Fiscal and Monetary Policies of Japan

in

Stable Growth Period

— 1972 to 1990 —

April 2010

Office of Historical Studies

Institute of Fiscal and Monetary Policy

Ministry of Finance

Fiscal and Monetary Policies of Japan

in

Stable Growth Period

— 1972 to 1990 —

Contents

List of Figures

List of Tables

Introduction: Overview of Japanese Economic Trends

This book describes fiscal and monetary policy over two decades - FY1972 to 1990.

The period preceding this is commonly known as the “High-Growth” Period, when Japan enjoyed a real economic growth rate of nearly 10% annually since around 1955, after a ten-year postwar reconstruction period. Although the Japanese standard of living increased dramatically and the economy was able to catch up with advanced countries owing to such high growth, the economy fluctuated sharply in the process. On the other hand, in the period treated in this Volume 2, the phase of rapid growth had ended and the growth rate had dropped by half - about 4% on average - and the fluctuation in the growth rate was moderate compared to the preceding period. So we might call this the “Stable-Growth period”. The direction of economic policy management also shifted from the former premise of high growth, to one of stable growth. However, the economy as a whole did not show stability, but encountered challenges one after another, as is described in the following

.

For reference, an overview of the economic trends in the stable growth period is given below.

1. Overview of Economic Situation in each period

Fiscal Year 1972 - 1979: We divided the period from FY 1972 to 1990 into three periods (See Figure-1).
The first period is from FY1972 to 1979.

In August 1971, due to the so-called “Nixon Shock”, or “Dollar Shock”, the fixed exchange rate system of ¥360/$, which had been the foundation of the long-continued postwar high growth, came to an end. Fiscal and monetary stimulation policies were taken to cope with this challenge, while inflationary pressure and speculation fever on real estate continued to grow.

Figure-1 Growth Rate of Real Gross National Expenditure

(Source) Economic and Social Research Institute, Cabinet Office, Government of Japan, *(Chōki Sokyū Shuyō Keiretsu Kokumin Keizai Keisan Hōkoku (Report on National Accounts* from 1955 to 1998)

It was at this point that the first Oil Crisis occurred in 1973, triggering skyrocketing inflation and speculation. With a restraint policy for curbing inflation, excess investment in plants and equipments was revealed, so that the Japanese economy faced its worst recession in the postwar period. The growth rate recorded a minus in FY1974 for the first time since the war.

Such a series of shocks and confusions led to the end of the high growth period of the Japanese economy. It is not simple to explain why the high growth ended. If the end of the growth was due to only external factors, such as the Oil Crisis or the surge in resource prices, it would be hard to explain why the irreversible downward shift occurred, since the oil prices dropped dramatically again afterwards. Therefore, one cannot help but conclude that a mechanism for high economic growth, which included domestic conditions, also vanished in this period. At the time, there was a decrease in suitable locations available for heavy industry (especially in coastal areas), a decline in the ripple effect of large scale investment mainly by such heavy industry, labor shortages (although labor had once been abundant) and a decrease of the consumption expansion effect due to the increase in households which had accompanied the labor shift from rural areas to big cities. All the factors described above emerged at the same time and were mutually relating: they acted to push the path of growth downward. Accordingly, we might say that the external shock merely triggered the negative shift in the Japanese economy. As described above, this trend also reflects a wider change in the social structure.

Figure 1 shows the decline of the growth rate to a little under 5% in the late 1970s, which was half of that of the high growth period. At the same time, at this point there was a period of transition to a low growth path, which was therefore accompanied by social frictions caused by the “streamlining” of management, through the cutting of labor, saving of stock and money, and by the change in the industrial structure from a high “resource consuming” to a “resource saving” structure.

Meanwhile, as the growth pattern changed from “plant and equipment investment-led type” to “export-led type”, the trend in trade and current balance shifted to one of gaining surplus. Yen rates kept rising (yen appreciation) after the introduction of the floating exchange rate system in 1973. Then the GDP on a dollar basis rapidly increased, in spite of the decrease in the growth rate, thanks to yen appreciation. Japan’s national income per capita on a dollar basis was only $211 in 1955 and $1,586 in 1970, then $3,652 in 1975, $8,851 in 1985, and eventually reaching $18,268 in 1988. With the rapid increase in exports of motor vehicles and electric appliances, the presence of the Japanese economy in the world market was heightened during this period. Under these circumstances, the world looked to Japan to be the “driving force (locomotive)” of the world economy, together with West Germany, so that the fiscal deficit and balance of the government bonds progressively increased since stimulatory fiscal actions were taken as being “locomotive”.

Fiscal Year 1980 - 1984: We have designated FY1980－1984 as the second period.

By around 1978 to 1979, as the economic fluctuation after the turmoil gradually settled down, Japan seemed to be back on track again for stable growth. However, when the second Oil Crisis occurred during these years, the resource prices surged again. “Stagflation” - the concurrence of stagnation and inflation - occurred in the early 1980s, and the negative impact on the economy was even more severe than in the first Oil Crisis. However, while the magnitude of the negative impact on the Japanese economy due to the Oil Crisis was the most severe of the advanced countries at time of the first shock (1973), it was the most slight at time of the second one (1978). There are two reasons for this. One is that flexible policy measures, such as a monetary tightening policy, were taken by the Bank of Japan at an early stage to curb inflation during the second Oil Crisis, which was a lesson learned from the first Oil Crisis. The second was the smooth economic adjustment that occurred in the private sector. For example, private management introduced new technologies to save energy and production resources and reorganized their industrial structure in response to the change in the comparative price system, and their labor also voluntarily refrained from making wage increase requests, to avoid a negative spiral of prices and wages. This proved the high ability of the Japanese economy to adjust, and gained attention from the rest of the world.

However, Japan’s economic growth remained low, at around 3%, affected by the world wide recession from FY 1980 to 1983 (although it showed a slight recovery in FY 1984 and 1985). The notable economic features were dollar appreciation and yen depreciation. Although the yen broke through 200 yen (per U.S. dollar), and even reached ¥170/$, it recovered to ¥200/$ in 1980. The yen depreciation was the reverse side phenomenon of the high interest rate for curbing inflation and the dollar appreciation arising from the “Strong Dollar” policy. As for the United States, on the one hand, domestic demand increased with a large scale tax reduction based on the economic policy known as “Reaganomics”. While, on the other hand, the deficit of trade and current balance of payments increased sharply together with the dollar appreciation, as Japan was the largest trade surplus country to the United States, and the export-led economic growth pattern was further intensified. With the background of the trade imbalance, economic friction was generated and the United States, especially, demanded the correction of the trade imbalance.

