public finance was high by international standards. The United States posted growth of only 4.3 percent in the late 1950s; the United Kingdom of 5.5 percent; and France of 8.7 percent.

Fiscal years 1955 and 1956 saw a continuation of the "One Trillion Yen" austerity budget of 1954. The level of one trillion yen itself was not particularly significant in relation to the economy, and it was stretching matters to maintain it for three years. Having a predetermined ceiling did help rein in the absolute value of public finance, however, and, because shares of the expense budget had to be

adjusted within that ceiling, it paved the way for a realignment of the fiscal structure after the peace treaty. The one trillion yen ceiling was not so much a general austerity package for the economy as it was a promise to hold down public finance in exchange for active investment by the financial sector. Public finance in the narrow sense was, indeed, administered on an austerity basis, but the Fiscal Investment and Loan Program (FILP) was used to provide fiscal services in a broad sense.

Between 1956 and 1957, investment in public corporations was transferred from the General Account to the Special Account for Industrial Investment. While the FILP began to cover more territory in the late 1950s, however, its primary source of funding, the Trust Fund Bureau (which, in turn, depends primarily on the Postal Savings system), did not necessarily grow to match it, a situation resulting, during this period, in an increase in both the number of agencies allowed to issue government-guaranteed bonds and the amounts they issued. The FILP became more dynamic in this respect; whereas it had previously merely invested the money that came in, it now actively sought private-sector funds. It was due to this process that the FILP was given the nickname that it still carries to this day: the "Second Budget."

Table 4-4 Tax Burden Ratio (1955-59)

(In ten Billions of yen)

Fiscal Year	National Income	Tax				Social Security		National Burden Rate
		Indirect Tax	Direct Tax	Total	Burden Ratio		Burden Ratio	
1955	6,973.3	746.7	589.1	1,335.8	19.2	229.9	3.3	22.5
1956	7,896.2	862.5	696.6	1,559.1	19.7	261.9	3.3	23.1
1957	8,868.1	986.5	770.0	1,756.5	19.8	311.2	3.5	23.3
1958	9,382.9	1,045.7	728.9	1,774.6	18.9	340.3	3.6	22.5
1959	11,042.1	1,184.6	864.4	2,049.0	18.6	392.2	3.6	22.1

Intentional control of scale was attempted in order to maintain public finance at modest levels. The index of scale, in this case, was the tax burden ratio, which the

policy-makers were determined to keep at a steady level. The lack of any bond issues on the General Account and the small size of bond issues on the special accounts made it possible to maintain the relative size of public finance vis-à-vis the economy by maintaining a steady tax burden ratio. The target was 20 percent. Though this would not be formalized until an interim report of the Tax Commission published on March 25, 1960, tax burden ratios of slightly under 20 percent were maintained throughout the late 1950s.

Thanks to Japan's economic growth, the growth in tax revenues was sufficient to meet spending needs without altering the tax rates; indeed, revenues usually exceeded estimates. (The term “natural increase” is often used to describe this process, even in official government documents, although the definition of “natural increase” is not necessarily fixed.) One of the hallmarks of public finance made possible by these conditions during the high-growth period was that growth in the absolute value of expenditures could be used to meet new demands on the country's coffers, while at the same time leaving room for tax cuts. The most extreme manifestation of this was the 1957 budget (an initial General Account budget of ¥ 1,137.5 billion), which offered “¥ 100 billion in new spending and ¥ 100 billion in tax cuts.” In other words, the government projected a ¥ 200 billion increase in tax revenues, which would be divided evenly between tax cuts and spending increases, thus reducing the tax burden, while providing for appropriate expansion of public finance. This 1957 budget belongs to the “activist” school of fiscal policy, which is why it is all the more notable for also making a show of tax cuts. During subsequent years, this pattern of dividing projected revenue increases between tax cuts and spending growth would be seen again and again, and would contribute to the maintenance of restraint in the relative size of public finance.

Meanwhile, the MOF tried to add more discretion to the budget while at the same time restraining the tendency of public finance to expand. Its strategy was to use “medium-term cyclical adjustment” as a counterweight to economic swings. The idea was not only to divide up revenue increases, but also to set aside some of the

increase occurring during boom cycles to be used to cover spending during busts. In drafting the 1958 budget, for example, the Ministry's policy was to avoid giving the economy unnecessary stimulus by not counting the surplus from the previous year (fiscal 1956) as income. Faced with the choice of setting aside the surplus or using it to cut taxes, the Ministry chose to set it aside, to make funding available for future countercyclical adjustments. The initial concept was to pool the money in a single reserve account that could be drawn down when fiscal policy required more flexibility in order to counteract business slumps. It was an idea that the Ministry had long been mulling over. It proved much harder than expected to set aside reserves, however, now that there really were surpluses to deal with. Much of the ¥ 100.1 billion surplus was required by law to be put into a bond sinking fund. That left ¥ 43.6 billion, which was assigned to the “Economic Base Reinforcement Fund” (to be used to pay for “future” road construction and the like, as warranted by the economic conditions) and a small excess that was assigned to the Small Business Credit Insurance Corporation reserves and the Export-Import Bank of Japan's “Southeast Asia Development Cooperation Fund." (Note that the initial General Account budget for fiscal 1958 was ¥ 1,034.9 billion.) The funds thus set aside were depleted in the following year, fiscal 1959, to fund spending in the face of a revenue shortfall.

3) Cooperation between the General Account and the FILP on Public Works and Housing Construction

The late 1950s saw several new special accounts set up to diversify financing of public works projects. Among these were the Special Account for Specific Multipurpose Dam Construction (1957), the Special Account for Specific Soil Improvement Work (1957), the Special Account for Road Construction (1958) and the Special Account for Special Port Facilities Construction (1959). The Special Account for Specific Multipurpose Dam Construction and the Special Account for Specific Soil Improvement Work were part of a policy to move public works out of the General Account into special accounts. The reason for their establishment was

that Japan was generally lagging behind in its public investment, and it was consequently necessary to distribute money evenly to all areas of public works, but projects in individual areas were not moving forward as quickly as expected during any given year, even though administrative expenses were mounting. The bill for

Table 4-5 List of New Special Accounts (FY 1952-69)

Name	Category	Implementation year (relevant law)	Note
Specific road development	Development	FY 1952 (Law No. 170 of 1952)	Transferred to the Japan Highway Public Corporation in FY 1956.
Reinsurance of loans to fisheries	Insurance	FY 1952 (Law No. 347 of 1952)	
Wooden boat reinsurance	Insurance	FY 1953 (Law No. 77 of 1953)	
Industrial investment	Loan	FY 1953 (Law No. 122 of 1953)	
Export insurance	Insurance	August 1, 1953 (Law No. 79 of 1953)	
Local allocation and transfer tax distribution	Settlement	FY 1954 (Law No. 103 of 1954)	
Economic support fund	Loan	FY 1954 (Law No. 104 of 1954)	Transferred to the industrial investment special account in FY 1967
Opium	Control	FY 1955 (Law No. 31 of 9854)	
Surplus farm products finance	Loan	FY 1955 (Law No. 100 of 1954)	Transferred to the industrial investment special account in FY 1967
Reinsurance of compensation for motorcar accidents	Insurance	FY 1955 (Law No. 134 of 1955)	
Reparations and special obligations	Settlement	FY 1956 (Law No. 53 of 1956)	
Special goods payment	Settlement	FY 1956 (Law No. 129 of 1956)	Transferred to the general account in 1962. Cash was transferred to the industrial investment special account.
Specific multi-purpose dam construction	Development	FY 1957 (Law No. 36 of 1957)	Transferred to flood control
Specific land improvement	Development	FY 1957 (Law No. 71 of 1957)	
Extraordinary construction	Settlement	FY 1957 (Law No. 86 of 1957)	Abolished in FY 1959.
Special national property settlement fund	Settlement	FY 1957 (Law No. 116 of 1957)	Transferred to the special national asset settlement funds
Road development	Development	FY 1958 (Law No. 35 of 1958)	
Specific port/harbor construction	Development	FY 1959 (Law No. 68 of 1959)	Transferred to the port/harbor construciton

Source: Prepared from a list of special accounts on "*Okurasho Hyaku-nen shi* "Appendix pp. 142-146

these two particular projects would ultimately be paid by the local beneficiaries, and the General Account would be reimbursed for the local portion of its expenses. It was therefore decided to transfer the projects to a special account that could borrow money from the Trust Fund Bureau to cover the local contribution. In other words, the local communities had been receiving what amounted to loans from the General Account. This would now be moved to the Trust Fund Bureau/FILP. Meanwhile, the

General Account would continue to spend as much money on the projects as before, thus enabling them to proceed faster. This system was significant in that it opened the way for issuing de facto construction bonds and borrowing money (provided for in the addenda to Article 4, Paragraph I of the Public Finance Law) for specific funds from the special accounts.

The late 1950s were also a period in which road construction advanced rapidly. From the perspective of fiscal policy measures, the creation of the Special Account for Road Construction, which took in funding from all other sources and disbursed money for road works, was particularly notable. Indeed, it was this special account that paid for all the road construction. The concept behind the Special Account for Road Construction was an expansion of the concept behind the special construction accounts established in 1957. Unlike those accounts, however, the road construction account was allowed to borrow to meet general expenses, not merely to cover money that would eventually be paid back by local communities. This marked the first time that the addenda to Article 4, Paragraph I of the Public Finance Law had been applied to general expenditures, and it further established the pattern of utilizing cooperation from the FILP to expand the scale of public works spending. (The Special Account for Road Construction did not borrow for general expenses immediately, however, even though such borrowing was permitted.)

The Special Account for Road Construction became the model for the special project account as employed during the high-growth period. A new law designated revenues from the gasoline tax specifically for road construction. The MOF was opposed to earmarked taxation, arguing that it would impair the allocation and distribution functions of fiscal policy, threatened to damage the tax system, and would serve as a constraint on the budgetary process, but the Ministry was overruled by the Diet. The Dietmen who submitted the bill argued that an extraordinary funding source was needed for reconstruction of roads damaged during the war and for the construction of new roads, and that using this tax would adhere to the "beneficiaries pay" principle. Because of this, the share of public works spending

(other than disaster reconstruction costs) directed toward road construction rose from 28.8 percent in fiscal 1955, to 45.3 percent in 1959, outpacing landslides and

Table 4-6 Public Works Budget Breakdown (FY 1955-1959, after supplementation)

(In thousands of yen)

	FY 1955	(%)	FY 1956	(%)	FY 1957	(%)	FY 1958	(%)	FY 1959	(%)
Soil and water conservation	31,260,663	22.2	32,705,855	23.1	34,435,095	21.0	36,119,434	19.9	47,488,905	19.2
Road development	23,944,701	17.0	26,967,081	19.0	46,427,412	28.3	53,427,623	29.5	79,795,310	32.2
Ports/harbors, fishing ports, airports	6,094,380	4.4	6,886,333	4.9	10,381,149	6.3	12,090,269	6.7	17,226,563	7.0
Forest road and urban development, etc.	4,826,983	3.5	4,937,551	3.5	5,632,392	3.5	6,178,020	3.4	7,938,053	3.2
Agricultural infrastructure development	22,863,534	16.3	24,627,272	17.4	26,768,653	16.3	29,161,343	16.1	32,887,580	13.3
Disaster restoration, etc.	50,690,144	36.0	44,005,704	31.0	39,819,595	24.2	43,454,247	24.0	61,979,548	25.0
Mining damage restoration	1,326,038	1.0	1,313,284	1.0	566,332	0.4	510,230	0.3	534,395	0.3
Adjustments			500,000	0.4	500,000	0.3	550,000	0.3	650,000	0.3
Total	141,006,443	100.0	141,943,080	100.0	164,530,628	100.0	181,491,166	100.0	248,500,354	100.0

Source: Ministry of Finance, Budget Statistics, FY1962, pp. 138-41

water control to become the top public works spending item. The Japan Highway Public Corporation was established in 1956 to meet the urgent need for new road construction by building toll roads in addition to regular roads through the special account. The corporation was eligible for FILP funding, but because it also had revenues from user fees, it was strongly oriented toward the idea of beneficiaries footing the bill. In the intervening years, it has become known as one of the best examples of a successful FILP institution.

In 1955, another representative FILP institution, the Japan Housing Corporation, was established. The purpose of this agency was to supplement local public housing projects, which were limited by local government boundaries, with services extending across boundaries. Rather than just an incorporation of General Account services, it was a new institution for policy administration; rather than just using FILP funds to distance fiscal policy from budget appropriations, it used the system to expand the range of national government activities. The agency's funding came from five sources: 1) investments by central and local governments; 2) borrowings from the government and private sectors; 3) housing bonds; 4) special housing bonds and housing-lot bonds; and 5) rents and sales. The FILP underwrote the borrowings and housing bonds. The agency was notable for its ability to borrow from the private sector, although government policy limited this borrowing to insurance companies and trust banks. The government also promised to mediate loan contracts as required. Special housing bonds and housing-lot bonds were sold to those wishing to purchase housing. In exchange for underwriting the bonds, buyers were granted a priority when agency developments went on sale. (In 1965, the government ceased to invest in the agency. To adjust the agency's costs to allow for the lack of new investment, an “interest subsidy” program was established in the General Account.) There were also other programs for housing construction at the government policy level, including the following: 1) the Housing Loan Corporation, which provided long-term loans for home purchases; 2) fiscal subsidies for public housing construction at the local level; 8) housing construction funded with “rebate

loans" and from other social-policy sources; and 4) housing for government employees. The first three received FILP funding, enabling the FILP to draw on a wider range of investment vehicles as well. Altogether, housing-related funding accounted for a full quarter of the FILP funding, the largest share for any single category.

The late 1950s saw the establishment of other public corporations on the same model as the Japan Highway Public Corporation and the Japan Housing Corporation. An overview of two and a half decades shows that 15 new public corporations were established in the early 1950s, as opposed to nine disbanded; in the late 1950s, 41 were established and none disbanded; in the early 1960s, 39 were established and two disbanded; in the late 1960s, the toll was 22 and 11; and in the early 1970s, it was 13 and 11, respectively. Most of the new public corporations were FILP institutions, which is why the scope of FILP activities was widened by funding primarily from special accounts, government enterprises (former special accounts), and government financial institutions at its establishment in 1953, to a plethora of public corporations and agencies in the late 1950s. Between 1955 and 1959, public works spending grew 1.8-fold in the General Account but 12.7-fold in the FILP; a clear testament to the role the program played.

4) Growth-promoting Taxation

The Tax Commission (originally a temporary body that later became a permanent commission) set the tone for taxation in the late 1950s with a report issued in December 1956. The basic idea was that the tax burden had grown heavier and that tax cuts should consequently be given a higher priority. With the economy growing and natural increases in tax revenues certain, the increases should be used to reduce taxation. Tax cuts, it argued, would serve as an engine to growth by encouraging private-sector savings. The commission also asserted that tax cuts should comprise cuts in the tax rate rather than newly created deductions, the preferred method in the early 1950s which was actually more in the nature of "payment in kind." Behind this proposal was an awareness that the high income tax

rates and steep progression in the system were impediments to people's desire to work or to go into business, and that they had robbed the nation of much of its motivation to improve productivity. During the early 1950s, the policy priority was on stabilizing living standards, which led to the creation of new deductions for various purposes. The commission turned its attention to the need to simplify what had become a complex system and to begin thinking more from the perspective of economic growth. One of its proposals for doing so was to transfer some of the tax burden from direct to indirect taxation. The argument against income taxes was that income levels were flatter now than they had been before the war and that there was potential for damage from income taxes because collection methods could give rise to charges of unfairness. Increased indirect taxation, on the other hand, would restrain consumption and promote savings. The commission considered the establishment of a sales tax to accomplish this, but it did not include one in its report. Finally, it advocated that the special tax breaks that had developed be consolidated and rationalized.

The Tax Commission's prediction proved correct. The natural increase in revenues during the late 1950s was sufficient to fund tax cuts, and the commission's goal of cutting taxes was indeed achieved. Likewise, most of the cuts were in the income tax, with a priority placed on flattening the progression, just as the commission had advocated. There was, however, no significant increase in indirect taxation. The natural increase was large enough to make this unnecessary. As the “¥ 100 billion in new spending and ¥ 100 billion in tax cuts” budget of 1957 illustrates, the government had enough money to cut taxes and increase spending without having to turn to indirect taxation for new revenues. Because of this, the commission's goal of changing the direct/indirect taxation mix was not achieved. The only thing that occurred was a tiny revision of the commodities tax.

The special taxation measures (tax breaks) for specific purposes also remained more or less unaltered from the early 1950s. One notably effective tax break from the late 1950s was the "export income deduction" introduced in 1953, which was

modeled on a similar measure in West Germany. This deduction initially had a limit of three years, but it was held over until it was declared a GATT violation in 1964. Other notable tax breaks during the late 1950s included the "technology export income deduction" (1959) and the "special depreciation schedule for exports" (1961).

Special taxation measures for savings encouragement were not consolidated to the extent the report advocated because they were considered effective in achieving their purpose. If anything, they were actively expanded. In a rather unusual measure, all interest on long-term deposits was declared tax free between 1955 and 1959. This break was supposed to be temporary: it was introduced in July 1955 and was scheduled to end in March 1957. The lawmakers extended it to the end of 1957, however, and then to March 1959. The MOF was not necessarily enthusiastic about exempting all interest income from taxation, and the measure was debated vigorously in the commission. The majority opinion affirmed the principle of "comprehensive taxation." As an interim measure, a 10-percent separate withholding taxation was introduced. In March 1959, a "savings deduction" was passed, retroactive to April 1958 and limited to December 1959. West Germany was again the model. During this period, those who placed a set amount of money into a long-term savings account each month for at least six months would be allowed to deduct 3 percent of their annual savings. The policy-makers were fully aware of the unusual nature of these tax breaks, but they nevertheless chose to place a priority on encouraging savings.

3. The Development of Activist Monetary Policy

1) Monetary Policy under the Five-Year Economic Independence Plan and New Long-term Economic Plan

The objective of monetary policy during the late 1950s was to develop a "sound financial sector." A priority was placed on "financial normalization," which in this case meant boosting savings and capital adequacy, although the top priority

remained on ensuring an adequate money supply because of the general shortage of funding. The major channel for industrial funding was private-sector financing: there was little short-term prospect for internal funding to take over for external funding. Both the Five-Year Economic Independence Plan and the New Long-term Economic Plan affirmed the importance of the FILP, which the policy-makers saw not only as a supplement to private-sector finance but as an independent source of funding.

Some argued that the only way to utilize the scarce industrial funding effectively would be to impose strict controls, but the intention of the Five-Year Economic Independence Plan was to form a structure that could be integrated easily into the world economy. New controls were therefore undesirable; rather, the government would articulate investment policy priorities with which it hoped the financial sector would comply voluntarily. The idea is apparent here that, while (additional) direct controls were not advisable, neither could private-sector adjustments by themselves necessarily be depended on in all cases. It would consequently be necessary to give some consideration to the allocation of funds in actual practice.

The shortage of domestic funding raised the issue of importing capital from abroad. Although no one argued against the need for importing technology - indeed, it was actively promoted - the mood was less favorable when it came to an excessively-easy dependence on foreign credits to supplement domestic funding for other purposes. Given the orientation of the Five-Year Economic Independence Plan, the government did not want to create the impression that Japan was closed or isolated. It also recognized that low-interest funding from abroad might spur economic expansion, but it was generally cautious. Imports of foreign capital were to be decided on a case-by-case basis, thus giving the regulators room to make individual adjustments.

Fiscal and monetary policy became more closely linked in the quest for "soundness." This was a reaction to the tendency seen since the Dodge Plan to use a large increase in credit to provide coverage from the monetary side for austerity on

the fiscal side. Greater integration of fiscal and monetary policy was one way to ensure that the effects of the “One Trillion Yen Budget” would be more widely felt.

The maintenance of stable currency values was a key policy for the achievement of the New Long-term Economic Plan. Though an issue for fiscal and monetary policy, stable currency values were viewed at the time more as a means of assuring stable domestic prices, a hold-over from the days when controls were used to stabilize prices of basic materials. The idea that monetary policy should be employed to achieve this had not yet taken root, nor were the conditions really in place for it to do so, since finance had yet to be restored to its normal, core functions.

The themes of “financial normalization” and “financial soundness” extended throughout the late 1950s, but for monetary policy to function normally required that all the elements be in place, including such orthodox tools of monetary policy as interest-rate policy, open-market policy and payment reserve manipulation. This, in turn, required a restoration of interest-rate functions, which in the prevailing “step-at-a-time” argument meant resolving the overloan problem and normalizing the supply and demand for funding. In other words, with “sound finance” as their goal, the policy-makers were forced to recognize the fact that, from an objective standpoint, the supply of industrial funding through private-sector over-lending had already, and quite obviously, become a determining factor in the quantities of funding available. This situation was in direct contradiction to the principle of “sound finance” (in fact, it was something that “sound finance” could not allow to happen). The monetary policy objective was therefore not as clear as the fiscal policy objective, and in actual practice, the authorities were left to “treat the symptoms” using the existing mechanisms to make adjustments that would meet real needs without bringing the system down.

2) Low-interest Rate Policy

One of the most important facets of the economic policy of the day, which targeted growth through greater external competitiveness, was the “low-interest rate

policy." Policies aimed at reducing interest rates included, first, lower production costs and, second, financial normalization. The latter was emphasized repeatedly by the MOF until about the mid-1960s.

Low interest rates are not, by all rights, possible when rapid growth has triggered a shortage of funding and the financial sector is unable to supply funding in a normal manner in any case. The only way they were maintained was by creating an artificial interest-rate scale, determined according to standards divorced from market rates, and pegging interest rates at low levels. The rationale for doing so came from the "Temporary Interest Rate Adjustments Law" that was passed during reconstruction and that provided the guidelines for interest-rate regulation. Although supposed to be only temporary, the system was held over with a few modifications. During the late 1950s and early 1960s, the basis for the artificial interest-rate scale was the yield bid on government-guaranteed bonds. Financial institutions underwrote almost all the government-guaranteed bonds, and the yields they bid were consequently determined by their own funding costs. This price formed the basis for calculating the yields on other bonds and the interest paid on deposits.

Table 4-7 Discount Rates of Major Countries

Year's End	Japan	US	UK	West Germany	France	Italy
1950	5.11	1.75	2.00	6.00	2.50	4.00
1953	5.84	2.00	3.50	3.50	3.50	4.00
1956	7.30	3.00	5.50	5.00	3.00	4.00
1959	7.30	4.00	4.00	4.00	4.00	3.50
1962	6.57	3.00	4.50	3.00	3.50	3.50
1965	5.48	4.50	6.00	4.00	3.50	3.50
1968	5.84	5.50	7.00	3.00	6.00	3.50
1971	4.75	4.50	5.00	4.00	6.50	4.50

Scholars disagree as to whether or not the low interest-rate policies were effective - and, indeed, whether or not low interest rates were actually established. On the lending side, the existence of derivative deposits meant that the real interest paid by borrowers was not actually so low. Clearly, the financial institutions took a

sufficient margin to place themselves in a comparatively advantageous position. On the other hand, it is also a fact that, if the interest-rate regulations had been loosened, the rates would have shot upwards immediately. The chronic tightness of the money markets made that inevitable, as the high rates on the call market, the only unregulated market, attest. It is therefore possible to argue that the rates were lower than they would have been had there been no regulation.

The government was consistently successful in its policy of keeping interest rates on deposits low, which enabled the financial institutions to raise funds inexpensively. The competition for funds among financial institutions was particularly intense from the early 1950s to the mid-1960s, and some institutions did attempt to attract depositors with “special rates” that went beyond the official, regulated rates. The MOF and BOJ were adamant about maintaining official rates on the fund-raising side, however, issuing “requests” for institutions to exercise restraint and in some cases charging over-payers with violation of the Temporary Interest Rate Adjustments Law. Though there were some obvious contradictions between the slogans encouraging private-sector savings as an engine to economic growth and regulations that kept the returns on those savings low, the priority was always on maintaining artificially determined interest rate scales and keeping rates pegged low according to them.

3) Industrial Funding Allocation Policies

The legal means and tools for the directly regulated allocation of funding seen during the reconstruction period remained in place through the early 1950s. During the late 1940s, the MOF considered the “Financial Institutions Capital Financing Regulations” to be one of the priorities in its policies governing fund allocations by financial institutions. The actual guidelines for enforcement were introduced in a May 6, 1954, circular from the head of the Banking Bureau entitled “Near-term Lending Guidelines.” The circular instructed financial institutions to place a priority in industrial lending on sectors that would contribute directly or indirectly to improving the balance of payments, as detailed in the basic investment guidelines

for government industrial equipment financing. By the same token, the institutions were to place strict limits on the extension of credit to "nonessential or uncritical sectors" (defined in the circular as building construction other than housing, inns and lodgings, restaurants and entertainment). The circular went on to note that the prioritization of industrial lending on a sector-by-sector basis (as detailed in the "Table of Industrial Lending Priorities" attached to the "Financial Institution Capital Financing Regulation") had attracted more than enough capital investment to the priority sectors, and that the Ministry looked for self-restraint on the part of institutions as a result. The Financial Institution Capital Financing Regulation was used as a means of regulating lending to "nonessential or uncritical sectors," by requiring consultations with the BOJ before making loans to sectors designated as "low priority."

