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		National Burden Rate
		Indirect Tax	Direct Tax	Total	Burden Ratio (%)		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.