As for the philosophy regarding economic policy management at the time, the Thatcher Administration in Great Britain and the Reagan Administration in the United States sought “Small Government”: liberalization and deregulation, reliance on economic benefit through market competition and the strengthening of the private sector’s vitality. The philosophy of “Big government” - represented by Keynesianism or the welfare state policy - was criticized severely. At this time, the Japanese government set the reduction of the increased fiscal deficit as the primary target of its economic policy.

Fiscal Year 1985 - 1990: The third period described is from FY 1985 to 1990.

In 1985, the United States changed to a “Strong Dollar” policy. At the G5 meeting (the Group of Five Ministers of Finance and Central Bank Governors’ meeting) in September 1985, the U.S. government obtained agreements and implemented an adjustment of foreign exchange rates, such as dollar depreciation and yen and mark appreciation through international cooperation (the “Plaza Accord”), and put these into effect. The yen was appreciated from ¥240/US.$ to ¥150/US.$ by the Plaza Accord in the following year. Accordingly, the “Yen Appreciation Recession” occurred in 1986, but in 1987 the appreciated exchange rate in turn began to give rise to some economic merits, such as the cost reduction of imported raw materials, which increased the cash reserve of companies. When this excessive liquidity, or funds, flowed into the asset market, such as the real-estate and stock market, asset prices were boosted. Furthermore, increased real-estate related loans by banks led to speculative asset trading. The Bank of Japan had continued its easy money policy and kept the interest rate low from the viewpoint of this being a measure against the yen appreciation recession, the adjustment of yen-dollar exchange rate, and saw “domestic demand expansion” as a countermeasure against the current account imbalance and a measure against the world-wide sharp drop in stock prices in October 1987 (so-called Black Monday). This monetary policy eventually accelerated asset speculation.

The “bubble economy” is thought to have emerged in Japan in 1987-1990. By definition, an economic “bubble” means that asset prices are booming beyond a reasonable price level from the viewpoint of fundamentals. Excessive confidence and expectation regarding the Japanese economy was also the cause of the surge in speculation. This was followed by a sharp rise in land prices, making it difficult for people to purchase their own houses, which became a social issue eventually. The gap between the haves and have-nots was also further widened.

There was not only monetary expansion and an asset bubble at this time. A boom in the real economy emerged as well. As shown in Figure-1, the growth rate in this period recovered to 5% from fiscal year 1987 to 1990 after a drop in 1986. Equipment investment also increased to a high level; private consumption, including that on luxury goods, expanded. Employment increased as well. This boom is often called the “Bubble Economy”. As tax revenue also increased, the issuance of deficit-bonds was zero in 1989.

However, the bubble economy then burst, and the boom turned into economic stagnation. This happened in 1990 and 1991, at the end of the period referred to in this paper. In contrast to the bubble economy, asset prices dropped sharply, and investment in equipment and consumption of durable goods decreased, while employment was cut. As the same time, the balance sheets of companies were getting worse due to excess debt, and there was an accumulation of bad loans in the banking sector and stock appraisal loss due to the drop in stock prices. “Balance sheet adjustment” - in other words, preferential debt repayment by companies and loss disposition by financial institutions - further hindered the flow of funds, and the vicious spiral continued. In particular, since the financial system had been damaged for the first time since the War, it was felt as a great burden to Japanese economy. Thus, the serious recession lasted for a long time.

The following describes the economic trends in each of the periods with numerical data relating to the following areas: public finance, money and finance, prices, asset prices, trade, international balance of payments and foreign exchange rate.

2. Public Finance

In this section, we briefly look at the trends in the fiscal situation.

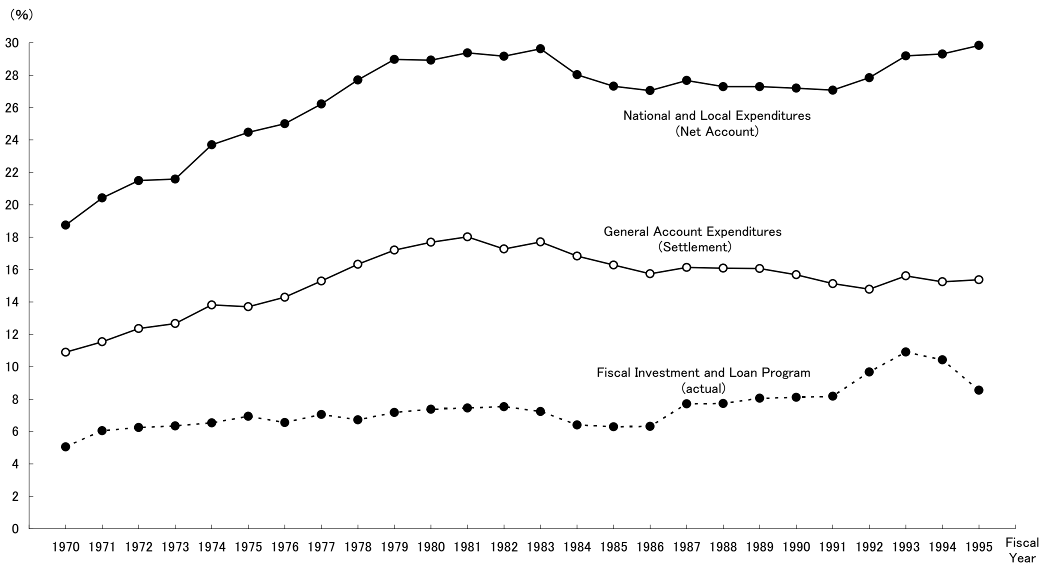
Figure-2 shows the scale of public finance in the ratio to GNE (equivalent to GNP). The General Account expenditure (on a final result basis) was only 11% in FY 1970 but it exceeded 18% in FY 1981, which means it nearly doubled in this period. This was due to the continuous increase in social security-related expenditures and the increase in public works as an economic stimulus measure. As a growing sense of crisis regarding the rise of bond dependency ratio developed, an Ad Hoc Commission on Administrative Reform (the 2nd) was formed in 1981 and a zero ceiling system was introduced as a tool for fiscal reform in the FY1982 budget compilation process. Under this policy, the bond dependency ratio began to decrease gradually and went down to 14% in 1992 (it began to rise again under the following recession).