Although the government tried to avoid direct controls wherever possible, the artificial interest rates did not allow socially valid allocations of funding, as a result of which it was necessary to provide official funding and credit allocation policies based on general industrial policy. The government and the BOJ employed monetary policy to guide industrial funding allocations. They also provided funds directly through official lending and tried to guide private-sector financing with joint-financing programs and the entrustment of screening to government financial institutions. One of the hallmarks of Japanese monetary policy at this time was the deep involvement of the government and the BOJ, not only in regulating the money supply but also in the allocation of market funds. Made possible by the mechanisms described above, this involvement is generally praised for bringing greater efficiency to the supply of industrial funding for economic growth. It is not necessarily clear, however, just how this was accomplished (one of its important components was the "foreign exchange budget" that was enforced under the foreign exchange control regime).

Extending this argument leads to the idea that the public authorities could interfere in market fund allocations themselves to direct them to priority industrial

sectors. The MOF was, however, fundamentally opposed to such direct methods of control. The “Bill Concerning Temporary Measures to Adjust the Fund Investments of Financial Institutions,” prepared by the political parties in 1955, had three main tenets: 1) use tax cuts to increase savings; 2) to require financial institutions to earmark a set percentage of the increase in savings for investments in public bonds, thereby providing funding for the FILP; and 3) to allocate the increased FILP funding to priority industries. In other words, the politicians wanted to let the FILP tap private-sector funding.

Specially, the bill would have required commercial institutions to set aside no more than 20 percent of the increase in savings for the purchase of government bonds, municipal bonds, interest-bearing bank debentures, public corporation bonds (for the national railroads and the telephone corporation) and other bonds as designated. In addition, a new commission established in the MOF would advise the Minister of Finance on issues of importance with respect to the investment of commercial financial institutions.

The Diet eventually rejected this bill, but a Council on Financial Institution Fund Operations was established as a compromise by Cabinet decision and charged with looking into the investments of private-sector institutions. The private-sector institutions, for their part, voluntarily established a Funding Adjustment Committee, which would maintain contact with the Council on Financial Institution Fund Operations and provide voluntary lending adjustments. We should note, however, that unlike those proposed in the “Bill Concerning Temporary Measures to Adjust the Fund Investments of Financial Institutions,” these adjustments had no binding force. In 1958, the Industrial Rationalization Council was established under the auspices of the Minister of International Trade and Industry for the purpose of conducting adjustments throughout industry. One of its subsidiary bodies, the Subcommittee on Industrial Funding, became an important institution in the regulation of capital investment financing.

During the late 1950s and early 1960s, bank debentures accounted for 60-70

percent of the bond market. Corporate bonds, only about 20 percent of the market during the late 1950s, declined to a mere 10 percent in the early 1960s. This share was the result of fund allocations by the “bond raising adjustment” structure. Since the financial institutions were perennially “overloaned,” their funding capabilities were dependent on credit from the BOJ, and it was these credits that determined their capacity to underwrite bonds. This structure made some sort of coordination essential for new issues and ensured that the effects of that coordination would be felt throughout the economy.

Adjustments among new issues were less a problem for the securities markets than an issue of how institutions were to allocate funds. Bank debentures were used by long-term credit banks and employed to fund loans for long-term capital investment in such priority sectors as electric power, marine transportation, coal and steel. As one of the chief vehicles for carrying out industrial policy, they were given a particularly high priority; this priority handling was the reason for their dominant share of financial institution bond investments. In fact, the Trust Fund Bureau also invested in bank debentures, with the result that they could actually be issued in excess of the financial institutions' underwriting capacity.

When they were first issued in fiscal 1953, the government-guaranteed bonds were floated on an entirely public-subscription basis. In 1956, however, they began to be assigned compulsorily to financial institutions, in a system that continued to expand throughout the second half of the 1950s. Ostensibly, government-guaranteed bonds were to be public subscriptions, but the returns on investment were so low that the public subscriptions were difficult to float in actual practice. Assigning bonds to financial institutions fulfilled the formal requirement that the entire issue be absorbed by the market (the underwriting syndicate). Corporate bonds had to be satisfied with whatever funding was left over after the bank debentures and government-guaranteed bonds.

With funding limited and the desire to issue bonds strong because of the high economic growth, corporate bond issues were subject to particularly severe

restrictions. During the early 1950s, this took the form of direct control - the "BOJ Collateral-qualified Corporate Bond" system allowed the Bank of Japan to decide who would and would not be allowed to issue. During the late 1950s, this decision-making was transferred to a self-regulatory system in the name of liberalization, and the decisions were now made by a "Bond Raising Consultation Committee" composed of the major banks and brokerages. Questions taken up by the committee included the amount of new issues projected for the year, ratings standards and amounts to be allocated to each rating level. (Note the use of an American-style rating system as the standard for new issues adjustments.) While virtually 100 percent of the desired government-guaranteed bonds were issued, adjustments in the corporate market led to wide fluctuations in the "achievement rate" for would-be issuers, and even then, electric power companies had generally high achievement rates while the rates for general issuers were low and subject to sharp swings. Corporate bonds were a marginal part of the new issues market, and with strategic sectors given priority on such issues as were allowed, general issues were often squeezed out. This is why bonds were a marginal means of fund-raising for industrial companies at this time.

4) Marshalling Savings in the Cause of Growth

Japanese savings and investment rates were demonstrably high during this period. From the micro perspective, it is easy to verify that the propensity of Japanese households to save was high by international standards. At the level of fiscal and monetary policy, however, there was an awareness of a shortage of savings, both from the perspective of the industrial fund-raising structure and from the perspective of financial institution funding positions. Obvious during the reconstruction period, this remained true in the high-growth period. Overcoming this scarcity of domestic funding was a central duty of fiscal and monetary policy. Policies to encourage savings, particularly personal savings which were the main component of savings in absolute terms, were emphasized throughout the period, both as an important part of monetary policy and as a clearly articulated component

of fiscal policy, where they took the form of tax breaks or savings-friendly taxation policies.

The dominance of indirect financing resulted from the fact that the savings surplus was overwhelmingly entrusted to financial institutions rather than invested in the stock market.

Nevertheless, the institutions' funding positions fell short of demand. Throughout the high-growth period, the government and private sector cooperated to encourage greater savings as a direct solution to the funding shortage. Heading up this push were the Central Committee for Savings Promotion, established in April 1952, and the Bank of Japan Savings Promotion Department. The Central Committee for Savings Promotion decided annual savings promotion policies and set a savings target that it encouraged the public to reach. This system was perpetuated until 1975. In April 1957, the MOF set up a “Savings Promotion Headquarters” under its jurisdiction, and two years later the office of “Savings Promotion Officer” was created.

These programs were large and quite active, but as already discussed, regulated interest rates (including those paid on deposits) did not leave much room for savings-promotion measures within the context of either monetary policy or financial institution services. The savings promotion movement was thus largely an educational and psychological affair, which makes it difficult to judge its effectiveness. In the end, the growth in savings and bank deposits occurred in tandem with high economic growth: higher incomes resulted in greater financial surpluses. Most of the increase consequently came in the early 1960s and beyond. While there were constraints on what could be done from the monetary side, fiscal measures, particularly tax-free small-deposit accounts, proved effective.

The reasons why people chose deposits and savings for their surplus funds rather than investments in stocks and bonds have been a focus of considerable debate. An analysis of “Methods for the Rectification of Overloans,” published on April 2, 1963, by the Standing Subcommittee on Research and Planning of the Financial

System Research Committee offered the following reasons: 1) The amounts of individual savings were extremely small, encouraging a preference for stability and liquidity; 2) bonds lacked liquidity because there was no trading market; 3) since new bond issues were made only with the wishes of issuers in mind, they were not attractive investments; and 4) the stock market continued to be highly speculative, preventing it from attracting personal savings. Others have argued from a different perspective, citing: 1) the failure of consumption to keep pace with the rapid growth in income during the high-growth period; 2) a strong preference for financial assets because of their sharp reduction in value resulting from postwar inflation; 3) bonus income, which encourages savings; 4) a backward credit system for purchases of housing and durable consumer goods; and 5) an ingrained habit of savings supported by high educational levels, a national work ethic and a strong desire to improve personal living standards. Another convincing argument is that the poor social security also encouraged people to save, although some point to high savings rates in West Germany, where the social security system was very good, to refute this position.

4. Rejoining the International Economy

1) Membership in the GATT

Since occupied territories were explicitly excluded from the GATT, Japan's membership in the Agreement had to wait until after independence, though steps to prepare for it were taken before independence had been achieved. In March 1951, Japan revised its tariff schedule, and after West Germany's membership was accepted in June of that year, the Plenary Session of the Agreement approved Japan's attendance as an observer in September, conditional on the signing of a peace accord. In July 1952, Japan filed a formal application for membership, but it was turned down due to opposition from one-third of the membership. The Plenary Session that October again delayed consideration of Japan's application because of the opposition of some countries. Japan's application eventually came up as an

Table 4-8 International Trade of Major Countries

(In millions of dollar)

Year	Japan		US		UK		West Germany		France		Italy	
	Export	Import	Export	Import	Export	Import	Export	Import	Export	Import	Export	Import
1955	2,011	2,471	14,291	11,384	8,605	11,021	6,138	5,822	4,800	4,688	1,857	2,711
1960	4,055	4,491	19,626	15,018	10,611	13,033	11,422	10,175	6,863	6,279	3,648	4,725
1965	8,452	8,169	26,700	21,366	13,722	16,104	17,912	17,611	10,191	9,630	7,200	7,378
1970	19,318	18,881	42,659	39,952	19,351	21,724	34,225	29,944	17,999	17,928	13,206	14,969
1975	55,753	57,863	107,130	96,116	44,124	53,576	90,176	74,931	49,524	48,217	34,815	38,365

Source: Bank of Japan, Foreign Economic Statistics (Annual Report), 1975

Table 4-9 Exports by Regions (by countries)

(In Thousands of dollar)

Year	Total	Asia				Europe			North America		South America	Africa	Oceania
			Republic of Korea	People's Republic of China	Indonesia		UK	West Germany		US			
1953	1,274,843	654,522	106,830	4,539	105,436	118,753	33,141	15,825	300,173	233,879	58,251	128,782	14,363
1958	2,876,560	1,058,771	56,694	50,600	48,647	348,852	105,235	43,830	858,441	690,479	114,982	415,511	48,921
1963	5,452,116	1,868,321	159,661	62,417	98,721	891,559	155,825	115,522	1,794,683	1,506,910	197,500	475,440	222,840
1968	12,971,662	4,415,418	602,653	325,438	146,595	1,896,265	364,587	287,371	4,831,302	4,086,454	343,395	939,992	541,586
1973	36,929,971	11,583,158	1,789,115	1,039,494	902,402	7,377,354	1,357,212	1,270,776	11,789,293	9,448,678	1,420,187	3,142,325	1,616,844

Source: Toyokeizai shinposha, "Showa Kokusei Souran", Vol. 1, pp. 638-41

Table 4-10 Imports by Regions (by countries)

(In thousands of yen)

Year	Total	Asia				Europe			North America		South America	Africa	Oceania
			Republic of Korea	People's Republic of China	Saudi Arabia		UK	West Germany		US			
1953	2,409,637	796,757	8,567	29,700	97,825	202,839	48,824	37,855	1,027,386	759,693	125,825	55,868	200,962
1958	3,033,125	964,057	11,039	54,427	144,817	287,045	59,349	90,282	1,357,688	1,056,093	80,687	83,737	259,795
1963	6,736,337	2,063,585	26,980	74,599	178,874	850,798	149,132	219,781	2,681,768	2,077,330	278,547	265,699	595,933
1968	12,987,243	4,004,292	101,630	224,185	389,136	1,878,430	257,356	400,570	4,538,710	3,527,383	609,869	839,082	1,115,328
1973	38,313,604	13,791,098	1,207,309	974,010	1,386,371	5,297,385	760,783	1,116,159	1,927,063	9,269,559	1,312,842	1,746,891	293,842

Source: Toyokeizai shinposha, "*Showa Kokusei Souran*", Vol. 1, pp. 642-45

Table 4-11 Exports by Major Commodities (Value)

(In thousands of dollar)

	fish and shellfish	Raw silk	Cotton Textile	Synthetic Fiber Textile	Rayon Textile	Thin Sheet steell	Steel Pipe	Radio Receiver	Clothing	Scientific & Optical Instruments
1953	33,678	42,828	179,172		43,314	2,606	19,490	196	37,549	17,027
1958	123,331	22,469	277,029	6,667	61,742	25,405	15,468	34,190	148,909	57,850
1963	127,937	49,563	307,841	98,021	61,810	151,275	116,203	189,008	211,063	149,089
1968	190,044	8,717	238,357	393,677	56,527	481,307	328,351	421,331	387,124	371,961
1973	261,486	374	194,666	1,000,271	42,262	1,274,716	817,133	1,242,566	369,857	969,635

Notice: The top five export items in 1953 and 1973 are selected for this table. Fish and shellfish are processed products.
Source: Toyokeizai shinposha, "*Showa Kokusei Souran*", Vol. 1, pp. 616-27

Table 4-12 Imports by Major Commodities (Quantity)

	fish and shellfish (ton)	Raw silk (ton)	Cotton Textile (thousand square meters)	Synthetic Fiber Textile (thousand square meters)	Rayon Textile (thousand square meters)	Thin Sheet steell (thousand ton)	Steel Pipe (thousand ton)	Radio Receiver (thousand sets)	Clothing	Scientific & Optical Instruments (thousand sets)
1953	46,962	3,856	764,230		191,010	16	78	6	-	116
1958	138,459	2,828	1,041,339	13,058	301,605	161	77	3,797	-	719
1963	151,424	3,485	1,007,680	187,302	195,019	1,054	696	21,938	-	1,254
1968	238,563	461	665,536	868,909	151,275	3,597	1,916	36,810	-	2,433
1973	259,503	10	246,724	1,341,890	73,028	5,646	2,879	36,292	-	4,556

(Source) Same as Table 4-12.

official agenda item in October 1953, but it was once again rejected. Finally, in July 1954, the Agreement adopted an "Accession Advisory" for Japan, paving the way for the start of tariff negotiations in Geneva. During negotiations with 17 countries, including a two-and-a-half month negotiating session with the United States, Japan agreed to large tariff concessions, leading to its formal membership in the GATT on June 7, 1955.

The reason for this protracted acceptance process lay in memories of Japanese dumping and exchange rate devaluations prior to the war, which had left a particularly bad taste in the mouths of European and British Commonwealth countries. Time was required to overcome those memories. Also, the countries of Europe were still in the process of reconstructing, and they were intensely concerned with the outcome of tariff negotiations. The resulting political calculations gave external factors a large sway in Japan's application. Japan, for its part, was intent on joining the GATT as soon as the peace treaty was signed. The delay in the acceptance of its application until 1955 was the result of external conditions that it had not foreseen. GATT membership did not carry with it the obligation of immediate trade liberalization, but the application came just as Japan was completing reconstruction and the "special procurement demand" from the Korean War was dying down. The government recognized the need to establish foreign relations within the framework of the free trade system, and it therefore provided incentives for strengthening the economy in the Five-Year Economic Independence Plan.

2) Capital Imports

Aware of the shortage of funds at home, the Japanese government adopted the position of actively encouraging the importation of "superior" foreign capital within the context of the foreign exchange control regime. The "Law Concerning Foreign Capital" was passed to provide an exemption from the strictures of the "Foreign Exchange and Foreign Trade Control Law" that would encourage the flow of more foreign capital into Japan. Industry was generally enthusiastic about importing funds,

but dependence on foreign sources for equity capital and lending was not, in fact, particularly high during the reconstruction and high-growth periods. Foreign investors had little awareness of or confidence in the Japanese economy, and the conditions were not in place in Japan to attract as much investment as it hoped. Furthermore, constraints on foreign reserves made it necessary for the government to place strict controls on the selection of "desirable" foreign capital, which did not always mesh with private-sector demand. To this was added an undeniable wariness on the part of government and the private sector when it came to foreign capital: the fear that foreigners would dominate Japanese markets had been widespread since the Meiji period.

Capital importing began after the peace treaty with government backing. On October 15, 1953, the Japan Development Bank and the World Bank signed a contract for a $40.2 million government-guaranteed loan for private-sector electric power facilities at 5 percent interest. Known as the "First Electric Power Loan," this represented the first significant importation of foreign capital since the war. Negotiations on the deal began in January 1953 with the Washington Export Import Bank, but they were transferred to the World Bank for U.S. reasons. The World Bank, cautious in its appraisal of the Japanese economy's ability to repay the loan, imposed strict conditions on it. Indeed, it was at the behest of the World Bank that the Japan Development Bank signed on as the borrower. The collateral and security requirements imposed on Japan brought criticism of the loan at home as not being in the country's interest, but the magnitude of the funding and the interest rate made it too attractive to pass up. Indeed, similar loans were employed positively in subsequent years. As it became more apparent that Japan had achieved reconstruction, the World Bank tried to restrain its lending, but the government of Japan worked energetically with the Bank to gain extensions.

The Washington Export Import Bank was also a major lender at this time. On July 6, 1955, the United States provided Japan with its first surplus agricultural produce credits, and at roughly the same time as the second credits were coming

Table 4-13 List of World Bank Loans

(In thousands of US dollar)

Contract Signing date	Effectuation date	Borrower	Beneficiary	Contract value	Project
10/15/1953	12/29/1953	Japan Development Bank	Kansai Electric	21,500	Thermal power plant (Kanagawa)
10/15/1953	12/29/1953	Japan Development Bank	Kyushu Electric	11,200	Thermal power plant (Karita)
10/15/1953	12/29/1953	Japan Development Bank	Chubu Electric	7,500	Thermal power plant (Yokkaichi)
10/15/1953	2/16/1953	Japan Development Bank	Yahata Steel	5,300	Plate steel rolling
2/21/1956	5/11/1956	Japan Development Bank	Nippon Kokan	2,600	Seamless steel pipe
			Ishikawajima-Harima	1,650	Marine turbin
			Mitsubishi Shipbuilding	1,500	Engine
	Toyota 5/19/1956		Toyota Motor	2,250	Machine tool
			2/21/1956 Subtotal	8,100	
12/19/1956	3/25/1957	Japan Development Bank	Kawasaki Steel	20,000	Chiba plant
12/19/1956	3/19/1957	Agricultural Land Development Machinery Public Corporation	Agricultural Land Development Machinery Public Corporation	4,300	Cultivation development
8/9/1957	11/9/1957	Aichi Yosui Kodan	Aichi Yosui Kodan	7,000	Aichi water system
1/29/1958	3/28/1958	Japan Development Bank	Kawasaki Steel	8,000	Chiba plant
6/13/1958	8/22/1958	Japan Development Bank	Kansai Electric	37,000	Hydroelectric power plant (Kurobe)
6/27/1958	8/22/1958	Japan Development Bank	Hokuriku Electric	25,000	Thermal power plant (Arimine)
7/11/1958	9/24/1958	Japan Development Bank	Sumitomo Metal	33,000	Wakayama plant
8/18/1958	10/10/1958	Japan Development Bank	Kobe Steel	10,000	Nadahama/Wakihama plant
9/10/1958	12/22/1958	Japan Development Bank	Chubu Electric	29,000	Thermal power plant (Hatanada)
9/10/1958	11/14/1958	Japan Development Bank	Nippon Kokan	22,000	Mizue plant
2/17/1959	2/24/1959	Japan Development Bank	Electric Power Development Co.	10,000	Hydroelectric power plant (Oboro)
11/12/1959	1/16/1960	Japan Development Bank	Fui Steel	24,000	Hirohata plant
11/12/1959	1/16/1960	Japan Development Bank	Yahata Steel	20,000	Tobata plant
3/17/1960	5/25/1960	Japan Highway Public Corporation	Japan Highway Public Corporation	40,000	Meishin Expressway
12/20/1960	1/20/1951	Japan Development Bank	Kawasaki Steel	6,000	Chiba plant
12/20/1960	1/20/1951	Japan Development Bank	Sumitomo Metal	7,000	Wakayama plant
3/16/1961	5/3/1951	Japan Development Bank	Kyushu Electric	12,000	Thermal power plant (Kanagawa)
5/ 2/1961	6/30/1951	Japanese National Railways	Japanese National Railways	80,000	Tokaido Shinkansen bullet train line
11/29/1961	1/30/1952	Japan Highway Public Corporation	Japan Highway Public Corporation	40,000	Meishin Expressway
9/27/1963	11/21/1953	Japan Highway Public Corporation	Japan Highway Public Corporation	75,000	Tomei Expressway
4/22/1964	6/24/1964	Japan Highway Public Corporation	Japan Highway Public Corporation	50,000	Meishin Expressway
12/13/964	2/25/1965	Metropolitan Expressway Public Corporation	Metropolitan Expressway Public Corporation	25,000	Haneda-Yokohama expressway
1/13/1965	3/26/1965	Electric Power Development Co.	Electric Power Development Co.	25,000	Hydroelectric power plant (Kuzuryu)
5/26/1965	7/25/1965	Japan Highway Public Corporation	Japan Highway Public Corporation	75,000	Tomei Expressway
9/10/1965	11/4/1965	Hanshin Expressway Public Corporation	Hanshin Expressway Public Corporation	25,000	Hanshin Expressway
7/29/1966	9/20/1965	Japan Highway Public Corporation	Japan Highway Public Corporation	100,000	Tomei Expressway

Source: Ministry of Finance, Monthly Fiscal and Financial Statistics, No.222, pp. 78

Table 4-14 Washington Export-Import Bank Loans

(In thousands of US dollar)

Approval date	Borrower	Project	Construction period	Approved amount
	〔Electricity〕			
8/21/1956	Kansai Electric	Osaka thermal power plant No. 1	1956-59	8,972
12./4/1956	Kyushu Electric	Karide thermal power plant No. 2	1956-59	8,500
3/19/1957	Chubu Electric	Shin-Nagoya thermal power plant No. 1	1956-59	8,500
5/21/1957	Tokyo Electric	Chiba thermal power plant No. 3	1956-59	8,000
7/2/1957	Kansai Electric	Osaka thermal power plant No. 2	1956-59	4,250
9/4/1957	Tohoku Electric	Sendai thermal power plant No. 1	1956-59	7,300
11/5/1957	Tokyo Electric	Chiba thermal power plant No. 4	1956-59	4,800
12/17/1957	Kyushu Electric	Karide thermal power plant No. 3	1957-59	5,000
1/21/1958	Chubu Electric	Shin-Nagoya thermal power plant No. 2	1956-59	6,700
8/19/1958	Tokyo Electric	Yokosuka thermal power plant No. 1	1957-59	11,000
8/19/1958	Kansai Electric	Osaka thermal power plant No. 3	1957-59	4,800
11/20/1961	Kansai Electric	Himeji thermal power plant No. 2	1960-64	15,100
3/22/1962	Tokyo Electric	Goi thermal power plant No. 1	1961-64	5,300
2/28/1963	Tokyo Electric	Yokosuka thermal power plants No. 3 and 4	1961-64	37,100
3/7/1963	Chubu Electric	Owase thermal nuclear plants No. 1 and 2	1961-64	37,890
7/1/1964	Kansai Electric	Himeji thermal power plant No. 4	1964-67	19,182
4/1/1965	Tokyo Electric	Anegasaki thermal power plant No. 1	1964-67	24,550
10/26/1965	Chubu Electric	Chita thermal power plant No. 3	1964-68	9,525
	Subtotal			226,454
	〔Steel〕			
11./9/1957	Fuji Steel	Hirohata plant rolling equipment	1956-60	10,300
3/29/1958	Yahata Steel	Tobata plant rolling equipment	1956-60	26,000
8/12/1958	Toyo Kohan	Rolling and electrogalvanizing equipment	1956-61	7,100
3/22/1960	Toyo Kohan	Rolling and electrogalvanizing equipment	1960-61	3,000
11/4/1961	Nippon Kokan	Mizue plant tinning equipment	1960-65	6,500
11/29/1961	Fuji Steel	Hirohata plant electrotinning equipment	1961-65	15,600
5/7/1962	Sumitomo Metal	Wakayama plant cold strip mill	1961-64	8,100
8/23/1962	Yahata Steel	Tobata, Kagami and Chiba plant equipment		26,000
10/31/1962	Kawasaki Steel	Chiba plant cold strip mill		18,500
2/15/1965	Nippon Kokan	Fukuyama plant hot and cold strip mill	1965-67	15,000
4/20/1965	Fuji Steel	Tobata plant steel winder	1965	600
	Subtotal			136,700

(In thousands of US dollar)

Approval date	Borrower	Project	Construction period	Approved amount
	〔Others〕			
9/17/1957	Japan Air Lines	Aircraft procurement	1957-58	7,700
11/4/1958	Nippon Gas Chemical	Fertilizer plant equipment	1958-59	2,300
3/3/1959	Nissan Motor	Auto produciton expansion equipment	1957-59	3,000
9/15/1959	Japan Air Lines	Aircraft procurement	1960	17,186
7/23/1960	Toyota Motor	Auto produciton expansion equipment	1960-62	12,000
12/15/1960	Isuzu Motor	Auto produciton expansion equipment	1960-62	9,300
4/7/1961	Industrial Bank of Jpan	Small and medium enterprise loans		25,000
6/15/1961	Japan Air Lines	Aircraft procurement	1961	4,702
	Japan Air Lines	Aircraft procurement	1961	14,333
12/20/1961	Nissan Motor	Auto produciton expansion equipment	1960-65	11,000
3/13/1962	Nippon Gas Chemical	Gas compressor	1961-62	800
6/13/1962	Prince Motor	Luxury car manufacturing equipment	1962-63	4,100
7/18/1963	Industrial Bank of Jpan	Small and medium enterprise loans		15,000
1/31/1964	Ube Kosan	High-pressure polyethylene manufacturing equipment	1963-65	3,100
10/28/1964	All Nippon Airways	Aircraft procurement	1965	15,160
11/20/1964	Nissan Motor	Auto production expansion and ratioalization equipment	1964-65	5,000
4/13/1965	Ube Kosan	High-pressure polyethylene manufacturing equipment	1964-67	2,200
4/14/1965	Toyota Motor	Auto production expansion equipment	1965-66	11,000
6/30/1965	Sumitomo Chemical	Ethylene, polyethylene, ammonia equipment	1965-66	6,400
1/11/1966	Toyo Kogyo	Auto manufacturing equipment modernization	1966-67	2,350
3/25/1966	Sumitomo Chemical	Chibe ethylene and polyethylene equipment	1966	3,327
	Subtotal			174,958
	Total			538,112

Note: The table covers data through the end of March 1966. Later, "others" were divided into four categories -- aviation, automobile, chemicals and others.

