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 l 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.