The net amount of national and local expenditures shifted in a similar manner. The ratio to GNE was over 18% in FY1970, and surged to about 30% in FY1983, but in turn gradually decreased to about 27% in FY1991. The increase was even more rapid than that of the General Account of national finance during the above period.

As for a comparison with other advanced countries in this period, Japan’s fiscal scale was as small as that of the United States. It was also characteristic that the ratio of investment expenditures had been high.

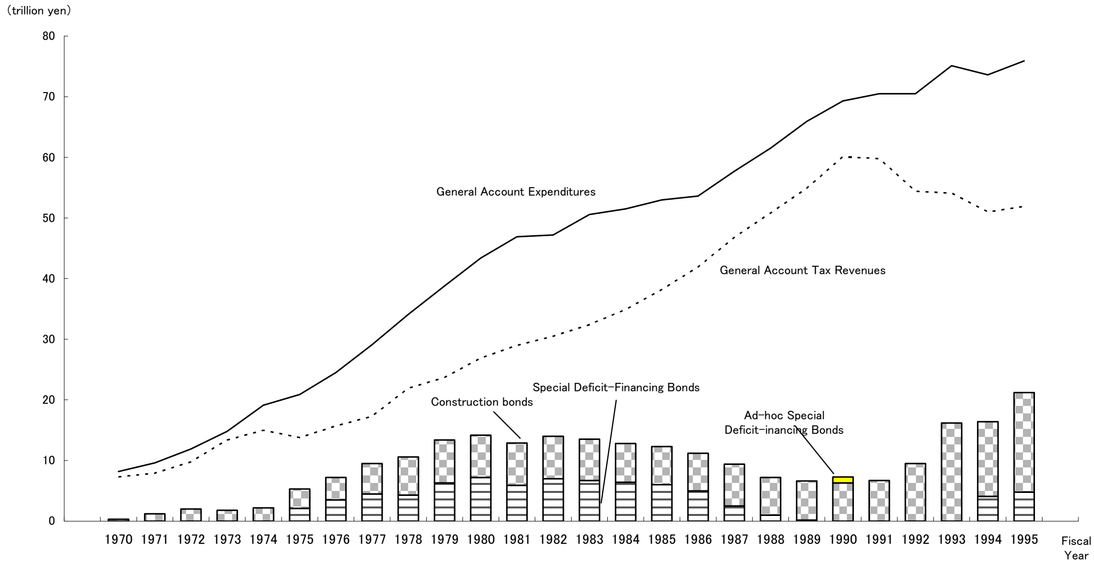
The ratio of the Fiscal Investment and Loan Program (FILP) to GNE increased from about 5% in FY 1970 to about 8% in FY 1982, and then started to decrease in FY 1983. It began to rise again in FY 1987 but the curve is different from the one for expenditures, as described above.

Figure-2 Macro Fiscal Index (to GNE Ratio)



(Source) Economic and Social Research Institute, Cabinet Office, Government of Japan, (Chōki Sokyū Shuyō Keiretsu Kokumin Keizai Keisan Hōkoku [Report on National Accounts from 1955 to 1998] Mininstry of Finance, Zaisei Kinyū Tōkei Geppō [Ministry of Finance Statistics Monthly] No. 372, 541 and 543.

Figure-3 General Account Revenue/Expenditures



Source: Research Division, Budget Bureau, Ministry of Finance "*Zaisei Toukei*" [Budget Statistics] each year, Research and Inte0rnational Division, Secretary Geneeral Secretariat, Board of Audit of Japan, *Kessan Toukei* [Settlement Statistics] Fiscal Year 1989 – 1993 and 1994 – 1998.

Figure-3 is a graph of the national General Account expenditures, tax revenues and government bond issuance. The expenditures increased at a high pace until FY1981, and then slowed down from FY1982 to FY1986, but increased rapidly again from FY1987. On the other hand, tax revenues showed a sluggish increase after FY1975. Therefore, the government started to issue deficit-bonds in FY1975 and kept increasing the issue amount. Construction bonds also increased in the same way. Tax revenue slightly increased after around FY1985, but government bond issuance gradually decreased after FY1983 and it achieved its policy objective of zero deficit-bonds in FY1990. However, due to the collapse of the bubble economy, tax revenue started to decrease from FY1991, and government bond issuance began to increase again.

Table-1 shows the change in expenditure by item in the national General Account budget. It shows a drastic rise in debt servicing costs. Although this rise led to the reduction of other ratios, local government finance-related expenditures and social security-related expenditures relatively increased, and public works related expenditures, expenditures on education and the promotion of science, and other expenditures, showed a tendency to decrease. Among other expenditures, foodstuff control expenditures decreased sharply from 5.6% in FY1970 to 0.6% in FY1990.

Table－1. General Accounting Budget by Major Expenditure Program

(%)

	FY1970	FY1975	FY1980	FY1985	FY1990
Social Security	14.1	19.4	18.9	18.5	16.6
Education and Science	11.7	12.7	10.5	9.2	7.7
National Debt Service	3.5	5.3	12.6	19.1	20.7
Local Finance	21.6	16.2	17.9	18.2	22.9
National Defense	7.2	6.6	5.2	6.0	6.1
Public Works	17.2	15.9	15.6	13.0	10.1
Others	24.7	23.9	19.3	16.0	15.9
Total	100.0	100.0	100.0	100.0	100.0