Source: Ministry of Finance, Monthly Fiscal and Financial Statistics, No.176, pp. 82

through, the Bank approved an $8.93 million loan at 5 percent for Kansai Electric Power on August 21, 1956. Loans by the Washington Export Import Bank were tied, but they were provided annually under a U.S. government directive to the bank to respond positively to Japanese requests.

Foreign currency public bonds were another vehicle used to import foreign capital during this period. On February 18, 1959, Japan issued $30 million in bonds ($15 million in 15-year long-term bonds at 5.5 percent and $15 million in three-to-

five-year medium-term bonds at 4.5 percent) to fund loans from the Special Account for Industrial Investment. This bond issue illustrates the gradual weaning of Japan from its dependence on World Bank lending. On the advice of the World Bank, loans from the Bank were treated as part of a package that included independent fund-raising by Japan. In April 1961, Japan floated another foreign-currency bond issue, this time not of public bonds but of government-guaranteed bonds, of $20 million for the telephone company. This marked the start of a series of foreign-currency public and government-guaranteed bond issues, although the World Bank still had the final say in decisions on the terms of borrowing. With the February 1962 issue of a (government-guaranteed) DM1OO million bond by the Prefecture and City of Osaka, Japan's fund-raising market was extended to Europe. Sources became more diversified in the ensuing years. In August 1963 a 5 million pound bond was issued in Britain (to roll over a bond from 1899). This was followed in March 1964 by a 50 million Swiss franc bond (for industrial investment) and in June 1964 by a DM200 million bond (also for industrial development). In April and June 1964 the Tokyo Metropolitan Government floated a dollar-denominated bond in Europe, becoming Japan's first public issuer on the Euro-market and helping to expand the vehicles for raising foreign capital after the imposition by the U.S. of an “interest-rate equalization tax.” At this point, however, Japan's government did not consider the Euro-dollar market worthy of confidence. Its use was merely part of a diversification strategy, and it was reserved for public and government-guaranteed bonds.

Thus, when Japan first began to raise foreign capital, it turned to the U.S. market. As a former enemy and one lacking in credit besides, however, Japan could raise the money only with direct government intermediation, and the terms of the loans were constrained by the U.S. government's policies toward the Japanese economy and Japanese aid and by the opinions of the World Bank. Overcoming the constraints of U.S. policy meant searching for other sources of funding, but even in prewar times Japan had neither the presence nor the experience in Europe that it did in the United

States. Thus, government intermediation was again required. The experience and track record that Japan acquired through this government-mediated fund-raising gradually boosted its presence in the international capital markets and paved the way for an expansion of purely private-sector capital imports.

3) Balance of Payment Trends and the Currency Crisis of 1957

During the late 1950s and early 1960s, there was a rough split in the trade balance between surplus and deficit. The basic trend was from deficit to surplus, however. Japan ran a deficit until about 1957, but thereafter posted deficits only in 1961 and 1963. Exports achieved consistent growth, but imports were subject to wide swings, a situation which had a significant effect on the bottom line of the trade balance. The invisible trade balance was in surplus throughout (with the exception of 1957), thanks mainly to strong income from marine transportation, a trend that had been seen since the early 1950s. In the early 1960s the invisible trade balance moved into the red, where it has remained to this day, but the late 1950s were marked by surpluses. The result was to produce current account surpluses in 1955, 1958 and 1959, with deficits in 1956 and 1957. The structure of the current account had also changed since the early 1950s, when large surpluses in the invisible trade balance covered large deficits in the trade balance to keep the current account in the black. With the size of the invisible trade surplus declining in the late 1950s, the trade balance determined on which side of the line the current account would fall. Similarly, the balance of both the long-term and short-term capital accounts was relatively small, which made the trade balance the determining factor in the total balance of payments as well. The trends of the mid-1950s continued with respect to foreign reserves, which fluctuated sharply and did not exceed $1 billion until 1959.

The government invoked special measures to deal with a foreign currency crisis in 1957. The "Emergency Program to Improve the Balance of Payments," approved by the Cabinet on June 19, contained the broad outlines of a general economic package coupling tight money policies at the Bank of Japan with "foreign currency

supplements" (foreign borrowings). This was the first of what would become a regular pattern of currency crises and solutions. Initially, the program followed the general outlines of monetary tightening, with the official discount rate hiked first one percentage point and then a second point. Stricter foreign exchange controls were then imposed: authorized foreign exchange banks were instructed to cut their local lending ceilings and to draw down some of their foreign currency deposits; the maturities and range of applications for British pound-denominated import usances were contracted; collateralization rates were hiked for import guarantees; and redeposits with the Bank of Japan were required. The Cabinet decision of June 19 set the stage for further controls in four areas: 1) fiscal: deferment of investments and public works projects; 2) monetary: BOJ lending restraints, draw-up of funds with sell-backs of bonds held by the Trust Fund Bureau, programs to avoid a squeeze on smaller businesses, and easier export financing, savings incentives; 3) industrial: deferment of capital investment; 4) trade: export-promotion measures and stiffer import collateralization requirements

Additionally, the government bolstered its foreign exchange reserves with $125 million from the International Monetary Fund, $175 million from the Washington Export Import Bank, $300 million from the World Bank and other borrowings for a total of $680 million. The borrowings from the IMF were expressedly to boost reserves; those from the Washington Export Import Bank were credits for American agricultural produce (cotton, wheat, barley, soy beans); and those from the World Bank were existing loans for electric power and other projects.

The currency crisis of 1959 and the infusion of foreign funds used to defuse it coincided with a visit to the U.S. by Prime Minister Nobusuke Kishi to discuss revision of the U.S.-Japan Security Treaty and with the joint communiqué that came out of those discussions. This established a precedent for solving Japanese economic crises within the framework of U.S.-Japan relations. Foreign exchange policy was in a particularly tricky position at this time, because Japan had done nothing to comply with repeated IMF requests for liberalization, which made it difficult to get through

the required IMF consultations. It was only the pressure of the checks in these consultations that prevented Japan from adopting more draconian foreign exchange controls. When the foreign exchange position did not improve even with the dollars drawn down from the IMF, there were some who argued that the automatic approval system should be abandoned for stricter foreign exchange controls. This path was not followed, however.

Chapter 5 1960-1964: Fiscal and Monetary Policy under the "Income-Doubling Plan"

1. Background and Economic Policies

Throughout the early 1960s Japan followed a consistent policy of building on the economic results of the late 1950s, in an attempt to encourage economic development while maintaining internal stability and adapting to the liberalization trends prevailing in the rest of the world. The European-led liberalization of trade and exchange rates proceeded faster than expected, and Japan was aware that it would be required to follow suit at some stage. This was, however, considered a problem for the future. At the moment, Japan needed to make progress with its own liberalization at home, and that became the focus of economic policy. The response to liberalized trade and exchange rates was mainly to treat the symptoms - providing relief to the most damaged sectors - while seeking greater competitiveness over the medium and long terms.

The "Income-Doubling Plan" was an effort to coordinate and systematize a number of different policies aimed at medium- and long-term economic rationalization and reinforcement. Its primary aim was to continue and quantitatively expand "massive growth," while at the same time pursuing qualitative rationalization and the improved international competitiveness this would bring with it. The idea of rationalization as a means of creating externally acceptable economic power had been around at least since the "Five-year Economic Independence Plan," and international necessities were forcing Japan to place more emphasis on it. Economic reinforcement in the face of trade and exchange-rate liberalization focused specifically on the heavy chemical "smokestack" industries. This was a continuation and expansion of the growth policies that had been in place during the periods of reconstruction and the Five-Year Economic Independence Plan, and under it, fiscal and monetary policy were positioned to take an active role in supporting these efforts. At the same time, since Japan's basic challenges were to

match international economic levels and strengthen international competitiveness, its plans and policies were underpinned by the assumption that exchange rates would be stable and the economy in equilibrium. In other words, there was a consistent assumption throughout this period that the economy would be managed soundly. In this respect, economic policy took on greater significance and economic management greater complexity during this period.

Though in part a continuation of previous policies, the Income-doubling Plan was based on the assumption that the economy had already reached the stage of autonomous development, and that the scope for direct government intervention would consequently narrow. Within this contracting scope, the government would take greater responsibility for economic management. The plan differed sharply in this way from the economic policies of the late 1940s and 1950s. It focused on the necessity of the government and public sectors, where the government possessed the means of realizing its policy goals directly. Four tasks were set out for the government within this framework: 1) upgrading infrastructure; 2) fostering human resources and promoting science and technology through education and training; 3) enhancing social security and improving social welfare; and 4) providing direction for private industry.

One of the distinguishing features of the Income-doubling Plan was that it made upgrading infrastructure a government priority. Ever since the scale of the economy had surpassed its prewar levels in the mid-1950s, there had been a consistent sense that Japan's infrastructure was insufficient, and when growth began to exceed the government's expectations in the late 1950s, the relative backwardness of the infrastructure became apparent. This lent support to the argument that a long-term plan for investment in infrastructure was essential to supporting and sustaining economic growth. The Income-Doubling Plan still placed the highest priority by far on “massive growth,” however, and it stated clearly that the industrial base was to be given precedence in programs to enhance infrastructure. The plan paid lip-service to the idea of gradually shifting the focus from the industrial base to the consumer

base, but as long as the high growth continued, no such shift ever occurred.

The enactment of the Income-doubling Plan permitted the perpetuation into the early 1960s of the high growth rates that emerged in the late 1950s, creating an even greater boom in private-sector capital investment and accelerating growth. Between 1955 and 1965, Japan recorded a real economic growth rate of 9.7 percent per annum (8.7 percent between 1955 and 1960). Externally, it began to show surpluses in its trade account, but internally, high growth had been accompanied by rising consumer prices since the early 1950s. Wholesale prices had remained stable ever since the late 1950s, but consumer prices turned sharply upwards about 1960, eventually placing constraints on growth.

Table 5-1 Outline of Economic Growth (1960-64)

Year	Economic Growth Rate		Growth Rate of Private Capital Investment (%)	Corporate Income / National Income (%)	National Gross Expenditure per capita (Real) (thousand yen)
	Nominal (%)	Real (%)			
1960	19.9	14.1	40.9	14.4	211.4
1961	23.4	15.6	36.8	14.4	242.1
1962	10.8	6.4	3.4	13.3	255.3
1963	15.4	10.6	5.3	12.0	279.4
1964	17.9	13.3	20.0	12.3	314.5

The process of economic growth led to wage hikes, even in smaller companies and agricultural concerns where labor productivity was still low, and these translated into higher prices for products from these sectors, boosting consumer prices as a whole. The 1962 Economic White Paper termed Japan an “economy in transition,” because of the structural changes being brought about by growth, touching off a debate on how policy should change to keep pace. But the high growth continued; becoming, indeed, the dominant trend of the decade from 1955 to 1964. In the early 1960s, the primary policy themes involved external liberalization and, in support of this, the domestic enactment of the Income-doubling Plan.

2. Shift of the Policy Focus to Public Investment

1) The Income-Doubling Plan and Fiscal Policy

The Income-Doubling Plan positioned fiscal and monetary policy at the center of economic policy, systematizing government-sector objectives while permitting appropriate direction to be given to the private sector in the course of their achievement. The plan itself was at the center of public-sector functions and its primary goal of upgrading the infrastructure should be seen as a recognition that fulfilling the central functions of fiscal policy is tantamount to fulfilling the central functions of government. Fiscal policy was required to meet its objectives by maintaining consistency and balance between the long-term plans that provided overall direction and the specific budgets for any given fiscal year.

There was nothing particularly new about programs aimed at upgrading the infrastructure, but the process of growth that began in the late 1950s had exposed the frailty of the industrial base. Lack of infrastructure became a chronic hindrance to economic expansion, and rectification of the deficiencies took on strategic importance for the achievement of sustainable growth. Enhancement of the social security system also ranked in importance with improving the infrastructure as a goal, but in a somewhat unusual move, the Income-Doubling Plan was made to specify clear priorities between them. The emphasis was to be on infrastructure in the first half and on welfare in the second. When the economy grew faster than government had forecast during the early 1960s, however, the relative frailty of Japan's industrial infrastructure was exacerbated, as a result of which the gradual transition to a greater emphasis on social welfare did not, in fact, materialize. Throughout the period of the plan, the top priority remained the industrial base.

With the elevation of fiscal policy to a key position, the demands on fiscal policy increased, and enormous pressure was exerted to expand government spending. The goal of the Income-Doubling Plan was to liberalize trade and exchange rates, however, to permit Japan to link its economy to the international economy. Stable currency values and a sound domestic economy consequently took

on even greater importance than before. The policy-makers also recognized the need to reduce the national burden (the amount paid by the people in taxes and social securities contributions), and they therefore adhered strongly to the principles of sound national finances and appropriate spending levels.

"Sound fiscal policy" in this case included leaving open the possibility of public bond issues, depending on the long-term scale of government spending and the size of tax cuts, with the provisions that the issues be within the scope of what the markets could absorb and that the proceeds be used for investment purposes. The policy-makers understood, however, that, given the high demand for fiscal spending, it would be easy to become overly reliant on bond issues. They deemed it best to avoid them to the extent possible by allocating available funding in a manner designed to maximize efficiency. The antipathy to bond issues also stemmed from the inadequacies of the capital markets at the time. The authorities judged it more prudent to allow natural growth in revenues from economic expansion to provide the funding for expenditures, thus maintaining a sound fiscal position.

When the Income-Doubling Plan was drafted, the tax burden was about 20 percent, and that is more or less the level at which it remained. We should note, however, that there were some who continued to argue that the burden should be decreased because it was higher than the prewar levels, while others complained that the perception of real burdens had increased because the inadequacy of spending on private-sector stability resulted in a smaller proportion of the budget being used for "transfer payments" which were returned to the people. Thus, reductions in the public burden through tax cuts continued to be a major policy issue during this period. As growth in income reduced individual perceptions of the tax burden, it was argued that the rate of overall taxation and the size of government spending ought to be reviewed in conjunction with the goal of enhancing social security. The commitment to ensure sound fiscal policy and restrain the size of government spending produced awareness among policy-makers, however, of the limits to the countercyclical effects that could be expected from fiscal policy. They were

therefore extremely careful to eliminate any destabilizing fiscal factors as the economy expanded.

The implementation of the Income-Doubling Plan meant a considerable boost in the importance of the Fiscal Investment and Loan Program (FILP), which saw its emphasis shift to supplying funds for infrastructure and which was expected to play a major role in achieving the objectives of the Plan. The FILP also provided more flexibility than did fiscal policy in the narrow sense. Because of its ability to supplement the monetary policy, it was considered the primary instrument of countercyclical adjustment.

During the first half of the 1960s, government spending (under the General Account) grew by 18.4 percent, roughly twice the rate seen during the latter half of the 1950s and well above the (nominal) GNP growth rate of 14.3 percent. As a result, the General Account grew at an overall rate of 13.9 percent during this period, a rate roughly equivalent to the (nominal) GNP growth rate of 13.6 percent. The major factors behind the rise in national government spending as a share of the national economy during the early 1960s included expenditures for public works, social security, and tax-revenue allocations to local governments. During the early 1960s, growth in public works spending outpaced that of the General Account, reaching a rate of 20.5 percent. Social security spending was an even higher 23.5 percent, and this claimed a markedly larger share of the budget by the end the period. Not surprisingly, this growth was fast by international standards as well. During the same period, growth in government spending was only 5.6 percent in the United States, 6.9 percent in the United Kingdom, 8.0 percent in West Germany, and 10.4 percent in France. The soaring Japanese rates were directly attributable to growth in public works and social security spending, both of which expanded far more rapidly than in other countries.

2) The Role of the FILP in Raising Public Works Spending

During this period, Japan continued to improve and enhance its systems for

administering public works spending under the auspices of the General Account, Special Accounts or state-run enterprises.

The Special Account for Waterway Control was established in 1960. This account was notable for two reasons. First, while it was, indeed, public works spending, it covered repairs and reinforcement of river banks and ocean shores around the country, as a result of which there was not necessarily any clear correspondence between the recipients of benefits and those who paid for them. And second, it could not necessarily expect funding from specific sources. In other words, it was a "special account" that provided conventional government services. The reason for establishing a special account was the same as that for the establishment of the special project accounts in the late 1950s - it enabled the government to use borrowings to expand the size of the program. We should note, however, that if programs of this sort could be used to open up a system for general borrowing, then they would fall under the definition of "construction bonds" in the addenda to Article 4, Paragraph I of the Public Finance Law. This would allow bonds to be issued on a routine basis and make it possible to transfer the associated burdens to the General Account. The Special Account for National Forestry Programs, which was similar in nature, established a separate landslide control account that was separated from the General Account, providing the finishing touches to a system that allowed most public works spending to be administered through special accounts. In other words, the role of the FILP in public works spending became established as part of the system, an arrangement that remained in place throughout the high-growth period. Thanks to this system, the government was able to maintain the equilibrium of the General Account while still expanding public works spending. It made it possible to provide institutional backing for the investment in infrastructure demanded by high growth, without resorting to construction bond issues.

Table 5-2 List of New Special Accounts (FY 1960-64)

Name	Category	Implementation year (relevant law)	Note
Flood control	Development	FY 1960 (Law No. 40 of 1960)	
Harbor improvement	Development	FY 1961 (Law No. 25 of 1961)	
Forest insurance	Insurance	FY 1961 (Law No. 4 of 1961)	
National pension	Insurance	FY 1961 (Law No. 63 of 1961)	
Machinery installment credit insurance	Insurance	FY 1961 (Law No. 157 of 1961)	
Small and medium enterprise upgrading finance	Loan	FY 1963(Law No.72 of 1963)	Transferred to the Small Business Promotion Corporation in FY 1967.
Motorcar inspection and registration	Management	FY 1964 (Law No. 48 of 1964)	
National schools	Management	FY 1964 (Law No. 55 of 1964)	

Source: Prepared from a list of special accounts on "Okurasho Hyakunenshi", Appendix pp. 142-146

The allocations for public works spending are notable for the reduction they entailed in the share earmarked for disaster reconstruction, from 26.8 percent in fiscal 1960, to 10.4 percent in 1964 (and to less than 10 percent in 1965 and beyond). Among the most rapidly expanding spending items was road construction, which gained nearly 13 percentage points between 1960 and 1964. Funding for road construction was not necessarily stable, however. Revenues from the gasoline tax had been allocated to the Special Account for Road Construction, but the switch to diesel engines significantly undermined the impact of this move. Like the late 1950s, the early 1960s were marked by high growth in overall public works spending covered by fiscal policy in the broad sense, in spite of the sluggish rate of growth of public works spending under the General Account, and the boost provided by the FILP was at the heart of this.

Japan also experimented with overseas funding. On March 17, 1960, the Japan Highway Public Corporation signed a loan agreement with the World Bank, the first of five borrowings from the World Bank up to 1971. The total of $380 million raised by the corporation was used to fund construction of the Meishin Expressway linking Nagoya and Kobe and the Tomei Expressway linking Tokyo and Nagoya. Also, though this was not strictly within the framework of public works spending, the Japan National Railways borrowed $80 million from the World Bank on May 2, 1961, to fund construction of the Tokaido Shinkansen (“bullet train”) line Overseas

Table 5-3 Public Works Budget Breakdown (FY 1960-1964, after supplementation)

(In thousands of yen)

	FY 1960	(%)	FY 1961	(%)	FY 1962	(%)	FY 1963	(%)	FY 1964	(%)
Soil and water conservation project expenses	46,919,426	15.9	58,906,799	15.3	70,770,879	15.6	85,176,579	16.0	99,953,362	16.4
Road development project expenses	97,530,316	33.0	148,460,200	38.5	186,253,000	41.3	225,364,000	42.5	274,164,998	45.0
Port/harbor, fishing port and airport development project expenses	20,105,381	6.8	23,990,654	6.2	31,424,023	6.9	39,716,453	7.4	45,642,125	7.5
Forest road and urban development project expenses	9,642,213	3.2	12,975,886	3.3	17,276,800	3.8	21,996,574	4.1	26,789,881	4.4
Agricultural infrastructure development expenses	38,963,979	13.2	46,890,275	12.1	55,748,173	12.3	65,541,796	12.3	75,292,249	12.3
Mining damage restoration project expenses	850,000	0.2	880,000	0.2	1,007,064	0.2	1,332,381	0.2	1,694,139	0.2
Adjustment expenses	770,000	0.2	1,000,000	0.2	1,200,000	0.2	2,200,000	0.4	3,494,010	0.5
Disaster restoration project expenses	80,078,965	27.1	91,597,397	23.8	87,135,247	19.3	88,429,362	16.6	81,341,852	13.3
Total	294,860,280	100.0	384,701,211	100.0	450,815,186	100.0	529,757,145	100.0	608,372,616	100.0

Source: Ministry of Finance, Budget Statistics, FY1964, pp. 174-175

fund-raising for Shinkansen construction both supplemented the JNR's financial resources and, by imposing external conditions in the form of import and maturation dates for the foreign funds, enabled the project to be completed earlier than would otherwise have been possible.

The establishment of a (universal) contribution-based National Pension system in 1960 sparked an intense debate on the issue of government fund pooling. The National Pension was required to entrust the management of its funds to the Trust Fund Bureau, and forecasts at the time showed pension funds growing to account for the majority of the bureau's assets. Since participation in the system was mandatory, it was essentially the same as a tax in nature. It was consequently argued that the pool of funds should be used for "rebate lending" closely aligned to the interests of those paying in the money. This debate eventually led to amendments to the Trust Fund Bureau Funding Law, resulting in the following changes in the system. First, the amendments reaffirmed the principle of pooled management for all government funds, including pension funds. Second, publication of a new breakdown of FILP fund utilization plans was provided to clarify the fields in which FILP funds were being invested. Investments were broken down into the following areas: 1) housing; 2) living environment infrastructure; 3) welfare facilities; 4) educational and cultural facilities; 5) smaller businesses; 6) agriculture, forestry, and fishing; 7) land conservation and disaster relief; 8) roads; 9) transport and telecommunications; 10) rural development; 1l) basic industries; and 12) trade and economic cooperation. Third, a "rebate lending" system was established under which a set percentage of the (increase in) funds paid into the National Pension and Employee's Pension Insurance systems would be invested in projects that were closely aligned to the interests of those making the contributions. The amendments imposed an organization on FILP, which had emerged somewhat haphazardly through the natural course of events.

The amount of funds managed by the Trust Fund Bureau expanded dramatically around 1961. Most of this increase came from the Postal Savings system. The

system's growth gradually began to stabilize after the early 1960s, but the Postal Savings system was growing rapidly at this time. This was partly due to government programs, but a more basic cause was that high growth had brought an absolute increase of surplus funds in the hands of the general public, which had gained confidence in the currency values and government economic management.

Once it started growing, the Postal Savings system expanded enormously. Its national network of branches (every post office had a window for handling banking transactions) allowed it to maximize its fund-gathering capabilities and to capitalize on its position as a government institution. Growth of the Postal Savings system translated into growth of the Trust Fund Bureau and FILP. This set the stage for the FILP, which had been a somewhat rudimentary and unstable program until the high-growth period, to absorb funds from the Trust Fund Bureau (whose source was actually the Postal Savings system), thus contributing to the structural transition from reconstruction to growth and providing a pipeline for the absorption of savings from the general public as economic growth geared up. Beginning in the early 1960s, money gathered by the system consequently served to fund Trust Fund Bureau investments, the majority of which went to the FILP. While the FILP was a passive recipient, funds were gathered in ample quantities, and therefore did not impair investment activity.

