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

1. Background and Economic Policies

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

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

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

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

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

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

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

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

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

2. Fiscal Policy for the "Welfare State"

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

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

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

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

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

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

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

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

(In millions of yen)

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

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

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

(In millions of yen)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(In 100 millions of yen, %)

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

Source: Materials from Budget Bureau, Ministry of Finance

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

(In millions of yen)

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

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

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

(In millions of yen)

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

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

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

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

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

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

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

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

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

(In millions of yen)

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

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

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

4) Greater Welfare with a Greater Tax Burden

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

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

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

(In ten billions of Ten Billion Yen)

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

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

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

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

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

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

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

3. Monetary Policy During Internationalization

1) Internationalization and Monetary Policy

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

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

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

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

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

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

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

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

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

2) Government Bond Issues and Monetary Policy

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

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

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

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

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

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

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

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

3) The "Securities Panic" and the Securities Markets

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(%)

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

Source: Materials from Securities Bureau, Ministry of Finance

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

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

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

4. The Currency Crisis and the Floating of the Yen

1) OECD Membership and the Liberalization of Capital

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

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

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

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

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

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

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

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

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

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

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

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

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

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

3) Balance of Payments Trends and the 1967 Crisis

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

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

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

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

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

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

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

4) The International Currency Crisis and "Nixon Shock"

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

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

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

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

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

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

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

December 17 and 18, the GIO met at the Smithsonian Institute in Washington, D.C., to discuss realignment. Prior to this, President Nixon had agreed in meetings with French President Georges Pompidou on a basic course that included lifting import duties and raising the price of gold. The main concern of the Smithsonian Meeting was to decide the size of the realignment. Japan went to the meetings prepared to walk away and let the yen float if revaluation went beyond what it could accept. It began by negotiating for a 14.15-percent upward revaluation, but strong criticism from America and Europe forced it to accept 16.88 percent, or 308 yen to the dollar. On December 18, the Smithsonian Agreement (the Communiqué of the Ministerial Meeting of the GIO) containing the new agreement was published.

A declaration by the government of Japan on the day of the revaluation proclaimed the merits and significance of the move, but its arguments were not of a sort the public was used to hearing, and any positive effects would, in any case, become apparent only over the long term. The government itself was worried about domestic economic and social difficulties revaluation might bring, particularly damage to exporters and smaller businesses, and its potential deflationary impact. Another government announcement made the same day described near- and medium-term programs to deal with the new rate. These included: 1) improved public welfare, primarily in the areas of housing, living environments, pollution, and care for the elderly; 2) an economic stimulus package; and 3) a vigorous and comprehensive economic policy.

Thus ended the days of the 360 yen/dollar exchange rate, the fundamental article of faith for the economy and people of Japan during the postwar period. With it went the conditions on which reconstruction, high growth, and especially, post-independence efforts to improve competitiveness had been predicated. It was anticipated that revaluation would deal a serious economic blow to the country and that strong fiscal and monetary programs would have to be marshalled in support. The new fiscal and monetary policies that came out of the “Nixon Shock,” as it would be known in Japan, clearly demarcate a new phase distinct from the reconstruction and growth periods.