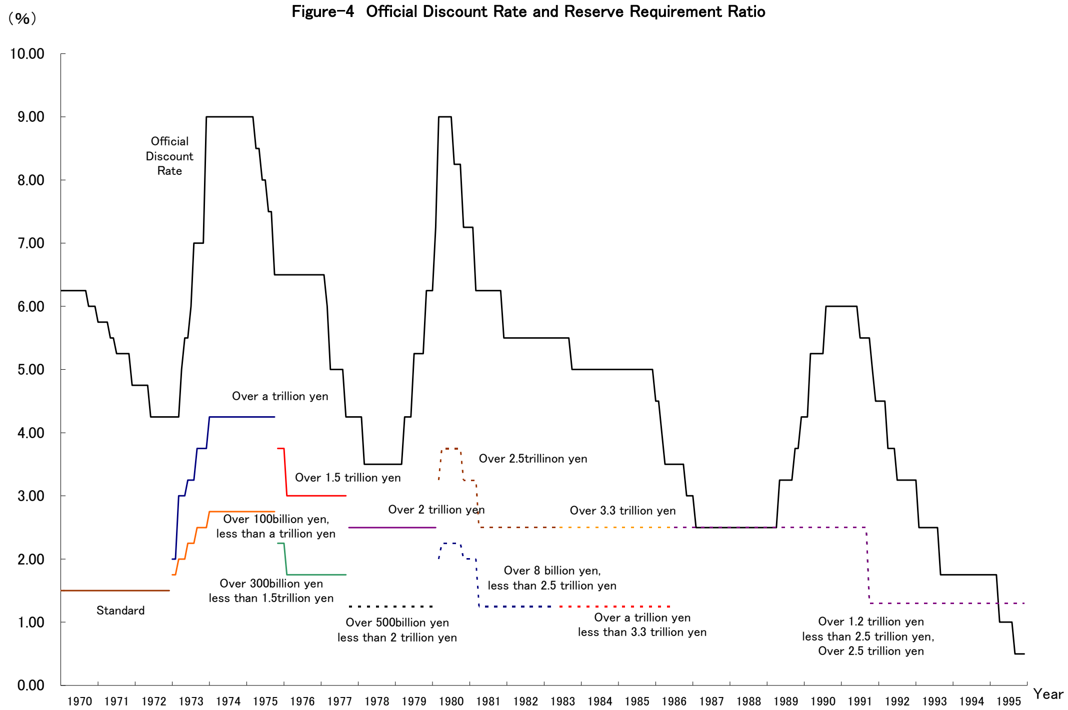
Source: Research Division, Budget Bureau, Ministry of Fiance, *Zaisei-Tōukei* [Budget Statistics] 1991.

3. Money, Prices and Asset Prices

Next is a summary of the trends in money and finance, prices and asset prices. Figure-4 shows the change in monetary policy.

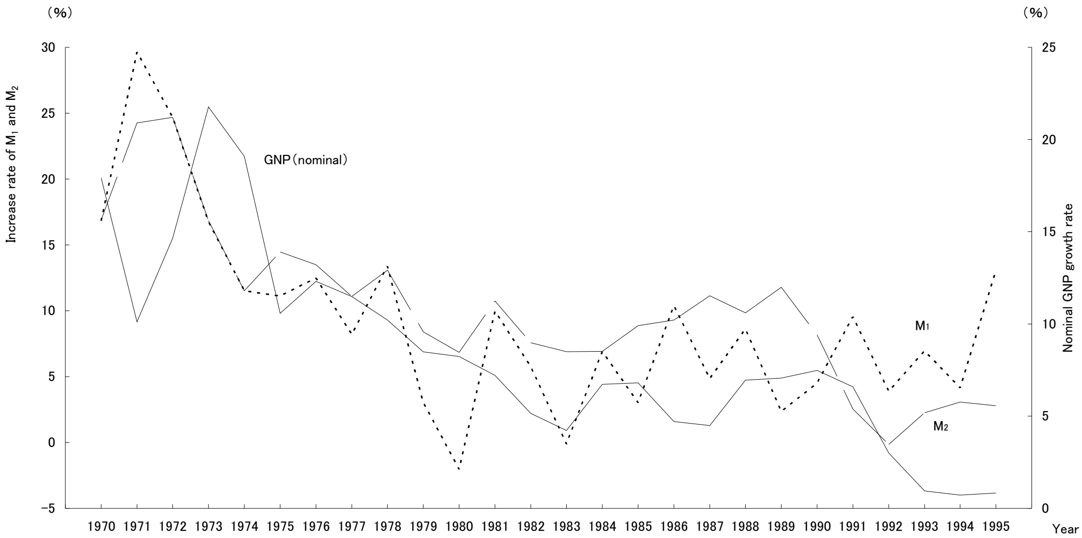
After the monetary easing policy, such as the official discount rate cut which was made in the pessimistic outlook after the 1971 recession and Dollar Shock, monetary policy shifted to a tight stance after 1972, by taking measures which included increasing the official discount rate, raising reserve requirements, and restricting bank loans by the Bank of Japan, in the face of severe economic conditions such as a sharp rise in price levels, real estate speculation and the occurrence of the first Oil Crisis. This monetary easing policy was taken and continued from 1975 to 1978 as the severe recession prevailed and yen appreciation advanced. However, in the period between 1978 and 1979, monetary tightening policy was again adopted, including raising the official discount rate to 9%, in order to control inflation caused by the second Oil Crisis. The monetary easing policy after 1980 aimed at taking measures against potential recession under the global economic slowdown and expanding the domestic demand to cancel the trade imbalance and external trade friction. The policy further continued as a measure against the drastic yen appreciation after the Plaza Accord in 1985, the economic slump resulting from yen appreciation in 1986 and the domestic demand expansion that followed in 1986, as well as to maintain the low interest rate to cope with Black Monday in 1987. Under these circumstances, as the bubble economy overheated, severe monetary tightening was implemented, which began with the official discount rate rise in May 1989 followed by “quantitative restrictions on the expansion of real estate related loans” in March 1990. However, many argue that this should have been done at least one year earlier. Although a series of unprecedented monetary easing measures were taken after the collapse of the bubble economy, the long and deep economic slump continued.

Figure-4 Official Discount Rate and Reserve Requirement Ratio



(Source) Research and Statistics Department, Bank of Japan, *Keizai Tōkei Nenpō* [Economic Statistics Annual] 1997
(Note) The reserve requirement ratios above refers to deposits (except time deposits) of banks, long term credit banks and foreign exchange bank. The reserve requirement ratio is for the deposit balance over 100 billion yen for 1972 and before, but it is for the top 2 rank of the deposit balance for 1973 and after.