As a general trend, a switch was apparent in FILP investments away from industry and- toward improvement of public living standards and welfare, but close examination of the ways in which funds were used reveals that, even at the beginning, the FILP inclination toward industrial investment was not as steep as is generally believed. Nevertheless, the FILP funds lent by government financial institutions were often used to co-finance projects with the private sector, and they consequently established private-sector funding as a direction. Thus, when this trend-setting function is taken into account, the FILP does deserve credit for playing a large role in ensuring adequate investment in industry.

FILP coverage was further expanded as the government continued to create new

Table 5-4 Fiscal Investment and Loan Program (FILP) Breakdown by Source (FY 1953-64)

(In 100 millions of yen)

FY	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964
Postal savings	811	1,015	820	1,120	1,027	856	1,332	1,506	1,771	2,296	2,937	3,907
Employee and national pension funds	162	290	314	400	574	572	620	918	1,460	1,826	1,999	2,462
Trust Fund Bureau clawbacks, etc.	773	380	395	77	757	1,120	1,230	1,047	1,523	1,441	2,266	2,611
Postal insurance funds	201	454	482	564	780	891	1,098	1,199	1,430	1,496	1,580	1,495
Government-guaranteed bonds, etc.	385	344	516	858	452	536	959	1,183	1,641	1,922	2,592	3,020

Note: Of the FILP financial resources excluding the Industrial Investment Special Account, the Trust Fund Bureau is divided into four -- postal savings, employee and national pension funds, and Trust Fund Bureau clawbacks -- for comparison.

Source: Ministry of Finance, Monthly Fiscal and Financial Statistics No.44, No.201

public corporations during the early 1960s. Among the major institutions dating from this period are the Metropolitan Expressway Public Corporation, the Hanshin Expressway Public Corporation, the Japan Railway Construction Public Corporation, and the Water Resources Development Public Corporation. Another notable trend of the early 1960s was the inclusion of various "agencies" within the scope of the FILP, among them the Overseas Economic Cooperation Agency, Pension Welfare Service Public Corporation, Employment Promotion Corporation, Coal-Producing Areas Promotion Agency, and Coal Rationalization Agency. Most agencies tend to be concerned with foreign aid and social policy. They are administered more along policy lines and less like corporations, and they may not necessarily be profitable. The FILP was considered an appropriate institution to fund them.

3) Universal Pension and Health Insurance

Spending on social security rose with particular rapidity in the late 1960s, becoming an important issue in national and fiscal policy. During the early part of the decade, social security spending increased at an annual rate of 23 percent, as opposed to 18 percent for the General Account in total. This growth stemmed from enhancements of the system that had led to great improvements in the social security being provided, but it nonetheless resulted in a large burden on the Treasury. The universal pension and health insurance programs inaugurated in 1961 are representative of the achievements of this period.

The pension system was initiated in November 1959 with government allocations for welfare pensions. Contributory pensions began in October 1960, and a premium collection system introduced in April 1961 rounded out the program. The first steps toward universal pension coverage came with the revival and enhancement of various insurance schemes after the war and the adjustment of the prewar pension system. This set the stage for a major overhaul of the Employee's Pension Insurance system in 1954. With employed people now covered, attention turned to those who were unemployed or self-employed, and in the late 1950s providing universal pensions became a major policy issue, ranking with tax cuts in

importance. Similarly, health-care insurance was almost universal among the employed by the close of the 1950s. Amendments to the National Health Insurance Law, which became effective as of January 1, 1949, aimed to provide health-care insurance for those not covered by the employee insurance programs, strengthening the National Health Insurance system. By March 31, 1956, universal coverage had been achieved.

Japan was one of the first developed countries to achieve universal coverage. Part of the rush to achieve it stemmed from the high percentage of the population working in the agriculture, forestry, or fishing industries or self-employed in small businesses, a situation which drastically narrowed the scope of coverage that employee insurance systems could offer. The high priority placed on jobs by the economic policies of the late 1950s was another contributing factor. The rush to achieve universal coverage one way or another resulted in a fragmented agglomeration of new and existing programs, as can be seen from the list of pension and health-care insurance groups in existence since the early 1960s:

Public Pension System

1. Employees: Employees' Pension Insurance; Seamen's Insurance; National Public Service and Affiliated Personnel Mutual Aid Association; Public Corporation Employee and Affiliated Personnel Mutual Aid Association; Prefectural Government Personnel Mutual Aid Association; Mutual Aid Association of Private School Personnel; Agriculture, Forestry and Fishery Organization Employees Mutual Aid Association
2. Non-employees: National Pension

Health-care Insurance

1. Employees: Health Insurance: 1) Government-operated health-care insurance; 2) Insurance unions; Seamen's Insurance; National Public Service and Affiliated Personnel Mutual Aid Association; Public Corporation Employee and Affiliated Personnel Mutual Aid Association; Prefectural Government Personnel Mutual Aid Association; Mutual Aid

Association of Private School Personnel; Agriculture, Forestry and Fishery Organization Employees Mutual Aid Association

2. Non-employees: National Health Insurance

These programs, each with its own history, add up to what has often been described as a patchwork affair. The next policy issue concerned determining how to coordinate burdens and benefits among them. Discussions were held and studies conducted, but nothing came of them. The government also recognized that the National Health Insurance, with its 50 percent deductible, was not nearly as attractive as most employee insurance programs, but it was forced to start at that level because of deep concern over the impact on national and local finances of an enormous insurance program covering all the nation's unemployed. As time passed, the government was to increase Treasury subsidies for the system in accordance with the results of Diet discussions and related decisions, taking the impact on national finances into account.

The enactment of universal health and pension insurance caused the amount spent on social security to rise in the early 1960s, and, in fact, it was at this time that social security spending first emerged as a fiscal issue. The share of the budget directed to the National Pension program (which began to go into effect in 1959) and social security rose rapidly as compared to the late 1950s, but spending on health care rose during the early 1960s at rates that can only be termed abnormal. It was for this reason that the issue of social security spending as a whole came to be symbolized by rising health-care costs and, more specifically, rising Treasury subsidies. High growth gave Japan some leeway in its fiscal management, however, and it was basically able to cover its costs and to support the programs that had been created.

As will be discussed later in this chapter, care was taken to use FILP funds for welfare purposes as well as for infrastructure, with “rebate lending” as the main vehicle for achieving this. The Pension Welfare Service Public Corporation established in 1961 dealt almost exclusively with FILP rebate lending. Its job was to

Table 5-5 Social Security Budget Breakdown (FY1960-64, after Supplementation)

(In thousands of yen)

	FY1960	(%)	FY1961	(%)	FY1962	(%)	FY1963	(%)	FY1964	(%)
Welfare Benefit	48,338,357	25.4	57,841,811	22.5	65,248,095	20.7	80,621,471	20.8	93,488,073	21.1
Social Welfare	13,624,593	7.2	17,910,202	7.0	24,540,195	7.8	29,802,441	7.7	38,168,931	8.6
Social Insurance	70,369,190	36.9	105,008,226	40.9	121,340,649	38.6	147,675,382	38.1	172,421,190	38.8
Unemployment Relief	31,191,480	16.4	36,408,271	14.2	48,146,639	15.3	58,398,931	15.1	59,544,558	13.4
Health	26,995,378	14.2	39,443,657	15.4	55,317,648	17.6	71,396,615	18.4	80,410,474	18.1
Total	190,518,998	100.0	256,612,167	100.0	314,593,226	100.0	387,894,846	100.0	444,033,226	100.0

Source: Ministry of Finance, Budget Statistics, FY1964, pp. 172-73

take money from the Trust Fund Bureau and lend it to organizations other than local government agencies. Rebate lending to local agencies took the form of bond underwriting, which was directed to a separate "Special Local Bonds" account. Rebate lending was also conducted through the Special Account for Nation Hospitals, Social Welfare Promotion Agency, Medical Care Facilities Financing Corporation, and Environmental Pollution Control Service Corporation. The Employment Promotion Project Corporation was also established in 1961 and given FILP funds to administer. One of its main responsibilities was providing support for people who had lost jobs in the coal industry. Coordinated funding by both the General Account and the FILP were consequently visible behind the expansion and diversification of social security.

4) Establishment of Direct Tax-based Revenues

During the early 1960s, Tax Commission reports were used to spearhead changes in the tax system. The First Tax Commission published its initial report in December 1960, setting the stage for revisions of the system during 1961. This was followed by the publication of the second report (the main report) in December 1962 and by revisions of the 1962 tax system based on the report. In December 1964, the Second Tax Commission published what came to be known as the "Report on the Long-term Tax System," which set the tenor for taxation in the latter half of the decade. In 1962 the Commission was made a permanent institution charged with studying taxation from a long-term perspective.

The commission's interim report of March 1960 looked at the overall tax burden, which was the basic taxation issue in the early 1960s. It found the burden of national and local taxes to be excessive in terms of national income levels and warned that, if the system remained unchanged and the Income-doubling Plan achieved its goal of higher nominal income, the progressive taxation structure would lead to an increased tax burden. The report therefore advocated holding the line at a rate of 20 percent of national income, with anything exceeding that level directed toward tax cuts. The December 1960 report reaffirmed this stance, and it was

included in the Commission's formal report, becoming one of the basic principles of fiscal policy management.

Table 5-6 Tax Burden Ratio (1960-64)

(In tens of billions of Yen)

Fiscal Year	National Income	Tax				Social Security	Burden Ratio (%)	National Burden Rate
		Indirect Tax	Direct Tax	Total	Burden Ratio (%)			
1960	13,496.7	1,413.1	1,174.5	2,587.6	19.2	483.8	3.6	22.8
1961	16,081.9	1,710.0	1,476.0	3,186.0	19.8	606.7	3.8	23.6
1962	17,893.3	1,804.1	1,713.9	3,518.0	19.7	752.2	4.2	23.9
1963	21,099.3	2,042.8	1,959.3	4,002.1	19.0	894.8	4.2	23.2
1964	24,051.4	2,336.4	2,301.8	4,638.2	19.3	1,059.6	4.4	23.7

The tone of the reports on tax revision differed from those of the late 1950s, in the sense that the commission appeared to lose interest in higher indirect taxation. The December 1960 report made the following acknowledgements: 1) the income tax burden was high in comparison to both prewar Japanese levels and the levels in other countries; 2) because of the priority placed on income tax cuts, the share of national revenues stemming from income taxes had nevertheless declined to less than corporate taxes and, indeed, to about the same level as liquor taxes; and 3) if, therefore, the total national burden was too heavy, it was not just income taxes that were too heavy, but other taxes and levies as well. While recognizing the need to cut income taxes, it also noted the importance of maintaining an overall balance within the system, which meant that cuts in indirect taxes would now be open for consideration. The December 1961 report developed this argument further with the following observations: l) the weight of indirect taxation should be noted when discussing the tax burden; 2) cuts in the income tax were increasing the relative weight of indirect taxation; and 3) a regressive system has developed in which households exempt from income taxes bore the burden for 50 percent of indirect taxes. It therefore advocated large cuts in the liquor tax, commodities tax, and

amusement tax. In the discussions that led to the report, the opinion held sway that the current Japanese system, which put direct taxes in the center and individual indirect taxes on the periphery, was rational in terms of fairness. This argument, together with income tax bracket creep, ensured that direct taxation would remain the centerpiece of tax revenues.

Table 5-7 Revenue Decline by Special Tax Measures

(In 100 millions of yen)

Category	FY 1950	FY 1955	FY 1960	FY 1965	FY 1970	FY 1975
Promotion of savings	3	274	510	1,363	1,864	2,710
Expansion of internal reserves and enhancement of busines quality	5	392	503	355	194	890
Technology promotion and equipment modernization		28	140	210	535	1,110
Industrial subsdies	5	128	265	265		
Environment improvement and regional development promotion						1,570
Social development promotion					625	
Resources development promotion					124	290
Export promotion					785	
Others			△ 11	△ 76	△ 286	△ 960
Total (A)	13	934	1,407	2,117	3,841	5,610
Total national tax (on an initial budget basis) (B)	4,446	7,748	13,366	32,877	69,385	173,400
A／B×100 (%)	0.3	12.1	10.5	6.4	5.5	3.2

Source: Prepared from materials from the Tax Bureau, Ministry of Finance

During this period, tax measures designed to encourage savings were held over and expanded. The 1963 revisions provided for a new “small savings tax-exempt scheme.” These accounts had been in existence previously, but the revisions enshrined them among the basic provisions of the Income Tax Law. From their very introduction, the tax-exempt savings accounts had been viewed with disdain by many, who found them questionable in terms of taxation principles, but it was only in 1987 that they were finally eliminated. After the withholding tax system was revived in 1952, taxes on dividends were provisionally handled at the receipt stage as a special exception to the income tax. Although provisional, this system had remained unchanged; only the rates charged were adjusted to maintain a balance

with taxes on interest income. The dividend tax aimed to promote savings and corporate capital accumulation, and because of this, the 1961 revisions contained special provisions for the corporate tax that lowered taxes on dividends paid. Corporate tax rates on dividend payments were reduced (from the normal 38 percent corporate tax rate to 28 percent), and the dividend deduction for personal shareholders was lowered (from 20 percent to 15 percent). These measures were based on a similar program in West Germany, but their direct objective was to correct the overlending situation that had developed as companies increased their equity capital in anticipation of the liberalization of trade and exchange rates.

3. Continuing Activist Monetary Policy

1) Monetary Policy under the Income-Doubling Plan

No specific or unusual monetary policies were prepared for the Income-doubling Plan. One prevalent argument at this time was that, while the booming demand for investment needed to be met by private-sector financing, steps should be taken to ensure that the necessary funds were available, maintaining a balance in funding allocations between the public and private sectors and thereby achieving an appropriate expansion of the public sector corresponding to the expansion of the private sector. On this point at least, however, precedence was in fact always given to meeting the demand for funds in the private sector; the monetary authorities took the stance that expansion of the public sector would merely constitute a disruptive factor, since it would cause the economy to overheat. As a result, the supply of funds through private-sector institutions was maximized, a practice that served to support high growth and, by eliminating inflationary factors from the public sector, helped to ensure that growth was non-inflationary. One upshot of this, however, was a chronic, long-term shortage of funding for infrastructure. The FILP did expand, but issues of government-guaranteed bonds had to be constantly adjusted to avoid crowding out private-sector flotation.

The pursuit of trade and foreign exchange liberalization created an urgent need

for companies to bolster their international competitiveness. It also resulted in continued emphasis on interest-rate reduction polices (to normalize Japanese rates to match international levels) due to the heavy influence of interest rates in Europe and North America on those in Japan. In the fall of 1960, government financial institutions, led by the Japan Development Bank, lowered their lending rates, as did the Shoko Chukin Bank and the Norinchukin Bank. The interest paid on Postal Savings deposits was also lowered at this time.

When the official discount rate was reduced in January 1961, commercial bank lending rates and bond yields declined. The purpose of the ODR cut was not to stimulate the economy but to "gradually narrow the spread between the high Japanese interest rates and international levels, thereby propelling the liberalization of trade and exchange rates forward." This was the first time the interest-rate scale, including Postal Savings rates, had been lowered since the end of the war. It came at a time when there was enormous demand for funding, and it was feared that easy money would cause the economy to overheat. The fact that the authorities went through with the rate cut anyway illustrates the priority they placed on strengthening international competitiveness.

Nevertheless, the basic situation had not changed markedly, so the only way to achieve low rates was to manipulate the scale artificially, and the only way to maintain them was through regulation. Manipulating the regulated interest-rate scale entailed striking an artificial balance among various rates, and the 1961 revisions of the rate scale were delayed because savings rate negotiations among the Ministry of Finance, Bank of Japan, and Ministry of Posts and Telecommunications faltered, as did those on bond yields between the commercial banks and securities industry. This was a pattern that would be seen over and over again in subsequent interest-rate revisions, and that would present a particular obstacle to the timely enactment of tight money policies when the economy needed to be slowed.

2) The "Overloan" Problem and the "New Methods of Monetary Control"

The financial structure of the high-growth period was distinguished by "indirect

financing" and "overloans," and to the extent that they became permanent fixtures, these two facets to some extent defined the financial system of the day. With the exception of a brief period in the initial stage of reconstruction, it is clear that private-sector capital investment garnered the predominant share of the funds that fueled Japan's high growth. The source of funds for new industrial capacity was (again excepting the initial postwar reconstruction period) overwhelmingly loans from private-sector financial institutions, or, more specifically, from the commercial banks.

The weight of equity financing was consistently low and extremely volatile, not only during the high-growth period but after it had ended, indicating that equity played a minor role in financing and that it was seen merely as a means of marginal fund-raising. It is true that the percentage of shares in corporate hands rose consistently during this period, particularly in the case of financial institution holdings, but the weight of equities in new direct financing was not so much an indication of direct financing trends as it was a supplement to indirect financing. By acquiring shares, the financial institutions won a place for themselves in loan syndications (led by the companies' main banks). Loans were still the mainstay business of the financial institutions, and holding shares was a means of establishing stable relationships with industrial firms. Corporate bonds accounted for a relatively minor portion of the fund-raising, but their share tended to grow more quickly than that of equities. The nature of the bond issues was closer to that of loans, however, and they clearly fell into the indirect financing category. In short, a structural priority on indirect financing can be confirmed throughout the period.

Indirect financing hurt the financial positions of the industrial companies, and it was consequently a situation to be rectified. At the very least, people argued, direct financing should be raised to more appropriate levels. A financial structure was already in place, on the other hand, and it was necessary for the financial system to operate smoothly within that structure. In point of fact, indirect financing did provide an extremely smooth flow of funds. From a quantitative perspective, the

Bank of Japan formed the center point in the extension of credit, enabling Japan to maintain a supply of funds in excess of the deposit-gathering and credit-creation capabilities of the private-sector banks, and thereby responding to the continued growth in the demand for funding. From a qualitative perspective, a financing system which gave banks a role of decisive importance provided for efficient adjustment of credit allocations and made it possible to ensure that funds were directed to priority areas.

The arguments for correcting the dominance of indirect financing consequently failed to make headway. The policy-makers did pay lip service to the idea of increasing the share of direct financing, but this was for the most part only sloganeering. Actual policy efforts were premised on indirect financing and sought to ensure a supply of funds within that framework. In this respect, at least, policy sought to maintain the status quo.

The discussion of the problem of overloans continued throughout the 1950s and early 1960s. On May 9, 1963, the Financial System Research Committee issued its “Report on the Correction of Overloans.” A document created by the Standing Subcommittee for Research and Planning during the course of the committee's deliberations, “Correction of Overloans” (April 2, 1963), provided a comprehensive analysis of overloans, including historical observations, along with proposals for corrective measures. The following examination is based primarily on the subcommittee's work.

“Overloans” can be defined as: 1) chronic over-extension of credit by banks, which is 2) mainly dependent on borrowings from the Bank of Japan for its continuation. The reverse side of this coin is “overborrowing” by non-financial firms. Overloans were for the most part a problem of the city (large, commercial) banks. The regional banks ran consistent surpluses in their reserves and maintained stable ratios of lending to deposits. The net shortfalls in the city banks' reserves meant that they were dependent on outside liabilities, most of which came from the Bank of Japan.

Table 5-8 Net Reserves and Loan-to-Deposit Ratio of Banks

End of Month	Net Reserve (100 million yen)			Loan-to-Deposit Ratio (%)		
	All Banks	Major City Banks	Regional Banks	All Banks	Major City Banks	Regional Banks
Sep. 1954	△ 2,973	△ 2,960	148	91.2	95.1	83.0
Mar. 1955	△ 1,683	△ 1,853	254	85.7	86.2	81.7
Mar. 1956	629	190	430	77.8	74.4	79.3
Mar. 1957	△ 1,752	△ 1,961	349	80.9	78.6	79.8
Mar. 1958	△ 4,633	△ 4,953	462	84.0	83.6	79.2
Mar. 1959	△ 2,601	△ 3,049	534	82.5	81.5	78.9
Mar. 1960	△ 2,053	△ 2,839	720	83.8	84.0	79.0
Mar. 1961	△ 3,738	△ 4,494	769	83.0	82.9	79.8
Mar. 1962	△ 9,245	△ 10,108	978	86.8	89.2	80.2

Source: Materials from Financial System Research Council

Table 5-9 Asset Composition of the Bank of Japan

(%)

End of Month	Loans to Private Sector	Gold and Foreign Currency	National Bonds	Others	Total
Mar. 1954	61.6	2.4	24.3	11.7	100.0
Mar. 1955	31.2	4.5	55.4	8.9	100.0
Mar. 1956	4.4	20.9	65.9	8.8	100.0
Mar. 1957	26.8	17.4	49.2	6.6	100.0
Mar. 1958	50.8	7.5	33.1	8.6	100.0
Mar. 1959	38.8	13.5	40.4	7.3	100.0
Mar. 1960	33.8	18.0	42.1	6.1	100.0
Mar. 1961	40.5	24.5	30.3	4.7	100.0
Mar. 1962	62.9	13.2	18.4	5.5	100.0

Source: Materials from Financial System Research Council

There were five principle causes of overloans: 1) the corporate appetite for investments was immense, and companies were generally investing in excess of their internal funding; 2) City banks were extremely aggressive in their lending stance, and they were quite willing to depend on outside liabilities, if need be, in order to land preferred borrowers and develop affiliate networks; 3) problems in the financial structure had rendered the capital markets unable to deal with the high demand for funding in their absorption and investment of funds; 4) Japan was running a balance-of-payments deficit and was committed to sound financial policy, and the major channel for development funding was lending from the Bank of Japan to private institutions; and 5) the regional structure of the flow of funds caused the city banks to take in excessive funds and the regional banks to distribute excessively, as a result of which the city banks were chronically short of funding.

The direct source of the first of these two causes was the progression of reconstruction and high growth, at a time when postwar reconstruction and inflation had robbed companies and financial institutions of most of their capital accumulation. In other words, overloans resulted primarily from structural problems within the Japanese economy and financial system. At issue here is the fact that overloans served as an effective system of industrial financing, actually representing the main tool for financing high-growth industries. As overloans became more serious during the high-growth process, the debate was rekindled and a gradual approach toward a more normal financial system resulted.

The subcommittee's report found four problems with the practice: 1) The banks had lost sight of their lending standards and were lending excessively; 2) the short-term money markets were tight and overlending impeded the flow of new funds to the bond market; 3) companies had lost much of their desire to improve their financial positions; and 4) most importantly, overlending tended to amplify business cycles. The report therefore called for corrective action. The basic idea behind the remedial measures it proposed was to put the conditions in place for a resolution of the overloan problem while still maintaining balanced economic growth. The main

policy for achieving this was to supply cash for economic growth through buying operations and the place strict controls on lending (the “new methods of monetary control”). In addition, interest-rate functions were to be used to adjust the supply and demand for funding via market principles, the capital markets were to be developed in order to diversify sources of funding, and new regulations, particularly on large loans, were to return bank management to normal.

In anticipation of the report, the Bank of Japan adopted its “new methods of monetary control,” on November 1, 1962. It had decided on its own that overloans had reached a point at which something would have to be done about it, and considering its prevalence as a topic of discussion by the Financial System Research Committee, the Bank decided to take what measures it could within the scope of its jurisdiction to resolve the problem. The major thrust of the Bank's policy was to set ceilings on the amount that city banks (except for the Bank of Tokyo, Kyowa Bank, and Hokkaido Takushoku Bank) could borrow from it, thereby restraining their dependence on BOJ borrowings. Any additional funding required would be supplied instead through bond operations. In exchange for this, the controls on lending by commercial banks would be lifted for all purposes, with the understanding that they would regulate themselves within established limits. These new monetary control methods put an end to the long debate on overloans and set finance on a course toward normalization. The debate on normalization was replaced by a new debate on “financial efficiency,” but while the talk about normalization faded into the background, the structural problems that had sparked the debate in the first place continued into the 1970s.

The bond operations consisted of "repos," or the buying of government-guaranteed bonds from ordinary, long-term credit or foreign exchange banks on the condition that they be sold back within a period of three months. Government-guaranteed bond operations were not themselves anything new, but they had heretofore been conducted on an individual basis. The significance of the new operations was that they included comprehensive, predetermined procedures that

allowed the Bank of Japan to initiate operations as it saw fit for the purpose of monetary regulation. Government-guaranteed bonds were not available in sufficient quantity for the operations to go smoothly, however. Nor did the financial institutions have sufficient quantities of them in their portfolios, a problem that had been foreseen from the beginning. As of January 1963, therefore, the operations were expanded to include long-term government bonds, interest-bearing bank debentures, electric power bonds and regional bonds qualified to secure BOJ borrowings.

The idea behind these new methods of monetary control was that qualitative regulations on lending by financial institutions should be done away with, and, in fact, the Bank of Japan ceased to practice “window guidance” in May 1963. It then turned around and revived it in January 1964, however, in the form of “ceilings on lending growth.” At the end of 1963 the central bank adopted a tighter monetary stance, citing a worsening balance of payments as justification. But when the city banks showed no signs of restraining their expansion of lending, the BOJ concluded that merely instructing them on their funding positions, as called for by the new system, would be insufficient to bring lending under control. This was the only decision it could realistically have made. The new system did not itself change the financial structure, and the lending stances of the city banks were not determined solely on the basis of BOJ lending activities. In addition, interest on bond operations was fixed at low rates, which led some to conclude that the “new instruments of monetary control” were simply low-interest BOJ loans in modified form. In other words, the new system ostensibly lowered the city banks' dependence on BOJ borrowings, but fell short of convincing them to restrain their lending voluntarily.

Another factor behind the adoption of the “new instruments of monetary policy” was that Japan was close to achieving IMF Article 8 status. The IMF was interested in Japan's economic structure, particularly in its peculiar financial structure, and it had suggested a need to return to normal, sound policy. This undoubtedly gave Japan indirect motivation to switch to the new system.

3) High Growth and the Securities Markets

With funds short and indirect financing predominant, quantitative and qualitative regulation of funding proved extremely effective in carrying Japan from reconstruction to independence. Because indirect financing succeeded so well in accomplishing this, there was little room left for the capital markets to perform their basic function of utilizing the pricing mechanism to allocate industrial funds. As the high-growth period geared up, the securities markets remained weak, frail entities consisting primarily of a secondary "trading" market in which securities dealers themselves were the primary players. In fact, capital increases were traditionally shares allocated to investors at face value, an indication of just how divorced the issuing market was from price formation in the trading market.

The result of this situation was to drive up the cost of raising funds on the stock-issuing market and, because the cost of funds was quite low on the lending market, to make equities marginal as a fund-raising tool. "Enhancement of net worth" had been held out as a goal since the 1950s, but the market structure made this virtually impossible to achieve. A new bond issue regulator was established by an underwriting company made up of the Industrial Bank of Japan and city banks with the Bank of Japan providing "internal guidance." New issues were screened for their adherence to fund allocation plans, and since bank guarantees were required in virtually every case, they really were nothing more than a component of the industrial funding allocations falling into the realm of indirect finance in the broad sense. Having learned its lesson from prewar abuses, Japan banned margin trading on the securities markets, but the securities companies still thought of themselves as brokers and placed most of their emphasis on the trading market. If anything, high growth widened the gap between indirect and direct financing, since the indirect financing system provided the efficient funding allocations that high growth required. The securities markets remained largely unchanged until around 1970.

The expansion of the economy encouraged more active securities trading and brought significant increases in trading volumes. Rising incomes gave the general

public more disposable income, and securities were often chosen as the preferred vehicle of savings.

The first factor encouraging this was soaring share prices on the trading market. Economic booms obviously meant higher prices, but there were other factors as well. First, the trading market was itself weak and unable to provide appropriate price fonnation. Shares were in short supply with respect to the expanding trading volumes, causing prices to skyrocket. Second, the more speculatively oriented brokers did much of their trading on their own account, and they often drove up prices when it was in their interest to do so. Share price trends during this period therefore provided an amplified reflection of the economic trends. Problems between brokers and their clients were common, and punters were everywhere. Speculation was so rampant, in fact, that attempts to corner shares became a major social issue in the late 1950s. The market regulators responded to this in the early 1960s with the Securities and Exchange Law, which provided for after-the-fact enforcement.

There was also a boom in new equity and bond issues. Policies had long been in place to encourage companies to build up their net worth by increasing their capitalization, and these policies received a boost when they were positioned as a central facet of trade and exchange-rate liberalization policies at the beginning of the decade. The 1961 tax revisions, for example, lowered the corporate tax rate for profits set aside to pay dividends. Nevertheless, new issues were a marginal means of fund-raising, as can be seen from the fact that the new equity issues market was experiencing a boom during a tight-money period. The markets remained volatile environments that amplified economic trends, whether good or bad. In the early 1960s, capital increases were commonly regulated (or “adjusted”). In 1949, the Ministry of Finance, Bank of Japan, Tokyo Stock Exchange, and major brokerages and banks had formed the Discussion Group on Capital Increase Adjustments, which met on an irregular basis at first and then fell more or less idle in the late 1950s. Revived in October 1961, the group often decided to delay new flotation because of

the boom in capital increases. In view of the situation in the securities markets, it decided in September 1964 to halt all new capital increases, effective February 1965. (The ban was lifted in October 1965.) As already noted, new bond issues were controlled as part of the lending market through a system of new bond issue adjustments.

And then there was the growth of investment trusts (which resemble mutual funds in the United States). The first investment trusts were established for equities in the early 1950s. The soaring share prices brought strong returns, which made the funds very popular with individual investors, touching off a boom around 1955. Individual investors saw the funds as an investment vehicle that required only a small start-up stake, that eliminated the need to investigate investments on their own and that provided security for principal by diversifying risk, all the while guaranteeing a set return (as many advertisements created trouble for their sponsors by claiming). Many individuals consequently withdrew their savings from bank deposits to place in investment trusts. The growth was so rapid and the advertising in some cases so exaggerated, however, that the MOF was forced to issue repeated warnings. One upshot of this was the separation of the companies managing the investment trusts from the companies which marketed them in 1959.

At their peak in 1961, the shares owned by investment trusts were worth 11 percent of market capitalization at prevailing prices. They were so good at attracting funds that the trusts at one point held 36 percent of all the outstanding calls in the country. Demand for shares from the investment trusts drove up share prices, and higher share prices, in turn, improved the trusts' results. The securities companies managing them were also able to expand their brokerage business by using bank debentures entrusted to them by the trusts as collateral on call loans from affiliated trusts, with which they could buy more shares for their inventory. It appeared as if the system had finally enabled the brokers to overcome their lack of fund-raising capabilities. Because both investment trusts and their management fell into the larger category of trust business, the securities industry found a place for itself

within the credit system. The growth of the investment trusts provided the impetus for a snowballing expansion of the brokerage business.

This expansion entailed enormous risks, however. If share prices were ever to fall, the influence on the brokerages would be amplified to the point that they would be in danger of bankruptcy.

4. Trade and Exchange-rate Liberalization

1) The Decision to Liberalize and the Liberalization of Exchange Rates

The liberalization of trade and exchange rates was considered an inevitable policy transition that Japan would have to make before it could rejoin the international economy in earnest. It was realistically difficult for Japan to make much concrete headway in the way of liberalization, however, since its balance of payments was unstable and it had a chronic shortage of foreign currency. The 1958 resumption of convertibility of European currencies was a major step toward worldwide liberalization, which increased pressure for liberalization in Japan as well. But for all the keenness with which it perceived the risks of missing the liberalization boat, the government was unable to act. Action had to be forced upon it from outside by the IMF, the GATT, and the countries of Europe and North America. Foreign pressure included the invocation of discriminatory measures against Japan, which drove home the very real possibility that failure to liberalize might derail economic development.

The government policy was embodied in a cabinet decision on the General Plan for Trade and Foreign Exchange Liberalization announced on June 24, 1960. The General Plan acknowledged that the Japanese economy had "grown for years up in the hot-house of managed trade, managed foreign exchange, and artificial protection," went on to chart a course to rapid liberalization, arguing that "a strong push forward toward liberalization is not just an international demand for the development of the world economy, but it is of utmost importance for the Japanese economy itself."

In trade, the government created plans for individual commodities and products, targeting a liberalization rate of 80 percent over a three-year period beginning in April 1960. In foreign exchange, the cabinet mandated the liberalization in principle of all current transactions in two years. Since the enactment of the General Plan was expected to exert a major impact on domestic industry as well as on external economic relations, it included a package of economic policies designed to ease the pains of liberalization. Its expressed goals were: 1) to maintain economic stability and high growth; and 2) to expand employment and improve liquidity. These goals would form the backbone of Japanese economic policy through the early 1960s. The high-growth policy corresponded almost exactly to trade and foreign exchange liberalization. The business community immediately voiced its support for government-led liberalization; years of government management had sapped companies of their appetite for rationalization and their entrepreneurial spirit. They were anxious to take an active part in the liberalizing efforts.

The foreign exchange controls of the time were distinguished by the fact that they were established to control both exchange and trade, as the name of the Foreign Exchange and Foreign Trade Control Law illustrates. Liberalization consequently meant liberalization of both foreign exchange and trade as two sides of the same coin. The IMF demanded that Japan lift its foreign exchange controls. For current transactions it wanted Japan to: 1) avoid setting payment restrictions; 2) avoid discriminatory currency measures; and 3) make foreign currency reserves convertible. The problem - and the one that impinged directly on industrial protection policies - was restrictions on current payments.

Let us review the exchange-rate measures taken at this time: (1) Liberalization of the foreign exchange rate (September 1959): allowed the yen to trade within a 0.5 percent band on either side of the official rate of ¥ 360 to the dollar, with the band expanded to 0.75 percent in April 1963. The move increased the business of the foreign exchange banks and expanded the inter-bank market. (2) Relaxation of regulations governing foreign exchange banks: removed limits on overseas lending

and unsecured borrowings (August 1960); relaxed position limits (eliminated limits on spot positions, September 1960). (3) Permission for trading companies to hold foreign exchange: granted as an exception to the rule that all foreign exchange be pooled with the government (April 1960), the first exception granted since 1951, when foreign exchange banks, overseas transport companies, and insurance companies were allowed to hold foreign exchange, and the last before the system was abolished entirely in 1972 with the scrapping of the foreign exchange concentrating system. (4) Establishment of a yen exchange system (July 1960): permitted transactions with foreign parties to be settled in yen, and allowed non-residents to set up unregulated yen accounts. The latter was of great significance, since unregulated yen accounts gave non-residents access to the short-term money markets. (5) Relaxation of regulations on short-term impact loans (November 1960): replaced the policy of in principle granting withholding permission for any short-term impact loans to permitting them on a case-by-case basis. (6) Creation of a foreign exchange equilibrium account (April 1963): provided a means of counteracting large swings in the foreign exchange market due to liberalization and wider fluctuation bands; operations were to be conducted by the government by application of the Special Account for Foreign Exchange Funds, with the Bank of Japan responsible for carrying out the actual work. (7) Liberalization of invisible trade transactions: phased in liberalization of transport and insurance, deregulation of foreign travel, and elimination of ceilings on overseas remittances of foreign film screening fees.

The government also considered doing away with the foreign exchange controls themselves at this time, but it did not act on the idea. Instead, liberalization proceeded based on the concept that everything was banned except things which were specifically permitted and that the range of permitted activities would be gradually widened. This strategy did, in fact, enable the results mandated by statutory amendments to be achieved within the specified time frame. We should note in this connection that government control of the process of liberalization itself

helped Japan to avoid the shock that would have come from sudden, full-scale deregulation.

2) Trade Liberalization

The underpinning for Japanese trade management was provided by the foreign exchange concentrating system mandated by the Foreign Exchange and Foreign Trade Control Law, which enabled the government to use allocations of the foreign exchange pooled with it (variously referred to as the "foreign exchange budget") to set what were, in effect, import quotas. Serving as both a foreign exchange control policy and a direct industrial policy, this was extremely effective in achieving its objectives. It was also quite obviously in conflict with the spirit of the GATT, and as trade liberalization progressed in Europe, pressure to liberalize was brought to bear on Japan. Liberalization was also a prerequisite to escaping the discriminatory treatment that had been invoked in retaliation for Japanese foot-dragging. Trade liberalization was phased in before foreign exchange liberalization, but beginning in 1960, the two were coordinated, and the pace stepped up. Trade liberalization in this context meant reducing the number of items subject to import quotas and expanding the number of unregulated items in the foreign exchange budget. The percentage of unregulated items in the foreign exchange budget was referred to as the "trade liberalization rate."

The product-by-product liberalization process established by the General Plan set the tenor for actual liberalization. Products were divided into four groups: 1) items designated for early liberalization (within one year); 2) items that could not be liberalized immediately but that should be liberalized as soon as possible, with a deadline of three years; 3) items that, judging from current conditions, could not be liberalized within the three-year time frame, but which required efforts to achieve liberalization as close to the three-years target as possible; and 4) items for which liberalization would be difficult if not impossible. To give some idea of the pace involved, Japan had a liberalization rate of 22 percent in April 1956, the year after it joined the GATT; by April 1958 this had grown to 33 percent; and by the time the

General Plan was drafted to 40 percent. The General Plan set a goal of raising the rate to 80 percent over the next three years.

The product-by-product liberalization plans were the outcome of adjustments and negotiations among domestic interests. Two factors are of specific note for our purposes: l) the care taken with developing infant industries, especially industries such as industrial machinery that held promise as future export sectors; and 2) the care taken to alleviate employment concerns (many of the lowest productivity sectors and sectors to be scrapped had absorbed the most workers). Treatment became a problem with the third group of above-mentioned products, however, which included coal, oil, copper, lead, nickel, machinery for which technology was under development (machine tools, chemical equipment, industrial electronics, full-sized and compact cars), leather goods, and sugar. Coal and oil were of particular importance because here they impinged on changes in the energy structure. The fourth group included rice, wheat, fruit juices, and most fresh citrus fruits.

In other words, the process of trade liberalization was a process of individual adjustments for leading industries. In general, industry was in favor of liberalization, because it would provide an opportunity to break out of overprotection and rationalize, but the adjustment of individual interests proved difficult. Throughout this period, it can be said that the MOF's stance was basically .pro-liberalization.

When Japan achieved IMF Article 8 status in 1964, it had a liberalization rate of 93 percent, putting it on a par with the levels in Europe and North America. The list of products that would not be liberalized included many major trade items, however, such as heavy chemical products. Adjustment was also advancing slowly for oil, nonferrous metals, and sugar, for which the decision had been made that liberalization would have to proceed in conjunction with the regulations and protective policies of individual industries.

3) IMF Article 8 Status and the Abolition of the Foreign Exchange Budget

Article 8 of the International Monetary Fund's Articles of Agreement sets forth the general obligations of its member countries. Membership in the IMF meant

Table 5-10 Progess in Trade Liberalization

Implementation month	Liberalization rate (%)	Accumulative number of AA products	Accumulative number of AFA products	Major products
As of 1958	33	617	－	
April '59	34	640	－	Copra, carbon black, germanium, agrichemical
October '59	35	786	48	Cotton linters pulp, crude benzol, cement, vinylon
January '60	37	869	84	Natural aromatics, cocoa butter, coal tar pitch, mohair yarn
April '60	41	1,067	366	Nickel ore, coffee beans, flocking, cresol, blended aromatic
July '60	42	1,102	406	Gold paste, gycrohexanone
October '60	44	1,339	642	Cocoa beans, zinc ore, titanium slug, sweet chestnut, raisin
April '61	62	1,864	767	Raw cotton, raw wool, waste cotton, bicycle, crude triol
July '61	65	1,997	748	Aluminum ingot, silver ingot, common steel, pure benzol, pure triol, oil meal
October '61	68	2,351	900	Yeast lecithin, whale oil
December '61	70	2,393	1,030	Stainless steel, common plate glass
	Liberalization rate (%)	Number of completely liberalized products	Number of non-liberalized products	
April '62	73	603	492	Part of specialty steel products, oil coke, chemical fiber pulp
October '62	88	833	262	Crude oil, dye, whale meat, sesame oil, agar
November '62	88	841	254	Wool yarn, knit goods, knit cloth, bed linen
April '63	89	866	229	Green bean, caustic soda, molybdenum ore, antimony ore
June '63	89	868	227	Accordion
August '63	92	903	192	Crude sugar, synthetic fiber yarn
Janaury '64	92	913	182	Kaoliang for feeding
April '64	92	921	174	Gasoline and kerosene (for AA), boiler, generator components and color TV receiver (for AIQ)
October '64	92	933	162	ammonium chloride, ammonium sulfate, bulldozer, tractor and natural-color dry plate (for AIQ)
October '65	93.2	934	161	Imitation precious stones （for AA）, cars (for AIQ)
October '66	93.2	936	159	Cocoa powder （for AA）, streptomycin and continuous synthetic fiber yarn (for AIQ)

Notes:

1. Japan shifted to the negative list and the Brussels tariff nomenclature on April 1, 1962.
2. Liberalization rate = $\frac{\text{Value of customs-cleared imports of liberalized products over 1959 calendar years (excluding government imports)}}{\text{\$3.6 billion in customs-cleared imports over 1959 calendar years (excluding \$2.4 million in government imports)}}$
3. AA: accelerated approval. AFA: automatic fund allocaton. AIQ: automatic import quota

Source: Ministry of Finance, "*Showa Zaiseishi--Showa 27-48 nendo*", Vol.12, pp.67

scrapping foreign exchange restrictions, but given the special needs of countries to reconstruct and stabilize after the war, IMF Article 14 provided for a transition period during which foreign exchange controls would be allowed within certain limits. Japan was not alone in taking advantage of this provision. Without exception, the leading countries of Western Europe spent many years under Article 14 status (with the attendant exchange controls), preparing for the transition to Article 8 status. Members were obligated to make this transition as quickly as possible, but the Japanese stance was to lay the groundwork for that eventuality while securing extensions on actual implementation. In November 1961, the IMF Annual Consultation on Japan announced that the time had come for Japan to make the transition. Behind this was the fact that United Kingdom, France, West Germany, and Italy had all made the transition to Article 8 status on February 1 of that year. Shifting to Article 8 obligations therefore became a pressing issue for Japan. On February 8, 1963, the IMF Board of Governors formally advised Japan to make the transition, and it finally did so on April 1, 1964.

Article 14 obligates countries with that status to engage in annual consultations with the IMF concerning their need for exchange controls. The idea behind these consultations was to reconfirm the justification for continuing with provisional controls; the governments were required to explain why they needed foreign exchange controls, even though they were following appropriate domestic fiscal and monetary policies. The consultations therefore covered general economic policies (management of aggregate demand, production, employment, prices, wages, and the like), fiscal and monetary policies, foreign trade, the balance of payments, foreign exchange management, and individual foreign exchange measures.

The IMF expressed great interest in the structure of Japanese economic management, which was closely aligned to balance of payments trends. While praising Japan for its rapid reconstruction and growth after the war, it expressed concern that the growth policies had gone too far. On occasion, it even commented

on matters of domestic policy, such as expressing its support for the "new methods of monetary control." In the event of a balance-of-payments crisis, Japan would have had to turn to the IMF to supplement its foreign exchange reserves. Thus, these IMF consultations served as both direct and indirect constraints on Japanese policy management. At times, they provided needed pressure, and they acted in some sense as a monitoring system that served to support prudent policy-making.

The objectives and methods of foreign exchange controls differ from country to country. The transition to Article 8 status involves a review of exactly which points require deregulation and efforts to bring individual issues and policy items into conformance with the IMF guidelines. Japan studied examples from the West in great detail in drafting its proposals. The biggest hurdle in its case was the handling of the foreign exchange allocation system or the so-called "foreign exchange budget." As late as 1962 and 1963, the foreign exchange budget was considered an important tool for industrial policy, with respect to which it would be difficult to arrive at a domestic consensus on immediate elimination. The IMF responded that this was a classic case of foreign exchange restrictions and demanded that this scheme be discarded unconditionally. Bolstering its case was the fact that none of the Western countries had anything resembling a foreign exchange budget when they were under Article 14 status. (They had, in fact, a foreign exchange concentrating system, another important part of Japanese foreign exchange control, so the IMF did not view this as a foreign exchange restriction and allowed it to continue.) In the end, Japan agreed to scrap the foreign exchange budget, effective the day it obtained Article 8 status.

It can be concluded with hindsight that there was in reality very little to be gained by holding onto the foreign exchange budget, since rapid liberalization had already brought the trade liberalization rate up to 93 percent. As a result, the timing of the transition to Article 8 status was constrained by the progress made toward trade liberalization.

4) Balance of Payments Trends and the Currency Crises of 1961 and 1963-64

By the 1960s, the trade balance had more or less established itself in the black, but its position was precarious. The trade structure was such that an increase in imports due to economic overheating could drive the balance back into the red, which is exactly what happened in 1961 and again in 1963.

The balance-of-payments situation during this period was distinguished by the appearance and widening of deficits in the invisible trade balance. There were three major reasons for the invisible trade deficits. First, the scale of trade was expanding, bringing with it an increase in associated costs, the largest of which was transportation. In spite of programs to encourage shipbuilding, the volume of trade far exceeded the capacity of the Japanese fleet, and payments to foreign shipping companies rose steadily throughout this period as a result. This was accompanied by rises in insurance premiums and agency fees. Port costs also accounted for a growing share of the trade-related payments. Most of these were for fuel, but with the world market dominated by the major oil companies, Japanese ships often paid in foreign currency, even when refueling in Japanese ports. Expansion of the activities of the Japanese fleet and an increase in transport between third countries also resulted in higher foreign expenditures. A second reason for the deficits was that the importation of foreign capital and technology meant higher interest, dividend, and royalty payments. And a third was that the foreign exchange liberalization had resulted in more foreign travel and foreign remittances. The deficits were thus part and parcel of Japan's economic growth, expanding trade, and liberalization. There was also a fourth factor to take into account: the decline in special procurement demand resulting from the Korean War. Beginning around 1960, the United States moved to defend the dollar, cutting its foreign sourcing to this end. The MOF dealt with the structure of external trade payments in a limited fashion, allowing the deficits to continue as a “cost of trade,” and moving to conserve payments where possible.

A second distinguishing feature of the balance of payments during the early 1960s was an expansion in the size of the capital account, which resulted from

policies to encourage the import of foreign capital and from the increased movement of funds due to the liberalization of trade and exchange rates. In the early 1960s, the structure of the balance of payments was still of a scale that enabled Japan, if it wished, to maintain a "developing-country" style of balance, under which deficits in the current account were made up by inflows into the long-term capital account, thereby creating an overall surplus. In point of fact, however, this pattern was seen only once in 1962. The predominance of net inflows into the long-term capital account was another of the unique phenomena observed during this period.

Inflows and outflows of short-term capital are, of course, a product of liberalized foreign exchange. At the same time, the return to convertibility of European currencies that set the stage for Japan's foreign exchange liberalization provided a basis for the Euromarkets to form and brought new activity to international flows of short-term funds. Most of the short-term funds that came into Japan were either trade related (import usance) or Euro-dollars not specifically tied to trade. After the liberalization of foreign exchange, the existence of import usance in the trading system gained particular attention. Most of the funding for import usance was borrowed from American banks operating in Japan, as a result of which increases here meant increases in short-term funds. Since export usance also depended on short-term funds, these funds became part of the Japanese trade finance structure, and the foreign exchange banks' dependence on them deepened. In other words, growing trade volumes meant greater dependence on short-term funding. Japanese economic expansion, particularly the expansion of foreign economic relations, was itself behind the growing dependence on short-term foreign funding.

One of Japan's goals in the early 1960s was to use domestic capital and foreign funding to relieve its chronic funds shortage. Most people welcomed the inflow of short-term funds for the capacity it provided to cover shortages. They also saw it as an indication that Japan's credit had improved. Policies dealing with short-term funds consequently sought to guarantee appropriate inflows, while staving off any rapid outflows. Key policies enacted at this time included a June 1962 ordinance

requiring that a set percentage of short-term funds be held in highly liquid foreign assets, and introducing a foreign currency reserve system (with a reserve rate of 20 percent at start-up) as a means of regulating the intake of short-term funds. This was followed in July 1964 by the issuance of guidelines instructing foreign exchange banks to maintain short-term funds within a set percentage of their investments in foreign-currency assets. Foreign exchange reserves, a product of the balance of payments, were generally around $1.8 billion at this time, though they varied somewhat depending on the overall balance. By the middle of the decade they had increased to $2.0 billion.

The foreign exchange crisis of 1961, which occurred immediately following the implementation of trade and foreign exchange liberalization, came as a deep shock to the government. The much vaunted Income-doubling Plan had also just gone into effect, and the authorities faced the unpalatable prospect of invoking austerity measures. The pattern for the policy mix had, however, already been set, and its form was essentially the same as that seen in 1957.

In the area of fiscal and monetary policy, the government and BOJ intensified window guidance, hiked the ODR, told the foreign exchange banks to refrain from overseas lending, raised collateral rates on imports, hiked the ODR again, and issued ministry-level circulars on operations by financial institutions. On October 13, Japan announced a Balance of Payments Improvement Program, the major thrusts of which were as follows: (A) Promotion of exports: l) tax breaks; 2) short-term financial incentives; 3) specific provisions to promote the export of industrial plants, agricultural products, and technology; 4) improvements in the export insurance system; 5) administrative guidance to enlarge export transactions; 6) better economic diplomacy and expansion to new foreign markets; and 7) improvements in the invisible trade balance. (B) Fiscal restraint: postponement of 10 percent of scheduled repairs to government buildings and deferment of some funding for the FILP and public works. (C) Financial restraint: tighter money. (D) Investment restraint: administrative guidance to restrain private-sector investments.

(E) Promotion of exports by smaller businesses: programs to provide them with a buffer against the effects of tight money. (F) Consumption restraint: a national program to encourage savings, the buy-Japanese movement and voluntary restraints on foreign travel.

Note that its commitment to the liberalization of foreign exchange prevented the government from enacting any foreign exchange regulations, except to restrict foreign travel and overseas lending. The government could have borrowed from exchange reserves, but the IMF demanded that deflationary policies be enacted as a prerequisite for the loan, and the government wanted to avoid cancellation of the Income-doubling Plan at all costs. During the IMF consultations in June 1961, it was suggested that Japan enact belt-tightening measures, especially on the fiscal side, and its failure to do so was in part responsible for the worsening balance of payments. Its priorities in covering its foreign exchange reserves were therefore defined as follows: 1) borrowing from U.S. commercial banks; 2) borrowing from the Washington Export-Import Bank; and 3) as a last resort, borrowing from the IMF. On November 26, 1961, Japan succeeded in obtaining a $200 million dollar-denominated loan from a syndicate of U.S. banks (Chase Manhattan, First National, and Bank of America, with the Bank of Japan as the borrower of record). On January 31, 1962, seven U.S. commercial banks lent Japan (the Bank of Japan) a total of $125 million in import credits for U.S. agricultural products guaranteed by the Washington Export-Import Bank. Nevertheless, Japan could not free itself of the IMF. On January 19, 1962, it signed a stand-by credit agreement for $350 million, though the funds were never actually used.