Figure-5 Percent changes from previous year of Money Supply and GNP

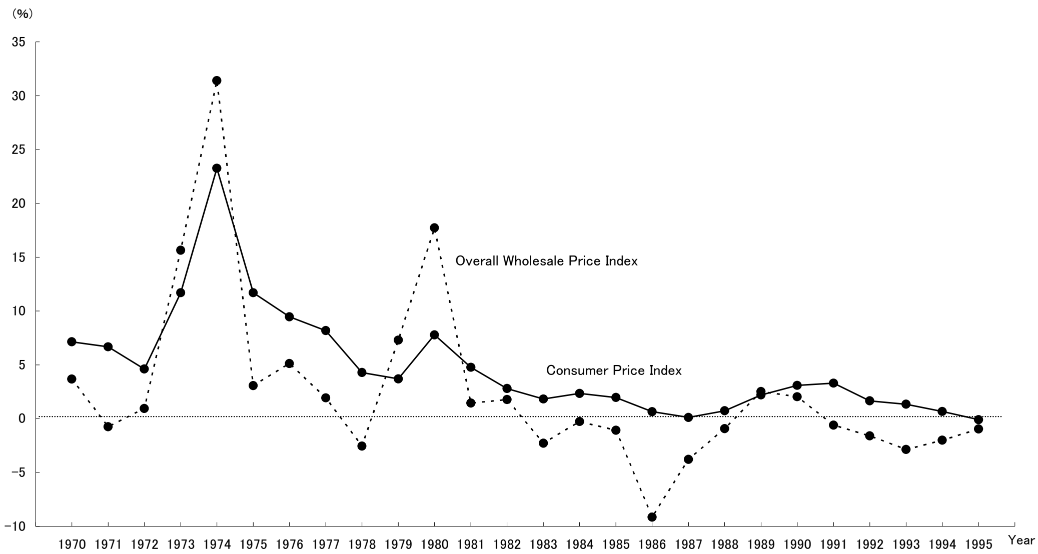


(Source) Economic and Social Research Institute, Cabinet Office, Government of Japan, *Chōki Shokyū Shuyō Keiretsu Kokumin Keizai Keisan Hōkoku* [Report on National Accounts from 1955 to 1998] Research and Statistics Department, Bank of Japan, *Keizai Tōkei Nenpō*. [Economic Statistics Annual], 1995

Money supply under this monetary policy was as is shown in Figure-5. While there is a slight difference in the movement of M_1 and M_2, the figure shows the surge in 1971 and 1972 of an over 20% increase compared with the previous year. Then the increase rate declined, particularly at the time of the second Oil Crisis. The next peak appeared during the bubble economy from 1987 to around 1989. M_2 showed a 10% increase compared to the previous year.

The trend in price levels (Figure-6) reached a peak in 1974 due to the first Oil Crisis. Wholesale prices hiked by over 30%, while consumer prices rose by over 20% compared to the previous year, and remained stable afterwards. In 1980, there was another upturn phase due to the second Oil Crisis, and consumer prices showed only a modest rise as compared to the first one. Prices in the following years became quite stable so that Japan was regarded as an "Honor Student of Prices". It should be noted that general price levels remained stable even during the bubble economy. This made it difficult for the Bank of Japan to take steps toward a monetary tightening policy.

Figure-6 Wholesale/Consumer Price Index (percent changes from previous year)

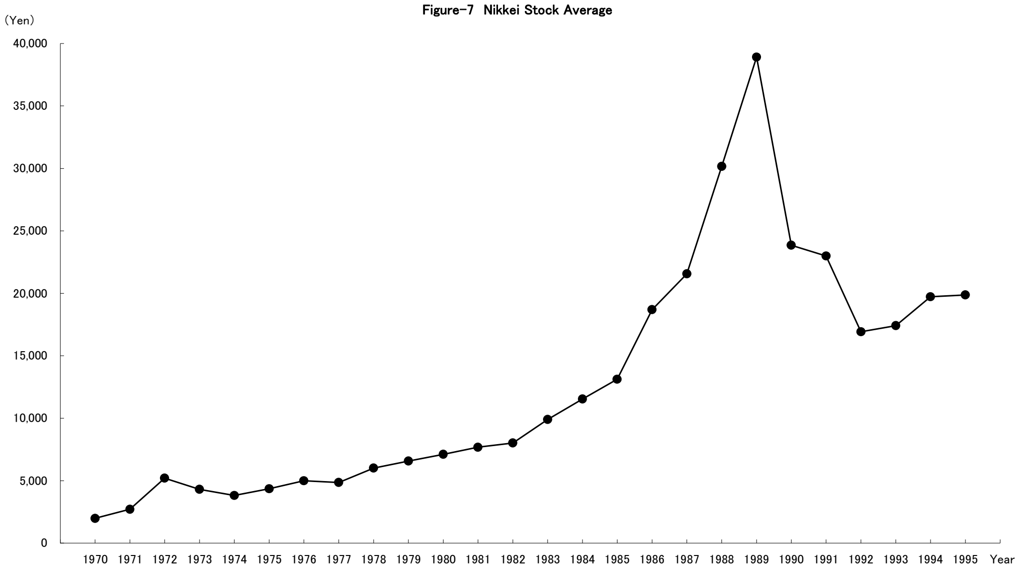


Source: Statictics Bureau, Ministry of Internal Affairs and Communications,*Shōhisha Bukka Shinshū Nenpō* [Consumer Price Index Annual Report] 1995
Note: 1990 average=100

Meanwhile, Figure-7and Figure-8 show the peak in stock prices in 1972 and in land prices in 1973 and 1974. In the bubble economy, stock prices soared to triple between 1985 and 1989, and land prices in 1989 showed another sharp rise of about three times since 1986 (in the 6 largest city areas/commercial and residential areas).

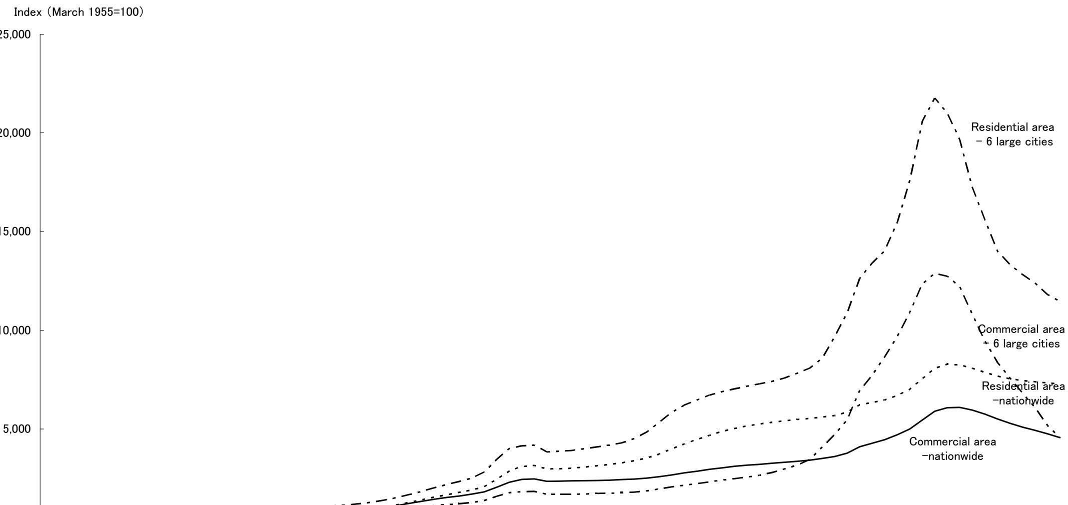
It can be said that the money supply increase in this period caused asset transaction overheating by flowing mainly into asset markets, without raising general price levels.