The 1968-64 foreign exchange crisis was much more of a preventative measure. With the transition to IMF Article 8 status and membership in the Organization for Economic Cooperation and Development (OECD) coming up, Japan did not think a deterioration in its balance of payments desirable, and it was, in fact, worried by the suggestion that Article 8 status would hurt its balance of payments. It therefore supplemented its foreign exchange reserves ensure to its preparedness for any future

crisis.

On October 29, 1963, the Bank of Japan and the New York Federal Reserve Bank signed a stand-by agreement providing for yen/dollar swaps of up to $150 million. The New York Federal Reserve Bank signed similar agreements with the central banks of most other countries beginning about March 1962 as part of U.S. efforts to defend the dollar (in the broad sense). This extension of mutual credit allowed the central banks to draw down dollars should they need them. For Japan, the agreement was nevertheless significant in that it meant that Japan, assuming it made the transition to Article 8 status, had been accepted as part of the Fed-centered cooperative system for maintaining monetary values. The ability to use swaps to raise dollars also gave Japan a means of supplementing its foreign exchange reserves should a foreign exchange crisis recur. Starting March 1964, IMF gold tranches were counted as part of foreign exchange reserves, resulting in a nominal increase, and this also helped to reinforce Japan's reserves against future crises. Another stand-by agreement with the IMF was also approved at this time, although it was never implemented.

As the swap agreement with the New York Federal Reserve Bank illustrates, the timing of the 1963-64 foreign exchange crisis coincided with Japan's transition to Article 8 status, and there were consequently no direct foreign exchange regulation policies enacted. In terms of related regulation, the government reinstituted the import guarantee redeposit system on March 18, 1964, and asked foreign exchange banks to refrain from borrowing or lending overseas. Though there were no general policies invoked, the ODR was hiked by 0.2 percentage points on the same day.

Chapter 6: 1965-1971 Fiscal and Monetary Policies for the Internationalist, Welfare State

1. Background and Economic Policies

There were three main economic plans during the late 1960s: the "Medium-term Economic Plan" (implemented by Cabinet decision in January 1965; covered fiscal 1964-1968), the "Economic and Social Development Plan" (implemented by Cabinet decision in March 1967; covered fiscal 1967-1971), and the "New Economic and Social Development Plan" (implemented by Cabinet decision in May 1970; covered fiscal 1970-1975). The slogan for the Medium-term Economic Plan was "rectifying distortions," that for the Economic and Social Development Plan, "development toward a balanced and sound economy and society," and that for the New Economic and Social Development Plan, "building a livable Japan through balanced economic development." In contrast to the economic planning prevailing through the early part of the decade, which emphasized growth above all else, economic planning in the latter half of the 1960s shifted the focus to the reallocation of resources and income, under the assumption that high growth had led to a degree of improvement in national income levels.

The high-growth policies had succeeded because specific core industries and growth industries had been given priority in resource and funding allocation, but this also brought clear economic and social regressiveness in its wake. The gaps between priority industries and low-productivity sectors widened, infrastructure was inadequate in relation to income levels, and the social security system was retarded. Moreover, wages had been allowed to rise in low-productivity sectors despite the fact that little had been done to improve their productivity or to encourage more effective utilization of their work forces. Price hikes for products in these sectors sparked a general rise in consumer prices that, in turn, became the primary constraint on growth. Thus, the very structure that made high growth possible became a fetter on economic management: a situation that the policies of this period

attempted to rectify. One of the basic assumptions was that the high-growth period had ended. But far from ending, high growth continued during the late 1960s, and the balance of payments was generally in surplus. Clearly, the basic assumptions underlying economic planning had changed, but there was no essential change in direction. The policy-makers did not yet perceive any fundamental shifts in the economic structure. Even at the end of the decade, for instance, they still refused to state with certainty that balance-of-payments surpluses had become an established facet of the Japanese economy.

Table 6-1 Outline of Economic Growth (1965-73)

Year	Economic Growth Rate		Growth Rate of Private Capital Investment (%)	Corporate Income / National Income (%)	National Gross Expenditure per capita (Real) (thousand yen)
	Nominal (%)	Real (%)			
1953	12.6	5.7	15.7	9.1	128.1
1954	11.0	6.1	4.3	9.8	134.0
1955	10.1	9.1	△ 3.2	7.9	144.5
1956	12.8	8.0	39.0	8.7	154.5
1957	13.9	8.0	25.1	12.1	165.3
1958	4.9	5.4	△ 4.7	10.5	172.7
1959	12.2	9.2	16.9	10.6	186.8
1960	19.9	14.1	40.9	14.4	211.4
1961	23.4	15.6	36.8	14.4	242.1
1962	10.8	6.4	3.4	13.3	255.3
1963	15.4	10.6	5.3	12.0	279.4
1964	17.9	13.3	20.0	12.3	314.5
1965	10.5	4.6	△ 6.4	10.6	325.5
1966	15.3	10.2	11.4	11.2	355.5
1967	18.3	13.5	27.0	12.8	399.5
1968	18.6	14.2	27.2	14.4	451.2
1969	16.7	12.1	20.9	14.6	499.8
1970	17.8	10.3	15.4	15.5	545.1
1971	11.7	6.8	3.2	14.0	575.4
1972	14.4	8.9	5.8	13.0	615.1
1973	24.1	10.5	19.3	10.1	668.7

The Medium-term Economic Plan provided an outlook for the economy in the mid-1960s. For the external economy, it noted the need to be internationally competitive and to contribute to the international community; for the internal economy, it called for socioeconomic modernization and progress toward a welfare state by placing greater emphasis on income redistribution and improved social services. Indeed, a major policy objective was catching up with the welfare benefits of other countries.

In short, the goals of economic policy during the late 1960s were to improve and strengthen economic fundamentals; the role of government was to develop programs and policies that would contribute to social stability. Primary among these was stable growth, which meant steady prices and equilibrium in the balance of payments. These had been the major causes of economic disruption in the early part of the decade, and it was assumed that they had been carried over into the latter half as well. A second priority was the normalization of the financial system. Financial stability and normalization had been goals ever since the war, but Japan was still stinging from the collapse of its securities industry, which had appeared to be expanding as a marginal fund-raising tool under the indirect financing format that dominated the high-growth period, but whose expansion had proved to be a chimera. Liberalization of capital was urgently required to improve Japan's financial health, and this area took on more weight at this time. The third area of emphasis involved the need to expand and enhance infrastructure and social security. Ostensibly, these were challenges to be met during the second quarter of the decade, but no fundamental improvements were seen. If anything, the strong economic growth made them appear even more undeveloped, as gains in the national income had made Japan's social inadequacies all the more glaring.

Those administering the economic plans were aware of the changes taking place in the relationship between the public sector and the national economy. The assumptions here were that high growth assured Japan of adequate production and living standards, and that the private sector was now acting autonomously. The idea

that government activities ought to promote private-sector accumulation and growth consequently took a back seat; the government, it was argued, should merely concentrate on discharging its core responsibilities. The Medium-term Economic Plan states explicitly that it was drafted to provide guidelines for government policy administration and assistance in policy decisions, not to provide guidelines to private-sector companies or households. But even though the plan's drafters envisioned a change in the role of government during the post-high-growth period, they did not think that government would come to account for a larger portion of the national economy. There was a certain sense of pride in the role that sound fiscal policies had played in reining in an economy that was prone to overheating, and a general perception that Japan would be wise to continue to adhere to such policies in managing the economy during the "stable growth" period that lay ahead.

2. Fiscal Policy for the "Welfare State"

1) "Welfare state" Policies and the Issue of Fiscal "Rigidity"

Policy-makers assumed during the late 1960s that it would be necessary for fiscal policy to undergo a great change. The basic ideas behind their economic planning bear this out. The plans rested on four assumptions: 1) economic growth would have to slow down; 2) the policy objectives of "rectifying distortions" and building a balanced economy would necessitate an expansion of the duties of the public sector in some senses, but it was not desirable to continue with the style of management seen in the early 1960s, which had caused the public sector's share to expand out of proportion; 3) a "natural increase" in the cost of programs established during the high-growth process in the first half of the decade would cause fiscal spending to rise; and 4) slower economic growth would mean slower growth in fiscal revenues.

What in fact happened, however, was that the high growth continued on into the latter half of the 1960s, making it possible to administer fiscal policy along the same lines as in the first half of the decade. The coincidence between increases in fiscal

revenues and higher demand for public finance to "rectify distortions" and solve other problems allowed the government to take a more activist stance toward the economy. One illustration of this change in the direction of fiscal policy is that, beginning about 1970, the magnitude of General Account spending as a percentage of national income entered a long-term rising trend after remaining more or less stable since 1955. We should also note, however, that part of this change stemmed from a need to provide fiscal remedies for the upheavals and crises triggered in the national economy by sweeping changes in the international economic climate.

Finance Minister Kakuei Tanaka used the term "welfare state" to describe the social security programs that were being presented in a fiscal policy speech he gave on January 25, 1965. During the late 1960s, rapid progress was indeed made toward putting a social security system in place. First on the list was a hike in benefit payments, to bring them in line with the improvement in incomes and living standards accompanying high growth. Second was the need to keep benefits in line with sharply rising consumer prices. And a third strategic priority was to help those who had been left behind by economic growth. In 1965, National Pension benefits were raised by ¥ 10,000. In 1968, the National Health Insurance deductible was reduced from 50 percent to 30 percent for household members; in 1969, there was another ¥ 20,000 hike in National Pension benefits; and in 1971, a new Child-rearing Allowance was established.

Though it goes beyond our scope here, this expansion trend continued until the mid-1970s. In 1972, the free senior citizen health care system was implemented (effective January 1973); and in 1973, the National Health Insurance dependent deductible was lowered from 50 percent to 30 percent, a new system of payments for high-cost medical treatments was established, National Pension benefits were hiked another ¥ 50,000, and pensions were indexed to consumer prices. This earned the year 1973 the nickname "the inaugural year of Japanese welfare."

During the first half of the 1960s, the main policy objective was to add breadth to the social security system; during the latter half, it was to add depth. The advent

Table 6-2 Social Security Budget Breakdown (FY 1965-69, after supplementation)

(In millions of yen)

	FY 1965	(%)	FY 1966	(%)	FY 1967	(%)	FY 1968	(%)	FY 1969	(%)
Public assistance expenses	106,649	19.5	124,389	19.6	145,584	19.6	164,021	19.8	183,501	18.8
Social welfare expenses	44,141	8.0	52,256	8.2	62,462	8.4	70,300	8.5	91,927	9.4
Social insurance expenses	228,781	41.9	271,249	42.8	340,698	46.0	405,697	49.0	494,193	50.7
Public health service expenses	96,651	17.7	111,334	17.5	114,583	15.4	107,607	13.0	123,933	12.7
Expenses for measures for the unemployed	69,548	12.7	73,741	11.6	76,243	10.3	79,153	9.5	80,732	8.2
Total	545,772	100.0	632,971	100.0	739,573	100.0	826,779	100.0	974,288	100.0

Source: Ministry of Finance, Budget Statistics, FY1970, pp. 208-209

Table 6-3 Social Security Budget Breakdown (FY 1970-74, after supplementation)

(In millions of yen)

	FY 1970	(%)	FY 1971	(%)	FY 1972	(%)	FY 1973	(%)	FY 1974	(%)
Public assistance expenses	220,778	19.0	250,486	18.3	310,744	18.4	358,446	16.1	462,400	14.7
Social welfare expenses	117,233	10.1	150,287	11.0	208,865	12.4	356,876	16.0	491,580	15.7
Social insurance expenses	591,501	51.1	704,328	51.7	861,110	51.1	1,165,880	52.5	1,776,093	56.7
Public health service expenses	143,721	12.4	165,696	12.1	194,838	11.5	214,059	9.6	254,201	8.1
Expenses for measures for the unemployed	83,455	7.2	91,050	6.6	106,580	6.3	124,321	5.6	144,431	4.6
Totla	1,156,688	100.0	1,361,847	100.0	1,682,137	100.0	2,219,582	100.0	3,128,705	100.0

Source: Ministry of Finance, Budget Statistics, FY1975, pp. 220-221

of the Child-rearing Allowance brought Japanese social security up to Western levels, and by 1970 benefit levels had reached international standards. During the early 1970s, social security spending grew sharply as a percentage of General Account expenditures, while spending on land conservation and development declined. Indeed, the two traded places in terms of their share of total spending, marking a shift in emphasis away from the public works spending that had dominated the high-growth period toward a new era of the welfare state. Much of the increase in social security spending was covered directly by the Treasury. Among the fastest growing social spending items during the late 1960s was medical care (which reached a peak of 59.1 percent of the social security budget in 1969), but economic growth made it possible to cover these new costs and, in the process, establish the Japanese “welfare state.”

Another factor which played a symbolic role in righting the distortions of the high-growth period was pollution. Laws were already in place to regulate factory smoke and waste water by the mid-1960s, and a budget was being provided for related programs, but pollution control did not become a priority budget item until the latter part of the decade. The Environmental Pollution Control Service Corporation was established in 1965. This was followed by the Pollution Countermeasures Basic Law in 1967, the Air Pollution Prevention Law and Noise Pollution Regulation Law in 1968, and the Law on Mediation of Pollution-related Disputes in 1970. These laws both expanded and clarified the concept of “pollution,” placing explicit responsibility on polluters and providing concrete measures to help victims. Later revisions of the Pollution Control Basic Law removed the words “in harmony with sound economic development,” reflecting the priority that social policy, including anti-pollution measures, had recently acquired over economic growth. The basic thinking concerning ways to pay for pollution control was: 1) to have polluters themselves bear as much of the burden as possible, using fiscal measures (spending and tax breaks) and FILP programs to provide effective and appropriate supplementation and incentives; and 2) to view cases in

which it is difficult to find a direct cause or that are intimately related to the general living environment as part of infrastructure to be actively pushed forward by central and local governments. Tax breaks introduced at this time included incentives for the installation of pollution-control equipment. On the fiscal side, a new "industrial pollution lending" scheme was established by the Japan Development Bank.

In a speech on fiscal policy delivered on January 27, 1968, during the debate on the budget for the upcoming fiscal year, Finance Minister Mikio Mizuta noted a growing rigidity in public spending. He singled out the costs associated with new laws, new systems, and new mandatory expenditures as causing the size of public finance to grow with noticeable rapidity. Unless something was done, he went on to argue, fiscal policy would no longer be able to provide countercyclical adjustments or distribution and redistribution services, even though Japan was more in need of them than ever before. In the narrow sense, mandatory expenditures consisted of allocations of tax revenues to local governments, government employee wages, debt service, medical-care and other social security expenditures, and the disbursement of revenues earmarked for special purposes (such as the money raised by the Volatile Oils Tax, which had to be spent on road construction). These items alone were causing the budget to grow by about 10 percent a year. Contributing factors included changes in the minimum standard of living (which served as the basis for setting the wages of government employees), wages for unemployment programs, and the resulting impact on the pension system. In addition, public works spending, which had been budgeted for on a medium- and long-term basis ever since the days of the Income-doubling Plan, began to appear more as an entrenched interest and became a factor in increasing rigidity and budget growth. In a yet broader sense, mandatory spending included defense spending, foreign aid, and other spending provided for in agreements with foreign governments.

Fiscal rigidity is a structural problem introduced by systems and programs that are established in order to meet the conventional obligations of fiscal policy. Quite aside from any question we may have concerning the appropriateness of the term

“rigidity,” we should note that this is an issue of universal significance and not something that can be immediately solved by introducing some particular budgetary or fiscal measures. The reason for the sense of crisis in the Ministry of Finance’s campaign against fiscal rigidity at this time was that similar factors had undermined public finances in West Germany (the object of Japan’s “catch-up” efforts in the late 1960s), and the resulting budgetary difficulties had led to dissolution of the Cabinet (in November 1967). Japan adopted three policies to reduce rigidity: 1) the general budget principle, which it was hoped would eliminate factors from later budget supplements; 2) administrative reorganization; and 3) disclosure of the .funding sources for “adjustments” made during the budgetary process (including establishing adjustment quotas for each ministry and agency). Some are of the opinion that these policies did little to relieve fiscal rigidity, but they did prevent public spending from growing any further. From 1955 until 1970, the size of the General Account as a percentage of national income was more or less constant. Meanwhile, bond issues were playing an increasingly smaller role in financing the General Account, preventing spending from growing unchecked in the face of greater pressures on fiscal funds.

2) Bond Issues on the General Account and Their Impact on Fiscal Policy

The economic slump of 1965 resulted in the invocation of the exceptions to Article 4, Paragraph I of the Public Finance Law and the issuance of “revenue-supplement” bonds as part of the fiscal 1965 supplementary budget. In the following year, 1966, the addenda to Article 4, Paragraph I were invoked to issue “construction” bonds as part of the initial budget. These were the first government bonds to be issued since the war, except for a few issued for emergency purposes immediately after the war. They were significant for two reasons. First, they opened the door to the use of “revenue-supplement” bonds, for which there was as yet no legal framework, as a means of covering near-term shortfalls in tax revenues. Second, they attempted to diversify funding sources and to permit more discretion in fiscal policy by establishing “construction” bonds, which were allowed under the

Public Finance Law, as a permanent source of revenue, on the one hand, and to use the tax system as a means of stimulating the economy, on the other. The bonds' specific purpose was to help the economy out of its slump, although they were also the first step in the transition to a fiscal policy predicated on stable growth. "Revenue-supplement" bonds, which were also known as "deficit bonds," were not issued again until fiscal 1975, but "construction" bonds have been issued every year since 1966.

As late as the early 1960s, issuing revenue-supplement bonds was unthinkable for the Ministry of Finance because of the taboo against them in the Public Finance Law. The addenda to Article 4, Paragraph I do not ban all government bond issues. Rather, they set out the basic principle that spending on the General Account can be divided into current spending and investment expenditures. Because of their nature, investment expenditures do not necessarily need to be funded from tax revenues. From this, the idea can be drawn that when countercyclical measures (more investment and public works) are needed, the government ought to use bond issues to adopt a more activist fiscal stance. During the late 1950s and early 1960s, however, bond issues were never considered. The demand for fiscal spending was so strong that it was feared that once the door to bond issues had been opened, it would be impossible to maintain sound fiscal policy. This prudence did not prevent the use of the FILP, which integrated borrowings on the Special Accounts and government-guaranteed bonds, to fund public works. In other words, the government had already been issuing what amounted to construction bonds for a long time. If it did not feel the need to use bonds to fund the General Account, it was probably because tax revenues were booming thanks to high economic growth. The slump of 1965 brought both the need to take fiscal measures and the very real possibility of a revenue shortfall, and bond issues once again became open to consideration.

History had taught Japan that once bonds were issued on the General Account, however, they eventually expanded to the point where they would break the public purse, and it was considered essential to retain measures to hold them in check. The

first such measure was the “construction bond” system. Experience was a reliable indicator of the share of public works spending on the General Account, and most spending items (such as road construction) had specific sources of funding, which consequently provided an external check on the amount of bonds that could be issued. Furthermore, these expenditures differed from highly rigid current expenses: they were flexible, at least in theory, and the bonds, once issued, could be sunk in a few years or called to a halt if necessary.

The second check on bond issues was the principle included in Article 5 of the Public Finance Law that issues must be of a size that could be absorbed by the markets. The ability of the markets to purchase bonds, coupled with interest costs, served as a constraint on issuing. The manner in which the bonds were placed is dealt with in greater detail in Chapter 3, Section 3.1. We should note, however, that in addition to its direct floats on the market, the Trust Fund Bureau also underwrote a considerable portion of public debt. It picked up 45 percent of the “revenue-supplement” bonds issued in the fiscal 1965 supplementary budget, for example. The markets bought all of the fiscal 1966 construction bonds, however, and since 1967, the Trust Fund Bureau has been used to underwrite only that portion of construction bonds that the markets are unwilling or unable to purchase.

The Ministry of Finance wanted the bond issue included in the 1965 budget supplement to take the form of construction bonds rather than “revenue-supplement” bonds, but it was overruled by a political decision that they would, indeed, be “revenue-supplement” bonds issued as a special exception to the Public Finance Law. The rationale for this decision was that the supplement itself was a temporary measure taken in mid-year to cover a shortfall in tax revenues and that the government wanted to make it clear that the issue was being undertaken as a fiscal stimulus measure. The legal rationale for the issue came from the “Law Concerning Special Fiscal Measures for Fiscal Year 1965,” which granted exceptions to the Public Finance Law. In terms of administrative procedures, part of the budget for public works set aside from tax revenues in the initial budget was transferred to

bonds instead. In other words, the issue was treated as if it were a construction bond within the general framework of the revised budget. Because it was in the initial budget, on the other hand, the 1966 bond issue was identified as construction bonds from the very beginning, formally complying with the provisions in the addenda to Article 4, Paragraph l. The issue of public works bonds, it was explained, would enhance infrastructure, provide for more discretionary fiscal administration, and facilitate a tax cut that would encourage private-sector capital accumulation.

Behind the bond issues was the idea, based on the initial projections for the late 1960s, that a more activist fiscal policy would be required (to rectify “distortions” and provide countercyclical adjustments), but this would necessitate a higher level of public spending and changes in the public spending structure itself, even though natural increases in tax revenues could no longer be counted on to provide funding. The Ministry of Finance wanted to use the switch to an active countercyclical fiscal policy to restore levels of investment in infrastructure, which had been comparatively slow to pick up during the early 1960s. The slump of 1965 was quickly overcome, however, and high growth recommenced, bringing with it rising tax revenues. This paved the way for the retirement of the “revenue supplement” bonds during fiscal 1971. Construction bonds were issued every year thereafter, but the General Account did not grow as a percentage of GNP, nor did its dependence on bond financing rise. In other words, the inclusion of construction bonds as an ordinary source of revenue was itself a major policy change, but it did not mark a change in the underlying policy that the scope of public finance should be controlled by its size relative to the national economy. There was consequently no real change in the structure of fiscal policy.

By the early 1970s, government debt had begun to mount as a result of ongoing growth in the size of public spending, even though the economic growth rate was slowing. Another factor was the need to enact fiscal measures to stimulate the domestic economy in response to a large influx of foreign currency through the balance of payments beginning in 1971. There was no active policy of financing

these measures with bond issues, but the supplementary budget for 1971 did eliminate the idea that bonds should be gradually reduced, causing real dependence on bond financing to soar from 4.2 percent in fiscal 1970 to 12.4 percent in fiscal 1971. Thus, 1971 marked a transition to the expansion of public spending and public debt that would characterize the early 1970s. In the ensuing years, the weight of debt servicing as a percentage of the budget would rise enormously.