Figure-7 Nikkei Stock Average



Source: Research and Statistics Department, Bank of Japan., *Keizai Tōkei Nenpō* [Economic Statistics Annual], 1995

Figure-8 Urban Area Land Price Index



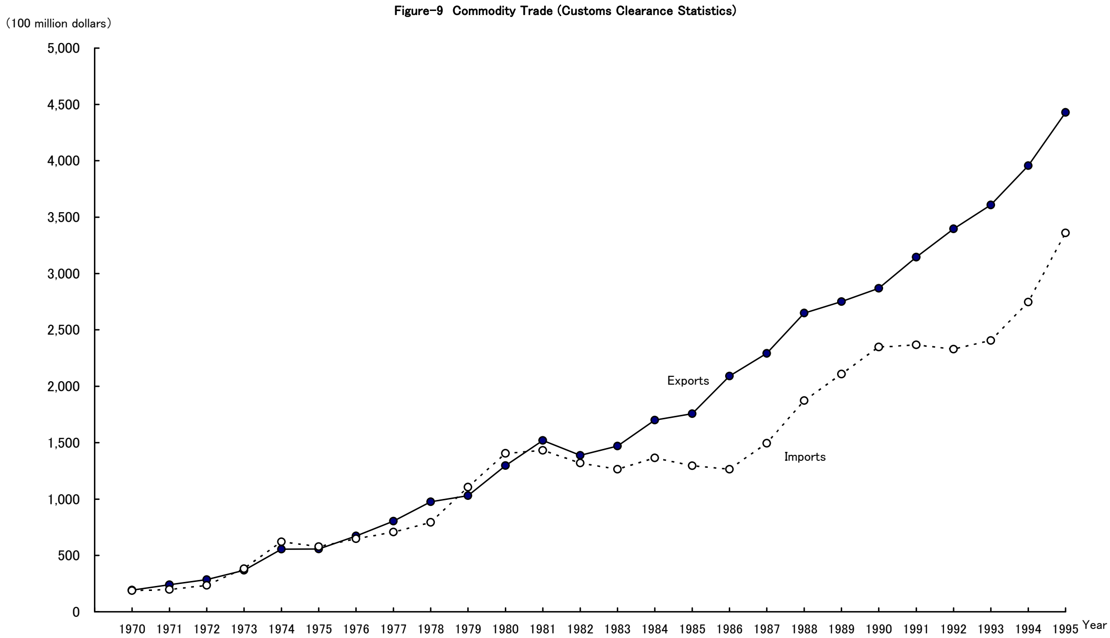
Source: Japan Real Estate Institute, *Shigaichi Kakaku Shisu*, [(Urban Area Land Price Index as of the end of September 1995]

4. International Trade, Balance of Payments and Foreign Exchange Rates

Figure-9 shows the strong increase in exports in this period. Import growth, however, remained low, even though it increased briefly during the two oil crises. These trends eventually led to the increase of trade surplus. Then, imports increased, except from 1990 to 1993.

Export items from Japan mainly comprised of machinery, and particularly centered on the products of high-tech industries. The ratio of finished goods among total imports increased, while that of raw materials such as crude oil decreased. After the drastic yen appreciation in 1985, foreign direct investment from Japan to the United States and East Asia sharply increased, so that a multilateral division of labor among East Asian countries developed and the intra-regional trade ratio began to rise.

Figure-9 Commodity Trade (Customs Clearance Statistics)

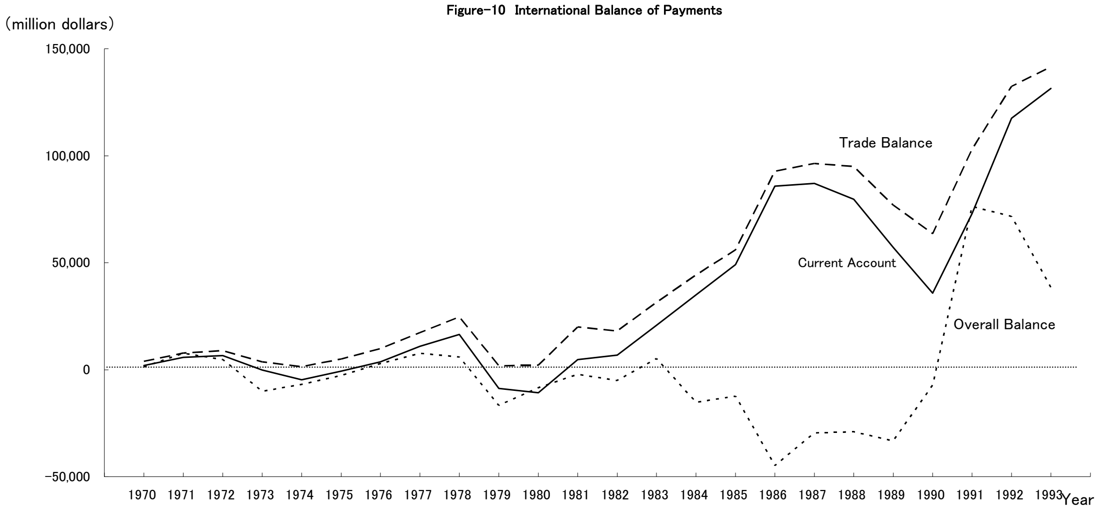


Source: Japan Tariff Association, *Gaikoku Boeki Gaikyo* [The Summary Report on Trade of Japan] January 1996

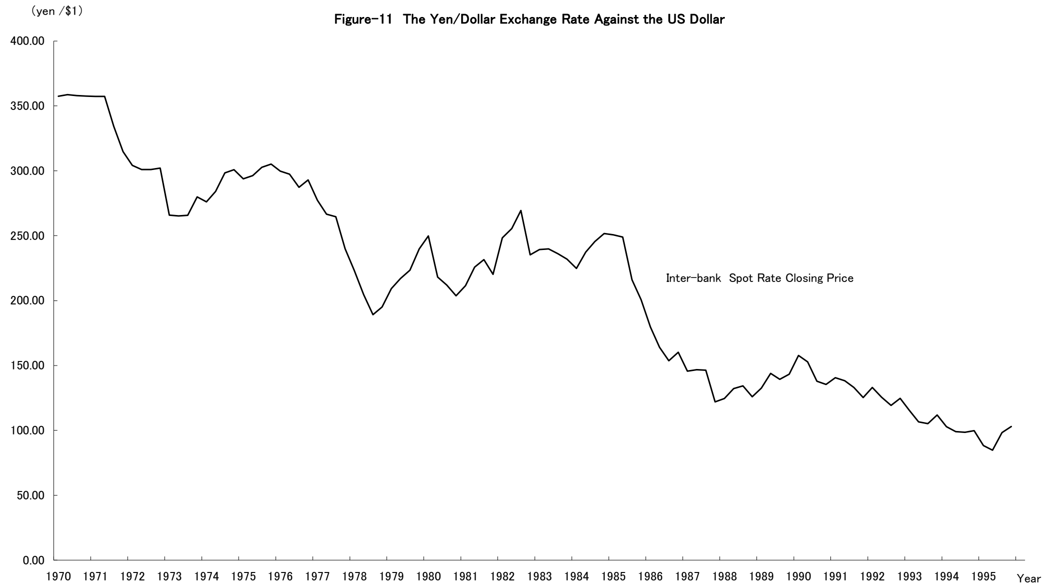
The international balance of payments (Figure-10) showed a trend of an increase of surplus, except for current account deficit periods - from 1973 to 1975 and from 1979 to 1980 - due to the sharp rise in the price of crude oil caused by the two oil crises. In particular, the sharp increase in surplus was dramatic after 1983 and it brought about trade friction. The current account surplus shrank briefly under the bubble economy, but soon reverted to an increase trend. Capital account deficit (capital exports) expanded in turn.

As for the yen-dollar exchange rate (Figure-11), after Japan's withdrawal from the fixed exchange rate system of ¥360/US.$ in August 1971, it was briefly fixed as ¥308/US.$ (16.88% appreciation of the yen) in December of the same year, under the Smithsonian Agreement. However, this could not be maintained and Japan decided to shift to a floating exchange rate system in February 1973. Although the yen rate against the U.S. dollar appreciated from 1977 to 1978 and the yen reached ¥200/$, the yen then depreciated, to around ¥200-250/$ until 1985, because of dollar appreciation due to the

Figure-10 International Balance of Payments



Source: Research and Statistics Department, Bank of Japan, *Keizai Tokei Nenpo* [Economic Statics Annual], 1994



Source: Research and Statistics Department, Bank of Japan, *Keizai Tokai Nenpo* [Economics Statistics Annual], 1994.

capital inflow that accompanied the high interest rate in the United States. After the Plaza Agreement in September 1985, there was a sharp appreciation of the yen. Although the yen depreciated in around 1990, it appreciated again, and hit a record high of ¥79.75/US.$ in 1995.

Chapter 1: Fiscal and Monetary Policies before and after the First Oil Crisis

Section 1 Fiscal policy

1 Fiscal Policy before the First Oil Crisis

External Economic Issues and Countermeasures against Recession. Until the FY1971 budget was compiled, fiscal management had been going relatively well, riding on the strength of high economic growth. However, fiscal authorities were suddenly confronted with a critical situation at the stage of budget implementation, because of various issues at home and abroad. As a result, after the Nixon Shock in August 1971, fiscal authorities concentrated their efforts on eliminating economic unrest and stimulating recovery from the recession.

The compilation of the FY1972 budget was accompanied by various unusual challenges, because of many issues that occurred at home and abroad before and after the budget request deadline at the end of August 1971. More specifically, the Japan Socialist Party gained substantial seats in the ninth election of the House of Councilors in June, as they successfully criticized the government for failures in welfare and pollution policies. Moreover, Okinawa promotion measures were recognized as being an urgent matter because negotiations for the reversion of Okinawa to Japan from the US were in the final stages. Furthermore, even after budget requests were made by the ministries, additional measures were still required to overcome the recession which had been brought about by the “Nixon Shock”, or the shift to a floating exchange rate system. Due to the result of the House of Councilors election, the compilation of the FY1972 budget faced many problems which could only be solved by social security measures, such as the enhancement of social security for the elderly, the reduction of medical expenses for the elderly by infusing public funds, the increase of welfare annuities for the elderly, the increase of medical service fees and introduction of fixed-rate grants for national health insurance.

In addition, as regards public works, a substantial budget increase for road works, caused by full implementation of the automobile weight tax, was an important problem, while other issues like the fourth defense power improvement program and an increase in subsidies for Japanese National Railways still needed to be handled. Meanwhile, the revenue policy of issuing a large amount of government bonds was decided upon, to secure fiscal resources for the implementation of planned policies and measures to stimulate the economy. Then a new question arose as to whether or not the issuance of government bonds should be expanded to include the issuance of special deficit-financing bonds.

While the Fiscal System Council accepted the large amount of bond issuance in its proposal in December 1971, the council required the government to abide by the principle of construction bonds (the principle of allowing the government to issue only capital investment financing bonds) and the principle of prohibiting bond subscription by the government. In its proposal, the council also advised that tax-cuts should be implemented carefully and from a long-term point of view. Under the circumstances, the government decided to expand the size of the budget and issue 1.95 trillion yen in construction bonds, in order to respond quickly to the new international economic developments caused by the currency adjustment, based on a policy of seeking to overcome the economic stagnation and promote national welfare. Therefore, the budget draft of the government in FY1972 contained an increase in public works and the introduction of various measures related to social security, such as free medical care for the elderly. Consequently, the General Account Expenditure increased by 21.8%, the highest increase since FY1966, from the previous year to 11.4677 trillion yen.

In the course of the FY 1972 budget implementation, in May the government set the target ratio for the progress of public works for the first half of the year at 72.4%, to implement the budget effectively. This action was taken as a countermeasure to the delay of the Diet's approval of the budget, and after the government had had to compile a one-month provisional budget. The practical purpose of this action was to make up for the delay in the implementation of measures to stimulate the economy. In addition, as external economic emergency measures, the government cut the official discount rate substantially and increased the Fiscal Investment and Loan Program (FILP). To wrap up this series of economic policies, the "Promotion of External Economic Policy" (the third program for yen) including the promotion of imports and the adjustment of exports by the liberalization and tariff reduction was decided upon, and the FY1972 supplementary budget featuring public investments for economic measures like the initial budget was compiled and approved by the Diet on November 13.