3) Public Works Spending and the Introduction of the "Beneficiaries Pay" Principle

The public works budget grew rapidly in the late 1950s and especially in the early sixties. As a result, Japan's public works spending was at this time among the highest of any of the industrialized countries in terms of both the absolute amount and the percentage of total public spending. Nevertheless, growth led by the private sector was so high that the relative lack of infrastructure was actually exacerbated. Japan tried to increase spending as much as possible using construction bonds, on the one hand, while endeavoring to keep public spending at appropriate levels, on the other. The emphasis was on a better living environment. The housing problem - which focused on overcoming the general shortage of housing - became increasingly pressing in urban areas at this time, as rapid growth brought people flocking into the cities. Beginning in fiscal 1966, housing measures were among the major spending items in public works spending. Park construction was among the main programs for the improvement of residential infrastructure. The FILP also placed a new priority on housing projects and raised their allocations by 43.5 percent in fiscal 1966. That same year, the Special Account to Fund Urban Development was established to encourage redevelopment in major cities. This account was funded in part by the FILP. The Japan Development Bank followed suit, creating a system for redevelopment lending in 1966 and steadily expanding it later. Note that FILP funding grew far more quickly than General Account funding, and much of this expansion came from government-guaranteed bonds and borrowings. One reason was that fiscal rigidity had so strained the General Account that the FILP was forced to take on a larger role. Another was that the establishment of construction bonds as

Table 6-4 Public Bonds Issues and Dependence on Public Bonds

(In 100 millions of yen, %)

		FY 1965	FY 1966	FY 1967	FY 1968	FY 1969	FY 1970	FY 1971	FY 1972
Public debt issues	/ Initial plan	—	7,300	8,000	6,400	4,600	4,300	4,300	19,500
	/ After supplementation	2,590	7,300	7,310	4,777	4,500	3,800	1,200	23,100
	/ Actual result	1,972	6,656	7,094	4,621	4,126	3,472	11,871	19,500
Depedence on publid debt issues	/ Initial plan	—	16.9	16.2	10.9	7.2	5.4	4.5	17.0
	/ After supplementation	6.9	16.3	14.0	8.0	6.4	4.6	12.6	19.0
	/ Actual result	5.2	14.9	13.8	7.7	5.9	4.2	12.4	16.3

Source: Materials from Budget Bureau, Ministry of Finance

Table 6-5 Public Works Budget Breakdown (FY 1965-1969, after supplementation)

(In millions of yen)

	FY 1965	(%)	FY 1966	(%)	FY 1967	(%)	FY 1968	(%)	FY 1969	(%)
Soil and water conservation project expenses	120,425	16.2	144,591	16.3	168,138	16.5	176,607	16.5	203,535	16.9
Road development project expenses	303,893	41.0	360,058	40.7	416,874	40.9	434,028	40.7	497,465	41.3
Port/harbor, fishing port and airport development project expenses	55,036	7.4	65,621	7.4	77,626	7.6	83,734	7.8	98,129	8.1
Housing measures expenses	37,092	5.0	48,665	5.5	64,796	6.3	69,748	6.5	79,431	6.6
Living environment facility development expenses	22,091	2.9	26,216	2.9	34,265	3.3	39,082	3.6	47,989	3.9
Agricultural infrastructure development expenses	92,224	12.4	109,820	12.4	130,616	12.8	139,373	13.0	162,457	13.5
Forest road and industiral water development project expenses	21,148	2.8	21,715	2.4	22,833	2.2	24,461	2.2	28,087	2.3
Adjustment expenses	4,500	0.6	5,200	0.5	5,900	0.5	6,200	0.5	6,900	0.5
Disaster restoration project expenses	83,276	11.2	101,726	11.5	96,928	9.5	92,333	8.6	78,735	6.5
Total	739,688	100.0	883,615	100.0	1,017,980	100.0	1,065,568	100.0	1,202,794	100.0

Source: Ministry of Finance, Budget Statistics, FY1970, pp. 210-211

Table 6-6 Public Works Budget Breakdown (FY 1970-1974, after supplementation)

(In millions of yen)

	FY 1970	(%)	FY 1971	(%)	FY 1972	(%)	FY 1973	(%)	FY 1974	(%)
Soil and water conservation project expenses	236,656	16.7	309,486	16.4	423,395	16.0	445,048	15.6	450,358	15.1
Road development project expenses	586,604	41.6	758,450	40.2	999,644	37.8	1,042,494	36.5	1,037,334	34.9
Port/harbor, fishing port and airport development project expenses	117,443	8.3	157,480	8.3	215,010	8.1	235,236	8.2	241,163	8.1
Housing measures expenses	95,399	6.7	128,164	6.8	165,603	6.2	203,420	7.1	263,377	8.8
Living environment facility development expenses	62,829	4.4	121,078	6.4	201,773	7.6	226,578	7.9	278,301	9.3
Agricultural infrastructure development expenses	189,025	13.4	246,976	13.1	323,734	12.2	345,441	12.1	350,138	11.8
Forest road and industiral water development project expenses	34,768	2.4	45,863	2.4	59,590	2.2	70,982	2.4	72,963	2.4
Adjustment expenses	7,300	0.5	7,800	0.4	8,500	0.3	14,250	0.5	13,750	0.4
Disaster restoration project expenses	79,857	5.6	108,490	5.7	243,737	9.2	265,252	9.3	257,560	8.6
Total	1,409,881	100.0	1,883,787	100.0	2,640,986	100.0	2,848,701	100.0	2,964,944	100.0

Source: Ministry of Finance, Budget Statistics, FY1975, pp. 222-223

Table 6-7 List of New Special Accounts (FY 1966-72)

Name	Category	Implementation year (relevant law)	Note
Urban development finance	Loan	FY 1966 (Law No. 50 of 1966)	
Earthquake reinsurance	Insurance	FY 1966 (Law No. 74 of 1966)	
Coal mining industry	Settlement	FY 1967 (Law No.12 of 1967)	Transferred to the coal and oil industry special account in FY 1972
Fishing boat reinsurance and fishery mutual aid reinsurance	Insurance	FY 1967 (Law No. 124 of 1967)	
National property special consolidation fund	Development	FY 1969 (Law No. 6 of 1969)	
Airport improvement	Development	FY 1970 (Law No. 25 of 1970)	
Labor insurance	Insurance	FY 1972 (Law No. 84 of 1972)	Taking over the special accounts for laborers' accident insurance and unemployment insurance

Source: Prepared from a list of special accounts on "Okurasho Hyakunenshi", Appendix pp. 142-146

an ordinary source of General Account revenues was accompanied by a more active government borrowing policy. Though public finance in the narrow sense was unable to provide any countercyclical adjustment, the FILP could be used with a high degree of flexibility for the same purpose. This resulted in driving up the ratio of the FILP to the General Account, a trend that was made possible by strong growth of the Postal Savings system.

During the late 1960s public works projects made a greater effort to tap private-sector vitality, technology, and funding. With the need for better infrastructure apparent, the idea was to expand public works spending by: 1) giving private-sector firms and others control over a project when warranted by its nature or the quality and level of benefits; and 2) requiring the beneficiaries of development or those who created the need for public investment to pay their share. Two new FILP institutions were created in 1967 - the Keihin Foreign Trade Pier Public Corporation and the Hanshin Foreign Trade Pier Public Corporation - each of which raised 40 percent of its funding through debts placed privately with beneficiaries. The Regional Roadways Public Corporation Law of 1970 allowed public corporations administering highways in different regions of the country to charge tolls, while a revision of the Ports Law implemented the same year permitted private-sector firms to build and operate designated port facilities (container piers). On the whole, there

were efforts to rein in the creation of new government-affiliated companies. In addition to the two pier companies mentioned above, the Hachirogata Farming Community Start-up Corporation, the New Tokyo International Airport Corporation, and the Honshu-Shikoku Bridge Authority also came into being at this time. In this way, FILP institutions were established to cover specific regions or projects.

Table 6-8 Fiscal Investment and Loan Program Breakdown by Source (FY 1965-73)

(In millions of yen)

FY	1965	1966	1967	1968	1969	1970	1971	1972	1973
Postal savings	4,645	5,939	7,963	9,853	12,068	14,201	18,902	25,963	30,717
Employee and national pension funds	3,697	4,652	5,566	6,420	7,780	10,243	12,022	14,124	15,946
Trust Fund Bureau clawbacks, etc.	3,530	1,951	2,498	2,767	2,568	3,470	6,556	7,211	14,821
Postal insurance funds	1,095	1,689	2,185	2,652	3,354	4,065	5,048	6,025	7,548
Government-guaranteed bonds, etc.	4,367	6,138	6,094	5,452	5,150	4,973	6,706	6,292	4,300

Source: Ministry of Finance, Monthly Fiscal and Financial Statistics, No. 201, 234, 245, 256

New taxes were also enacted to provide funding specifically for infrastructure enhancement. In 1971, an automobile tonnage tax was established to help fund road and transport infrastructure, an area in which Japan had been slow to develop. This tax was supposed to provide funding for general transportation projects, including the Shinkansen ("bullet train") and conventional railways, urban subway systems, and other projects to deal with urban transport problems. It also adhered to the principle of "making those responsible pay," since it focused on the social costs of automobile traffic. An aviation fuel tax imposed in 1972 likewise provided funding for airport construction, another example of asking the beneficiaries to pay for expanding public investment. At the same time, however, this earmarking of funding also contributed to greater "fiscal rigidity."

4) Greater Welfare with a Greater Tax Burden

In July 1968, the Tax Commission published a document entitled the Long-term Perspective for the Tax System that supported the notion of greater welfare with a greater tax burden. Keeping in mind the need to balance the public and private economies, the report advocated "gradually raising the relative weight of the public

economy in the process of building a welfare state to respond to growing demand for better national welfare," and noted that "higher levels of welfare will result in a higher [tax] burden." As long as the economy maintained a certain level of growth, funding for this system could be found without intentionally raising taxes because of the high income-elasticity of the current tax system. If anything, care should be taken to avoid an overly rapid rise in the tax burden due to the progressive structure of the tax scale.

Table 6-9 Tax Burden Ratio (1965-73)

(In ten billions of Ten Billion Yen)

Fiscal Year	Nationa Income	Tax				Social Security	Burden Ratio (%)	National Burden Rate
		Indirect Tax	Direct Tax	Total	Burden Ratio (%)			
1965	26,827.0	2,459.4	2,486.4	4,945.8	18.4	1,345.7	5.0	23.5
1966	31,644.8	2,785.9	2,762.6	5,548.5	17.5	1,611.5	5.1	22.6
1967	37,547.7	3,306.9	3,392.6	6,699.5	17.8	1,910.1	5.1	22.9
1968	43,720.9	3,941.5	4,155.5	8,097.0	18.5	2,235.9	5.1	23.6
1969	52,117.8	4,639.0	5,134.1	9,773.1	18.8	2,677.7	5.1	23.9
1970	61,029.7	5,385.0	6,388.4	11,773.4	19.3	3,308.3	5.4	24.7
1971	65,910.5	5,797.2	7,021.0	12,818.2	19.4	3,898.7	5.9	25.4
1972	77,936.9	6,789.3	8,672.4	15,461.7	19.8	4,564.1	5.9	25.7
1973	95,839.6	8,381.9	12,343.6	20,725.5	21.6	5,676.0	5.9	27.5

The commission had already voiced the idea that the tax burden might have to rise somewhat in order to expand public investment and social welfare during the debate leading up to its Report on the Long-term Tax System of 1964. The report itself merely stated that the relative weight of the public sector might have to rise, but that appropriate levels of taxation should be maintained in order to ensure the stability of national life. The interim version of the Long-term Perspective for the Tax System, released in October 1966, took this idea a step further by stating that rising income levels would make a higher tax burden unavoidable - a clear indication that more taxation was in the offing.

The late 1960s represent a time of transition for the tax system, characterized by efforts to work from both the successes and distortions of previous economic growth to create a structure that would support a higher level of public investment. A higher tax burden was also advocated as a means of reducing Japan's dependence on bonds. The final version of the Long-term Perspective for the Tax System, published in June 1971, clarified this further, and then went on to state that the burden of income taxes, corporate taxes, and indirect taxes alike should be increased. As the economy moved into the ranks of the most advanced in the world, international comparisons were unavoidable, and these provided further justification. With income taxes low compared to those of other countries, it was argued that there was sufficient room to raise them, and that corporate taxes (when compared to income taxes) were even lower by international standards. The commission advocated hiking indirect taxation through the introduction of a general consumption tax. These ideas led to a change in the tax burden standard of 20 percent of national income that had been maintained through the early 1960s. Future levels were now open to discussion, although the commission did affirm that 20 percent of the natural increase each year should be earmarked for tax cuts.

Although the tax burden did begin rising in the mid-1960s, the tax system was not necessarily reformed along the lines advocated by the Tax Commission, and Japan did not make the transition to an explicitly high-burden system. There was no need for such a transition. High growth continued through the late 1960s, producing a sharp rise in income tax revenues that enabled Japan to cover its fiscal outlays and reduce its dependence on bonds without changing the tax structure. If anything, strong growth in consumer prices necessitated a counteractive tax cut. Of particular urgency was the so-called "salary man tax cut," a break for the salaried workers whose share of the tax burden had expanded most in the process of economic growth. As in the early part of the decade, rising prices prevented the government from making any bold hikes in indirect taxes and aborted attempts to impose a general consumption tax. The major components of indirect taxation - such as the

automobile tonnage tax and the aircraft fuel tax - were specific in nature and earmarked for specific purposes, representing not so much a "rectification of distortions" as an enhancement of industrial infrastructure.

Among special taxation measures, savings incentives were maintained and expanded. In 1967, interest on small government bonds was declared tax free, a supplement to the tax-free savings program that followed similar procedures and encouraged individuals to hold government bonds. The tax break was initially limited to the first four interest payments on bonds issued between January 1968 and March 1970, but like the tax-free savings program, it was held over until 1987. In 1971, the Workers' Asset Formation Promotion Law was passed, providing yet another tax-free small-lot savings program.

In the late 1960s, the focus of special taxation measures shifted to pollution, housing and welfare, and energy (see Part I of this section for more on antipollution measures). In the area of housing, a home-ownership savings deduction was implemented in 1967, and an owner-occupied home acquisition deduction in 1972. In the area of welfare, tax breaks for the elderly and disabled supplemented other welfare policies and programs. In the field of energy, selective tax breaks were provided for oil resources development and for electric power and natural gas companies, in order to stabilize the nation's energy supplies.

3. Monetary Policy During Internationalization

1) Internationalization and Monetary Policy

By the mid-1960s, trends in overseas markets had come to exert a measurable impact on the domestic financial markets. Though circumstances warranted monetary policy management that took foreign factors more into account, the mind-set of the policy-makers continued to be dominated, even in the late 1960s, by the idea that their job was to find ways to eliminate, or at least neutralize, foreign influences. One example of this is the yen conversion regulations, enacted in 1968, which were aimed at preventing Japanese banks from raising funds on the

Euromarkets and investing them domestically during periods of tight-money, since doing so would have counteracted the effects of monetary policy. These regulations show that the policy-makers had not yet overcome their anxieties concerning the balance of payments, and that they could not see beyond the traditional tools of monetary regulation that relied on a clear division between domestic and foreign financial markets.

In point of fact, the objective conditions for balance-of-payments concerns had been eliminated by 1968. The monetary tightening of 1969 took place even though the balance-of-payments deficit was at an all-time high, because the Price Stabilization Policy Council, meeting in August, affirmed that the priority in economic policy should be shifted away from growth toward price stability due to its concern about inflation. Since 1953, the money supply had been tightened only in response to a deterioration of the balance of payments - in other words, for purely international, as opposed to domestic, reasons. The 1969 rate hike therefore marked a fundamental shift.

It would take some time, however, before this change in thinking took root, and the monetary tightening was, in fact, delayed once before being finally enacted. When it did come about, however, it marked the end of the previous pattern in which the balance-of-payments ceiling served as a constraint on economic policy. Freed from this pattern, the monetary policy-makers now had more leeway for discretion, but at the same time, they faced more difficult challenges. The pattern of monetary tightening following balance-of-payments crises was imposed automatically, and considered one of the “rules of the game.” Without these guidelines, the policy-makers were forced to confront the newly internationalized nature of their work and to develop policies that achieved both domestic and international equilibrium.

Looking back from our perspective today, we can see that exchange rate adjustments serve as a vital component in any attempt to mediate between domestic and international equilibrium. As obvious as this may be to us today, however, and

in spite of the fact that European countries had already adopted such policies, in the late 1960s, changes in the exchange rate were not even considered an option that Japanese policy-makers had at their disposal, let alone use as a tool for monetary regulation. Monetary policy was therefore forced to seek equilibrium on both the domestic and international fronts within the limits imposed by a fixed exchange rate, while the international monetary system was itself cracking. In addition, although the liberalization of foreign exchange was bringing Japan into new international monetary relationships on the outside, the financial sector was still hemmed in by regulations at home. No one had as yet thought, however, that internationalization could be achieved by using deregulation to close the spread between the Japanese and international markets, nor, in fact, were the objective conditions in place that would have allowed a financial structure capable of achieving this to emerge.

Another aspect of internationalization comprised policies designed to create a more "open" system, such as policies aimed at liberalizing capital. Indeed, the idea of an open system informed the many debates on monetary policy that were held during the latter half of the 1960s. These eventually led to what came to be known as the "monetary efficiency" argument, which maintained that "greater efficiency" was needed to create a monetary system that would provide stable, balanced growth within an open environment able to supply the required funding at low rates of interest. One key to this would be the introduction of "appropriate competition," which was defined as a dismantling of "overly protective government regulations" to enable financial institutions to grow stronger as corporate entities, although sufficient limitations would continue to be placed on them to maintain orderly credit and protect depositors. More specifically, there were three areas to be tackled: (1) reevaluation of regulations defining areas of business activity: a review of the compartmentalization of the Japanese financial system, paying special attention to the problem of small-business financing; (2) review of administrative regulations with an eye to promoting competition: establishment of uniform accounting standards and a reexamination of rules on new branch openings designed to "keep

all competitors equal”; (3) creation of an environment conducive to competition: creation of an environment that would allow for mergers between institutions, with a deposit insurance system to provide a safety net.

The creation of a deposit insurance system had first been proposed in the “Deposit Insurance Fund Bill” of 1957 but this had failed to pass the Diet because it was not perceived as sufficiently urgent; under government and Bank of Japan supervision, the financial institutions were on relatively solid footing. The reorientation towards capital liberalization and economic internationalization in the late 1960s changed all this. The recognition of the need for depositor protection was accompanied by the idea of introducing competition as a means of stimulating institutions to make self-motivated efforts to achieve greater efficiency. In 1971, a new “Deposit Insurance Law” was passed on the recommendation of the Financial System Research Committee, and the deposit insurance system began operating on July 1 of that year. The general objective of the law was to lay the groundwork for greater competition between financial institutions and companies as capital liberalization moved forward. More specifically, it was aimed at readying monetary policy for the use of competition as a means of promoting financial efficiency. The debate on the law was to a large extent a rehash of previous debates. In the end, a new quasi-governmental corporation was established, with insurance mandatory for all ordinary, trust, long-term credit, foreign exchange and mutual banks, as well as for all savings and loans and credit unions. The organization of the new corporation, the headquarters of which would be located within the Bank of Japan, was to be kept as simple as possible. Its only duties would be to collect premiums and disburse benefits. Though extremely formalistic, the system did accomplish its purpose, which was to establish a deposit insurance system. Though it assumed a certain amount of cover from financial regulators and protective government administrators, it avoided duplication of regulatory efforts and minimized burdens on financial institutions, thereby reducing conflicts of interest between and within different financial sectors.

2) Government Bond Issues and Monetary Policy

From the perspective of supply and demand for funds, the issuing of bonds on the General Account signaled the start of a new relationship in which the public sector was perennially in deficit and other sectors perennially in surplus. This was, indeed, the relationship that developed in the late 1960s.

The first problem for monetary policy raised by the 1965 government bond issue involved the manner in which it would be underwritten. The Ministry of Finance consistently demanded that the principle of market flotation be adhered to in issuing public bonds, but there were others who were of the opinion that the urgency of the circumstances - bonds were being issued mid-year to cover funding shortfalls - was sufficient to excuse underwriting by the Bank of Japan. The Ministry of Finance held fast to its position that market flotation must be adhered to, however urgent the circumstances. Its reasons were: 1) that it did not want to jettison the prudent fiscal policies it had followed for so many years; 2) that history had shown that a cavalier dependence on the BOJ could result in a destructive bloating of the money supply, a temptation against which market flotation would act as a powerful check; 3) that market flotation would be to the benefit of the “new methods of monetary adjustment” which used bond operations to regulate the money supply; and 4) that market flotation would provide a supply of high-quality bonds that would encourage financial institutions to increase the weight of securities in their portfolios. The Bank of Japan, in its capacity as the central bank, also came out strongly in favor of market flotation. The question was whether the markets had the capacity to absorb the debt: a shortage of funds and “overloans” continued to be chronic problems.

Some compromises were made in order to make the issue floatable. The amount of the issue was reduced (and some of it was underwritten by the Trust Fund Bureau), but liquidity still needed to be provided for, in the interest both of negotiating better issuing conditions and of developing the government bond market. The interest paid on government bonds also had to be worked into the general regulated interest-rate scale in order to maintain order in the financial markets,

however, which clearly meant that they would be a low-liquidity product. An underwriting syndicate similar to that for government-guaranteed bonds was organized, with the city banks taking the lead. Because government bonds fell under the provisions of Article 65 of the Securities and Exchange Law, over-the-counter sales were limited to securities companies, but this deprived the banks of their incentive to underwrite them.

To work around this, the Bank of Japan included long-term government bonds among the debt qualified for bond-market operations, and while government-guaranteed bonds, bank debentures and electric power bonds were only traded as repos (in both directions), long-term government bonds could be bought and sold by the BOJ with no conditions attached. It is important to note, however, that, in conformance with the principles of market flotation, government debt was not open for trading with the BOJ until a year after its issue. (We should acknowledge, however, that these measures were taken not so much to encourage the markets to underwrite government debt, as to provide a boost to the "new methods of monetary adjustment," which by this time had virtually collapsed. A cut in the ODR in 1965 had lowered the interest on BOJ loans to well below the interest available from bond operations, paralyzing the monetary adjustment system from about July of that year.) The government bond operations were carried out extremely effectively, and most of the bonds issued in 1965 and 1966 were eventually absorbed by the BOJ. This system had a significant impact on the banks' attitudes towards government debt and on secondary trading, however, because the BOJ operations, while facilitating market flotation, inhibited inter-bank trading. Commercial banks underwrote the bonds on the expectation that the BOJ would eventually buy them. The emergence of government bonds did not, therefore, bring any immediate changes in the financial structure and had no impact on the trading market.

The size of the government bond issues increased in the early 1970s. Between 1965 and 1974, the Bank of Japan ultimately absorbed some 80 percent of the debt floated, but bank holdings of government bonds rose nevertheless, and the need to

utilize the trading markets became apparent. Meanwhile, the BOJ's government bond holdings ballooned as the middle of the decade approached, becoming the largest factor in increasing the money supply. Nevertheless, the issues were kept within a range that could be absorbed by the existing financial markets and systems. The international currency crisis that occurred at this time brought a large influx of foreign money into Japan, and the resulting glut of funds in the financial markets gave the banks room to increase their government bond holdings without the issues themselves bloating the money supply. The glut of money kept interest rates low as well, staving off any fundamental changes in the artificially low rates paid on government bonds, as well as any need to change the official interest-rate scale because of a large secondary market. Low interest rates meant, moreover, that institutions did not have to take losses on their portfolios from their government bond holdings. Signs appeared in April 1970, however, that issuing conditions would soon be determined more by the market. As part of a package of revisions (hikes) in long-term interest rates, the issuing conditions for government bonds were also modified (the issuing prices were lowered).

In the mid-1960s, as the volume of government bonds on the market accumulated, the "new methods of monetary adjustment" began to function properly.

3) The "Securities Panic" and the Securities Markets

The major factors in the Securities Panic, which reached its peak in 1965, were structural problems within the markets themselves, occurring in the wake of the enormous market expansion in the early 1960s. The problems intensified the contradictions produced by expanding volumes during the high-growth process, because the development of securities markets during the early 1960s brought with it a mechanism that amplified economic swings. When the economy turned sour and one of the factors driving it stalled, the securities markets caused the trend to accelerate in a vicious and potentially destructive spiral. From the standpoint of the financial and monetary policy structure, indirect financing for current needs was expanded and reproduced, and in spite of this, direct financing was positioned as a

marginal fund-raising tool, which meant that it was direct financing that absorbed the structural pressure when the economy went bad.

Share prices peaked in 1961 and began to turn downward. The crises were triggered and the brokers weakened by the fact that declining share prices caused investment trusts to loose much of their attraction. Since they had been booming, the reaction was a rush of cancellations, which forced the trusts to sell shares to raise funds for repayment, and this, in turn, pushed share prices further downward. Meanwhile, the brokerages found themselves being forced to repay deposits they had taken in from the trusts, but the deposits had been used to finance purchases of shares for their inventories. Liquidation of these shares resulted in yet further price slippage.

The Ministry of Finance responded by initiating a review of its securities finance policies, which led to an expansion of the regulatory agencies overseeing the market. In May 1962, a new Securities Division was set up within the Finance Bureau. During that and the following month, the division began to float loans secured with government bonds. In December 1963, the decision was made to reorganize the Securities Division into the Securities Bureau, which was then established in June 1964. In January 1964, a company called Japan Joint Securities was established to prop up the market by purchasing excess shares. In the process, securities regulation became an integral component of financial regulation. Japan Joint Securities was essentially a vehicle to enable the banks to purchase securities; and this proved to be a very powerful program for supporting the market. The only precedent was a similar institution set up as part of the wartime controls, which had also been given a corporate structure and was charged with buying stocks. In January 1965, Japan Joint Securities was supplemented by the Japan Securities Holding Association, an institution established by the brokerages themselves to take over their share holdings.

The brokerages were frail to begin with, and that frailty had not been remedied during the boom years. The bust almost drove many under. The authorities and

brokers worked among themselves to come up with policy supports that would prevent bankruptcies and give the industry a chance to rebuild. The slump of 1965 further exacerbated their problems, however, and brought more pressure to bear. On May 21 of that year, news reports began to circulate about just how bad the situation was at Yamaichi Securities, by far the worst off of the major brokerages, causing a panic among general investors. There was even a run on the brokerage at one point, which threatened to undermine confidence in the entire credit system. The Ministry of Finance consulted with the Bank of Japan and agreed that it was time to apply the provisions of Article 25 of the Bank of Japan Law, which reads, "The Bank of Japan may, with the permission of the competent minister, undertake such businesses as are necessary for the maintenance and fostering of the credit system." The BOJ extended a special loan to Yamaichi. Special loans had been issued repeatedly in the 1920s, up to the credit crisis in 1927, but this was the first time since the enactment of the Bank of Japan Law that the Article 25 provisions had been invoked. The loan was unusual both because of the form it took and because it was made to a securities house. It was justified, however, by the immense ramifications on the public due to Yamaichi's trust business (investment trusts and their deposits), and by the potential the brokerage's failure had to shake an already frail credit system. The loan was for all purposes unsecured, since Yamaichi had no collateral to offer, and it was again the first unsecured loan issued by the BOJ since the Depression. Yamaichi's loan amounted to ¥ 28.2 billion, and another struggling broker, Oi Securities, received ¥ 5.3 billion, for a total of ¥ 33.5 billion in special lending. Altogether, the BOJ extended some ¥ 500 billion in credits to bail out the securities industry, including these special loans and credits extended to Japan Joint Securities, the Japan Securities Holding Association and individual brokerages. In real value, it was roughly equivalent to the amount lent during the credit crisis in 1927.

The Securities and Exchange Law was amended in May 1965 to introduce a new licensing system for brokerages. The debate on licensing began in 1963 and proceeded in parallel to reinforcement of regulatory supervision. The licensing

system gave the Ministry of Finance more regulatory power over the securities houses and allowed it to switch to a system of preventative supervision.

The new system required brokers to incorporate and obtain licenses rather than simply to register, as they had before. Existing companies would have to meet "business reinforcement goals" by September 1966, after which they would be subject to review and, if found worthy, allowed to begin doing business as licensed brokerages in April 1968. The business reinforcement goals consisted of standards for net assets, an ability to offset costs from fee-based income, and improved management. The regulators had, in fact, already been systematically raising net asset standards prior to the amendments. A de facto licensing system had also emerged, since the regulators had used the securities slump as a pretext to instruct new registrants to withdraw their registrations. The amendments were therefore more significant for providing a single, clear statement of the rationalizations to take place, including a deadline for their achievement, than for reforming the system itself. When the stock market was overheating in 1962, there were 601 registered brokers. At the time of the amendments to the Securities and Exchange Law, there were 484, of which 302 applied for licenses. Some 275 of the applicants actually began operations as licensed brokerages; 24 others withdrew their applications, and three were refused. The slump had already begun weeding out the ranks of the brokers. The amendments merely accelerated the process, enabling those which were not up to standards to be eliminated, and the industry as a whole was ultimately strengthened.

The introduction of the licensing system roughly coincided with a jump in share prices that improved the securities companies' results. Yamaichi and Oi (now known as Wako Securities) were able to repay their loans from the Bank of Japan ahead of schedule, as the securities markets recovered rapidly from the residual effects of the panic. Part of this should certainly be ascribed to the rationalizations imposed by the amendments to the Securities and Exchange Law, but a more fundamental factor was the speed with which the Japanese economy overcame the

slump of 1965 and resumed high growth. Another factor more specifically related to the securities industry was the expanding share of "stable" corporate shareholders, which lowered the volume of freely traded stock and drove up prices as a consequence. One reason for the growing number of stable corporate shareholders was the pronounced aversion of individual investors to the markets in the wake of the crash and crisis; another was programs intentionally designed to encourage stable shareholding to offset the upcoming liberalization of capital. The result was that the securities industry continued to be plagued by structural problems even after the high-growth period. The reduced size of the flotation encouraged speculative, capital gains-oriented share price formation, while the issuing companies tended to slight individual shareholders. The brokers, whose business it is to facilitate the issuing and trading of stock, were likewise less concerned with the mass of individual investors than with corporate shareholders. As the bias in favor of companies became more apparent in the brokerages, it provided further impetus for individual investors to leave the markets.

One urgent task facing the trading markets was the creation of a market for bonds following the market flotation of General Account debt in 1965. There was, in fact, little secondary trading of government bonds during the late 1960s, but a pricing mechanism did gradually begin to function and links began to be forged between the trading and issuing markets. The stock issuing market grew rapidly following the first issues of new shares at market prices in January 1969. Although the first convertible bonds (containing a clause permitting conversion of debt to new shares at prevailing market prices) had been issued as early as 1966, this market also took off in 1969. The price adjustment functions provided by these links between issuing and trading markets enabled the markets to begin playing a significant role in resource allocation. At the same time, however, issues of new shares at market prices also constituted an infringement on the expectations and rights of shareholders who had purchased shares earlier, because the general custom had been to distribute new shares at par to shareholders. Finding ways to mediate

between the interests of issuers and shareholders - to return premiums to shareholders - emerged as a problem at this time.

Table 6-10 Shareholding Ratio by Shareholders (1949-73)

(%)

Year	Government (including Local Gov.)	Financial Institution (excluding Investment Trust)	Investment Trust	Securities Companies	Business Corporations	Individuals	Foreigners (including corporations)	Total
1949	2.8	9.9		12.6	5.6	69.1		100.0
1950	3.1	12.6		11.0	11.0	61.3		99.0
1951	1.8	13.0	5.2	9.2	13.8	57.0		100.0
1952	1.0	15.8	6.0	8.4	11.8	55.8	1.2	100.0
1953	0.7	16.3	6.7	7.3	13.5	53.9	1.7	100.1
1954	0.5	16.7	7.0	7.1	13.0	54.0	1.7	100.0
1955	0.4	19.5	4.1	7.9	13.2	53.1	1.8	100.0
1956	0.3	21.7	3.9	7.4	15.7	49.9	1.5	100.4
1957	0.2	21.4	4.7	5.7	16.3	50.1	1.5	99.9
1958	0.3	22.4	6.6	4.4	15.8	49.1	1.5	100.1
1959	0.2	21.7	7.6	3.7	17.5	47.8	1.5	100.0
1960	0.2	23.1	7.5	3.7	17.8	46.3	1.4	100.0
1961	0.2	21.4	8.6	2.8	18.7	46.7	1.7	100.1
1962	0.2	21.5	9.2	2.5	17.7	47.1	1.8	100.0
1963	0.2	21.4	9.5	2.2	17.9	46.7	0.1	98.0
1964	0.2	21.6	7.9	4.4	18.4	45.6	1.9	100.0
1965	0.2	23.4	5.6	5.8	18.4	44.8	1.8	100.0
1966	0.2	26.1	3.7	5.4	18.6	44.1	1.9	100.0
1967	0.3	28.2	2.4	4.4	20.5	42.3	1.9	100.0
1968	0.3	30.3	1.7	2.1	21.4	41.9	2.3	100.0
1969	0.3	30.7	1.2	1.4	22.0	41.1	3.3	100.0
1970	0.3	30.9	1.4	1.2	23.1	39.9	3.2	100.0
1971	0.2	32.6	1.3	1.5	23.6	37.2	3.6	100.0
1972	0.2	33.8	1.3	1.8	26.6	32.7	3.5	99.9
1973	0.2	33.9	1.2	1.5	27.5	32.7	2.9	99.9

Source: Materials from Securities Bureau, Ministry of Finance

Stable shareholding was intentionally encouraged as a means of offsetting the liberalization of capital. When the securities panic knocked many investment trusts out of the market, it was corporate investors that bought most of their shares. This solidified the somewhat unusual share distribution that has come to be identified with the Japanese market - the primacy of corporate shareholders and widespread cross-shareholding. Some were worried that foreign capital would take a controlling

equity position in Japanese firms when capital was liberalized because of the generally low net-worth ratios. Several strategies for preventing this were considered, one of which was the creation of stable shareholding. A May 17, 1967 report by a specialist subcommittee of the Foreign Capital Commission recommended that companies prepare for liberalization by finding stable shareholders and setting up employee share-holding plans, and asked the government to look into the legal framework for doing so. Employee share-holding programs did become widespread in the years that followed, but this did not lead to any significant rise in the percentage of shares in the hands of individual investors. (A report from the Specialist Committee on Capital Liberalization of the Securities Dealers Association of Japan noted that stable shareholding would be more easily encouraged if the limits on self stock holdings and financial institution holdings were relaxed and if holding companies were permitted.)

The internationalization of the securities markets began in the late 1950s, when foreign investors were allowed to invest in Japan and Japanese companies were permitted to issue debt overseas. The brokerages grew stronger, giant securities companies emerged, capital was liberalized and further progress was made in internationalization at the same time. Indeed, in the early 1970s, progress was made in both directions in areas such as investment, securities issuance, and market entry. Among the leading topics of the period were the Phase III capital liberalization of September 1970 (which included securities companies among the "50-percent liberalized" industries), Sony's listing on the New York Stock Exchange in September 1970 - the first such listing by a Japanese company - and the acquisition of seats on the Pacific Coast Exchange by local subsidiaries of the Nikko, Yamaichi and Daiwa brokerages in November 1970. Foreign investors were also playing a larger role on the domestic front, and international factors now had to be taken into consideration in market supervision, a point that was driven home in 1970 when foreign selling triggered a stock market slump.

4. The Currency Crisis and the Floating of the Yen

1) OECD Membership and the Liberalization of Capital

On April 28, 1964, Japan joined the OECD (Organization for Economic Cooperation and Development), which asks its members to liberalize non-current transactions and capital transactions. Japan partially liberalized prior to joining, then obtained approval to keep the implementation of 17 of the 82 items in the organization's bylaws pending (which became 18 items due to the amendments instituted immediately thereafter), with the requirement that it commit itself to a program for the completion of liberalization. Unlike the IMF, the OECD's liberalization standards are not obligatory. They did act as a very strong external incentive for liberalization, however, and it was thanks to that push that liberalization moved forward.

In contrast to the liberalization of trade and foreign exchange, the liberalization of capital transactions was not a condition that Japan was obliged to meet in order to be accepted into the international economy. As a member of the OECD, however, Japan would be expected to abide by the organization's "Capital Movement Liberalization Code," compliance with which had already been demanded by the United States during meetings of the Joint U.S.-Japan Committee on Trade and Economic Affairs. It was clear that a delay would open the door to discriminatory treatment, not to mention diplomatic problems. In March 1967, the government reorganized the Foreign Capital Commission into an advisory committee charged with considering measures to liberalize capital. Several problems were pointed out, including the following: 1) the potential for foreign investors to gain a controlling position in companies with dispersed shareholdings structure and low net-worth ratios; 2) the potential for giant foreign corporations to use their technological advantages to dominate the Japanese market; 3) the potential for fund-raising in Japan by foreign companies to drive up Japanese interest rates; and 4) the impact of "world enterprises" (multinationals) on domestic economic management. Taking the first problem particularly seriously, the committee recommended that stricter

conditions be imposed on securities investment (acquisition of shares in existing companies) than on direct investment (acquisition of shares in new companies).

The report of the Foreign Capital Commission produced a Cabinet decision on June 6, 1967 on "Liberalization of Incoming Direct Investments, etc." The decision, which took effect on July 1, came to be known as "Phase I Capital Liberalization." It divided industries into three categories depending on the type of subsidiaries they were allowed to create through direct investment: 1) wholly-owned subsidiaries; 2) up to 50-percent-owned subsidiaries; or 3) such subsidiaries as would be permitted based on a case-by-case review (essentially non-liberalized industries). Phase II liberalization came on March 1, 1969; Phase III (which included banks and securities companies in the 50-percent liberalized category) followed on September 1, 1970; Phase III and one-half (liberalization of direct investments in the automotive industry) became effective on April 1, 1971, and Phase IV began on August 1, 1971. Final liberalization, permitting wholly-owned subsidiaries in all industries in principle, came on May 1, 1973. Most of these phase changes were marked by an upgrading of ownership categories, from "not permitted" to "50-percent owned" to "wholly-owned." The target for Phase IV was to permit at least 50-percent ownership in all industries, preparing the ground in Japan for liberalization before moving rapidly to the 100-percent level. Meanwhile, the Foreign Capital Law limited foreign securities investments to no more than 15 percent of a company (with no more than 5 percent to be held by any single investor). This ceiling was gradually raised to the OECD standard of 25 percent (10 percent) concurrently with the liberalization of direct investment.

During the lead-up to Phase III, the Foreign Capital Commission considered ways to prevent "raiding," setting up a specialist subcommittee specifically for this purpose. The ideas considered included placing limits on the transfer of shares in companies' articles of incorporation, requiring all trades to go through the stock exchange, placing limits on foreign directorships in the articles of incorporation, relaxing the limits on shareholding by financial institutions, allowing holding

companies to be established in order to provide stable shareholding, and providing greater incentives for employee shareholding programs. Some were even of the opinion that, instead of allowing holding companies, the holdings of Japan Joint Securities ought to be frozen. In the end, however, the subcommittee concluded that there were really no effective, concrete steps the government could take to prevent raids and hostile takeovers.

Technology imports (a sub-category of foreign capital imports), which made a particularly large contribution to postwar reconstruction and growth, had been actively encouraged by the Foreign Capital Law since the early 1950s. Deregulation in the early 1960s resulted in approval of virtually all technology imports, though the formal requirement of case-by-case review was still maintained. The significance of the regulations was not as a general restriction on transactions but as a tool of industrial policy, since the review process could be used to prevent overcompetition in technology imports. After Japan joined the OECD, these restrictions were gradually lifted in a two-phase program, with the first phase beginning on June l, 1968, and the second on July 1, 1972. Computers were the only field in which technology imports continued to be subject to government approval, and these restrictions were lifted on July l, 1974.

2) Development as a Capital Exporter and the Beginning of Economic Cooperation

The long-term capital account turned to an outflow surplus in 1965, the year that marked the beginning of Japan's role as an exporter of long-term capital, which it continues to play today. Factors behind the increase in long-term capital investment included a rise in development investment for the purpose of securing foreign resources, transfers of production to low-wage foreign economies, and expansion of foreign aid. The liberalization of foreign investment followed in the wake of these trends. The ceiling on investment in foreign companies in which Japanese firms maintained de facto control was lifted in three phases in September 1969, August 1970, and July 1971, before full liberalization (automatic approval by the Bank of Japan) was achieved in June 1972. During the early 1970s there was an increase in

both loans and direct investment, and unlike the situation in previous periods, the increases were mostly in “real” foreign investment (as opposed to investment directly related to trade). By nature, most investments were concentrated in the Asian region.

Foreign indirect (securities) investment had in principle been banned up to this time; residents were forbidden from buying foreign securities. In April 1970, partial liberalization began as the scope of permitted investments was gradually widened, first for institutional investors and later for investors as a whole. Most of the liberalization process was enforced after 1972, however, and it was consequently this year that saw the first significant increases in foreign securities investments.

The framework for foreign economic cooperation was put in place in the late 1960s. The organization of the Overseas Economic Cooperation Fund was modified in 1965, and again in 1968, to allow it to draw on FILP funding and diversify its investments. In November 1966, the Asian Development Bank was established, and Japan willingly became its largest investor. When the Asian Development Bank introduced its third bond issue in Tokyo in December 1970, it was the first yen-denominated foreign bond flotation on the Japanese market, an event marking the first step toward Tokyo’s emergence as an international financial center. In 1969, the Bank of Japan began to provide financial cooperation to the World Bank, another manifestation of Japan’s transformation into a creditor nation. By 1970, Japan accounted for 40 percent of the funds raised by the World Bank, ranking second only to the United States.

Foreign economic cooperation actually dates back to 1960, the year in which Japan joined the Development Assistance Group (DAG), an organization which was later to be incorporated into the OECD as the DAC. Spending on foreign economic cooperation in yen terms doubled between 1960 and 1965, and rose 3.8-fold again by the end of the decade. Virtually all of the funding came from the General Account (reparations, grants, technical cooperation, investment in and contributions to international institutions, and investment in the Export-Import Bank of Japan and

Overseas Economic Cooperation Fund) or the FILP (loans via the Export-Import Bank of Japan and Overseas Cooperation Fund), and it rapidly became an important budgetary item. Between 1964 and 1966 General Account spending on foreign aid in the budget rose 2.1-fold and FILP spending 2.3-fold. Foreign aid became one of the most hotly contested issues in the debate on fiscal "rigidity." When massive inflows of foreign funds were seen, starting in 1971, foreign aid was also considered a remedy, and the amount spent on it grew sharply as a result (with the consecutive yen measures of June 1971 and May and October 1972). The need to dispose of foreign funds was pressing enough to cause a considerable portion of Japan's aid to be "untied" (not tied to contracts for Japanese firms). By 1971, Japan ranked second only to the United States in total assistance to developing countries and fifth in official development assistance (ODA). The economic cooperation and aid budget amounted to 0.72 percent of GNP (the DAC target was I percent) by this time. Though these achievements were laudable, needless to say, they also resulted in a greater fiscal burden.

3) Balance of Payments Trends and the 1967 Crisis

The balance of payments trends in the late 1960s were dominated particularly by the expansion of exports (the trade balance) and the invisible trade balance. The establishment of the overall balance of payments in the black was underscored by the fact that the size of the trade surplus exceeded the size of the invisible trade deficit. Another distinguishing characteristic was a consistent deficit (payment surplus) in the long-term capital account, which was itself caused by marked growth in deferred payment credits and loans as a portion of Japanese assets. The growth in deferred-payment credits indicated a shift toward heavy industry in exports; it followed significant growth in exports of ships, machinery, and plants under deferred-credit arrangements. This trend had already been gaining momentum in the early 1960s. The growth in loans, on the other hand, was the result of greater economic cooperation with developing countries.

The payments surplus on the Japanese long-term capital account was structural,

resulting from a stronger economic orientation toward heavy industry and growth in exports, brought about by improved international competitiveness. It was at this time that the pattern of surpluses was set. There was a growing awareness during the late 1960s that the overall shortage of funds had been solved, which combined with new current account surpluses to shift the focus of short-term capital policies toward the increasing instability of the international currency markets. In other words, the authorities tried to impose strict regulations on inflows of short-term capital. This, however, proved difficult, because trade finance was structurally dependent on short-term foreign capital. While the sharp growth in exports during the late sixties was the product of Japanese economic development, exports also became the primary route by which short-term funds, including speculative money, flowed into Japan, making the treatment of short-term funds one of the top policy priorities of the period. Finding ways of dealing with short-term funds became particularly urgent during the international currency upheavals that began in the fall of 1967. Among the major steps taken were: 1) yen conversion regulations introduced in February 1968, which banned the conversion of short-term funds into yen as a means of circumventing Japan's tight-money policies, and 2) stricter regulations on short-term impact loans introduced in September 1968.

The first half of the 1970s was a period of intense volatility for the balance of payments. On the one hand, export growth was racking up surpluses in both the trade balance and the current account; on the other, Japan was also feeling the full impact of the international currency instability. The payments surplus in the long-term capital account shot up to $1 billion, but the increase in the receipts surplus in the short-term capital account was even more dramatic. The result was large swings in the overall balance of payments, which then determined foreign currency reserves. Here again, large swings were seen, but in 1971, the reserves soared to $15 billion, eliminating all worries about foreign currency shortages.

One of the main challenges of the early 1970s was to contain the growing international currency instability, with the result that regulations blocking

speculative short-term funds were fleshed out and made stricter at this time. Having learned from experience that regulations on short-term funds themselves are not necessarily as effective as hoped, the priority was shifted to remedying the structural dependence on short-term foreign funds, including attempts to move from dollar financing to yen financing. Structural improvements are not near-term solutions, however, and the transition to yen financing did not proceed as hoped, in any case. It was thus without a fundamental solution in sight that Japan found itself immersed in the foreign currency crisis of the 1970s.

During 1967 and 1968 the devaluation of the pound, among other factors, was expected to weaken Japan's balance of payments and to trigger a foreign currency crisis. This crisis, as it turned out, was not as bad as expected. With hindsight we can see that major structural changes in the Japanese balance of payments were already under way at this time. In the years that followed, the balance of payments and foreign reserve levels would cease to be issues for economic managers (although it would still take some time for them to feel confident that structural change had indeed taken root). This was exactly the state toward which the policy-makers had been aiming, ever since the war, and its achievement was without doubt the product of their efforts. Unfortunately, the international currency problems, which also began to become apparent in the mid-1960s, were also structural in nature. When U.S. President Richard Nixon took the dollar off the gold standard in 1971, it destroyed the very foundations upon which Japanese postwar economic policy had rested: the Bretton Woods system and, more importantly, the fixed yen/dollar exchange rate. This was the beginning of the end for high growth. Structural changes in the international economy had thrust Japan's fiscal and monetary policies into the post-high-growth era.

4) The International Currency Crisis and "Nixon Shock"

Cracks began appearing in the Bretton Woods system in the late 1960s, and one of the results was to cause Japan's foreign reserves to soar, beginning in about 1968, eventually moving it into third place behind West Germany and the United States in

May 1971. The government began introducing steps to restrain foreign currency growth in 1969, fearing that large increases in foreign reserves would add to domestic inflationary pressure, not to mention the pressure for exchange rate realignment that could be expected from Europe and North America if the reserves grew too sharply. The basic objective of policy at this time was to shelter Japan from the buffetings of the international monetary system, maintaining a rate of ¥ 360 to the dollar and avoiding at all costs revaluation resulting from the yen's appreciation. This led to active policies to reduce foreign currency holdings beginning around 1969. Since both the Ministry of Finance and the Bank of Japan viewed the balance of payments surplus as the result of residual regulations and controls on capital transactions, policies aimed at restraining foreign currency growth took the form of deregulation. At the same time, steps were taken to stimulate domestic demand in hopes of boosting imports through "expansionary equilibrium." Other programs included the use of dollar swaps to promote yen shifts, stricter regulations on yen conversions, and reductions in export incentives. The public sector also paid back its GARIOA/EROA debts and surplus agricultural product credits ahead of schedule in an effort to reduce foreign currency holdings further. These were the conditions that drove the radical liberalization of capital imports and investments described in the preceding sections and allowed Japan to complete liberalization with the removal of the remaining import restrictions. It is difficult to measure just how effective these programs were in restraining foreign currency growth, however. Deregulation included a reworking of the foreign exchange control system itself, and full liberalization was scheduled to begin in 1971, but the "Nixon Shock" and the oil crises that followed it forced policy in the opposite direction, and the controls were actually tightened instead.

Policies aimed at avoiding a revaluation appeared to be the fundamental assumptions on which other policies were based, but they, themselves, did not necessarily have any clear rationale. Both government and industry shared a faith in the 360 yen/dollar rate that had supported growth for so long. The mood of the

country was that revaluation would be counter to Japan's interests, and this made a policy shift all the more difficult.

As this debate was raging, President Nixon announced his New Economic Program on August 15, 1971 (August 16, Japan time), unilaterally declaring that the United States would defend the dollar by: 1) suspending the exchange of U.S. gold reserves or other reserve assets for dollars held by foreign governments; and 2) imposing a 10-percent surtax on imports. This declaration was made with absolutely no advance notice to Japan or Europe. The European countries were divided in their reaction, and there was a sharp conflict of opinion within the EEC, with France advocating a dual-rate system and West Germany pushing for joint flotation. The one thing the parties did agree on, however, was that the foreign exchange markets should be immediately shut down to give the governments time to consider their options.

Japan, by contrast, kept its foreign exchange markets open for another two weeks, but the pace and size of the dollar selling far exceeded government expectations. As the European markets reopened, the Ministry of Finance and Bank of Japan floated the yen provisionally on August 28. During this period, buying by the government added another $4.5 billion to Japan's foreign exchange reserves. Opinions are still divided on whether keeping the markets open was the right choice. Some say the government had not made sufficient preparations to do so, others that open markets helped the foreign exchange banks, which were long on dollars under the yen conversion regulations.

Although united in their criticism of President Nixon's sudden announcement, Europe and Japan also understood that, under the circumstances, even if the U.S. were to bear the brunt of a currency realignment by devaluing the dollar, Japan and the EEC would also have to pay a price. On September 18, the Japanese government issued an announcement to the effect that it would accept a revaluation of the yen. Internationally, it was recognized that multilateral currency realignment was a high-level political issue that would have to be negotiated by the major countries. On

December 17 and 18, the GIO met at the Smithsonian Institute in Washington, D.C., to discuss realignment. Prior to this, President Nixon had agreed in meetings with French President Georges Pompidou on a basic course that included lifting import duties and raising the price of gold. The main concern of the Smithsonian Meeting was to decide the size of the realignment. Japan went to the meetings prepared to walk away and let the yen float if revaluation went beyond what it could accept. It began by negotiating for a 14.15-percent upward revaluation, but strong criticism from America and Europe forced it to accept 16.88 percent, or 308 yen to the dollar. On December 18, the Smithsonian Agreement (the Communiqué of the Ministerial Meeting of the GIO) containing the new agreement was published.

A declaration by the government of Japan on the day of the revaluation proclaimed the merits and significance of the move, but its arguments were not of a sort the public was used to hearing, and any positive effects would, in any case, become apparent only over the long term. The government itself was worried about domestic economic and social difficulties revaluation might bring, particularly damage to exporters and smaller businesses, and its potential deflationary impact. Another government announcement made the same day described near- and medium-term programs to deal with the new rate. These included: 1) improved public welfare, primarily in the areas of housing, living environments, pollution, and care for the elderly; 2) an economic stimulus package; and 3) a vigorous and comprehensive economic policy.

Thus ended the days of the 360 yen/dollar exchange rate, the fundamental article of faith for the economy and people of Japan during the postwar period. With it went the conditions on which reconstruction, high growth, and especially, post-independence efforts to improve competitiveness had been predicated. It was anticipated that revaluation would deal a serious economic blow to the country and that strong fiscal and monetary programs would have to be marshalled in support. The new fiscal and monetary policies that came out of the "Nixon Shock," as it would be known in Japan, clearly demarcate a new phase distinct from the reconstruction and growth periods.