Aggressive Large Budget in the Mood of Revamping Japan. Unlike the previous year, in which the government had continued to struggle with recession and external economic problems, Japan's economy returned to a moderate recovery path, mainly due to domestic demand at the beginning of FY1973, and the economy showed a steady recovery from the autumn of the year onward. Mr. Kakuei Tanaka took over the Cabinet from Mr. Eisaku Sato, and showed his intention to realize aggressive economic policies through the FY1973 budget. The ministries were allowed to submit additional budget requests until the end of September, while budget requests usually had to be submitted by the end of August in ordinary years. Consequently, the total amount of budget requests for public investments increased by 38.0%, as compared to the previous year. Among other public investments, investments in facilities for improving living environments increased by 82.3%, and expenditures on measures for housing increased by 56.9%, respectively, compared to the previous year. In short, budget requests from the ministries for budget compilation were very aggressive compared with those in ordinary years, because the newly formed Cabinet clearly intended to revamp Japan. The fourth defense power improvement program (FY1972-1976), which had been a pending problem, was approved by the Cabinet in October 1972.

The FY1973 budget draft which was compiled under these circumstances was a large-scale and aggressive one. In the draft, the General Account Expenditure increased by 24.6% compared to the previous year, a higher growth rate than that in FY1972. As for respective expenditure items, expenditure on social welfare increased considerably, within the expenditure on social security. Among other matters, the government placed much importance on the expansion of the free medical service for the elderly, the increase in expenditure on the management nursing homes and the increase in home helpers. In addition, the government promoted improving the pension system, securing finances for national health insurance and expanding the coverage of child-care allowances.

Despite the mood created by the idea of revamping Japan, the growth rate of expenditure on public works was relatively low in the Finance Ministry’s original budget draft, but the expenditure increased in the process of negotiations between the MOF and the ministries. On the other hand, the overall expenditure on environmental protection and dealing with environmental pollution was increased by 61.7%, as compared to the previous year, because measures for the prevention of air and water pollution, the development of pollution control technology and the relief of pollution sufferers were enhanced further. On the revenue side, a significant automatic increase of tax revenue was expected, and the revenue from bond issuance was increased by 390 billion yen over the year to 2.34 trillion yen.

Regarding the evaluation of this large-scale and aggressive budget, some critics insist that compiling such a budget was not justified from the view point of price stability, because the price of goods and land were obviously rising. Some people also thought a tightening policy would have been adequate at the time. On the other hand, some point out that the government may have intended to calm down the international opinion that required yen appreciation, by slowing down the increase in exports by raising domestic prices somewhat relative to international prices, as fiscal measures were expected for economic recovery by the business world, and some people had anticipated controlled inflation in order to avoid the further appreciation of yen at the time.

In FY1973 the government had to deal with new problems that came up at the beginning of the year while implementing measures in the budget for revamping Japan. Although Prime Minister Tanaka pledged to make efforts against a further appreciation of the yen in his administrative policy speech in the Diet on January 26, 1973, the yen's exchange rate against the dollar began to surge after the introduction of the floating exchange rate system. Besides, in 1973 wholesale prices soared from the beginning of the year, and consumer prices followed the same trend a little later. In addition, signs that indicated the overheating of the economy could be seen, while investment in plants and equipment increased further. In response to this situation, the government launched a flexible implementation of public works after the passage of the FY1973 provisional and principal budget, in order to show its intention to control economic overheating. As for public works, the government set the target of keeping the concluded contracts within 60% of all projects in the first half of the budget year, and then lowered the target to 50% in June. However, private companies' willingness to invest was still very strong, although the government squeezed or postponed public investment. Import prices continued to go up in spite of the yen appreciation, and the rise of wholesale prices accelerated. In the meantime, the Bank of Japan raised the official discount rate gradually on April 2, May 30, July 2, and August 29. These were the circumstances under which the first Oil Crisis occurred in October.

Fiscal Measures of the Inaugural Year of Japanese Welfare. The economic growth after WWII had clearly made a great contribution to the improvement of national welfare. However, people recognized that economic growth did not always support an increase of welfare when a period of high economic growth was coming to an end. It was true that full-employment had almost been realized and that standards of living had increased significantly due to rapid economic growth, but various issues including environmental damage, overpopulation and congestion in large cities and the collapse of local communities had also emerged. Therefore, the government was required to play a more active role in resource allocation and income redistribution, and people called for more efforts from the government to promote national welfare.

Under the above circumstances, the growth rate (28.8%) of the budget for social security in FY1973 was the highest in ten years and the amount of the social security budget reached two trillion yen for the first time. Looking at the breakdown, there was a significant increase in expenditure on social welfare, mainly for medical and welfare service to the elderly, and expenditure on social insurance, mainly for the improvement of the pension system.

The reason why the FY1973 budget was called the "Budget to overcome the trilemma" was that the budget was expected to realize conflicting goals: namely, to establish an equilibrium in the balance of payments (correction of trade surplus), to ensure stability of prices, and to improve welfare. At first, the Ministry of Finance started compiling the budget based on the view that it would not be impossible to achieve these three conflicting goals at the same time. This was because economic structural reform like import liberalization was possible only in terms of an international trade issue, and the measures for promoting national welfare were expected to contribute to solving the problem of trade surplus. In other words, it was thought that the problems could be solved by diversified operations of fiscal and monetary policies and comprehensive price policy, including measures for price stability. However, this expectation was shattered by the first Oil Crisis, which occurred at the stage of the FY1973 budget implementation. Therefore, the government had to place its highest priority on the containment of overall demand and price stability through a comprehensive price policy, including emergency countermeasures for oil prices, deferment of government spending, the compilation of the FY1973 supplementary budget, and the compilation of the FY1974 budget, as described below.

2 Fiscal Policy after the First Oil Crisis

Supplementary Budget Aiming to Restrain Overall Demand. In order to tackle the serious effects arising from the first Oil Crisis, the government took measures like the strengthening of demand squeeze, the control of public utility charges, securing of daily essentials and stabilization of prices, based on its "Outline of emergency oil measures" and "Immediate emergency measures" decided upon on November 16 and December 22, 1973, respectively. Four more measures for additional expenditure, through the fiscal investment and loan program (FILP) and the compilation of the FY1973 supplementary budget, etc., were put into practice as fiscal measures, although most of these measures could be regarded as passive ones to the rise of price and wages. The FY1973 supplementary budget approved on December 14 was a large one, and it amounted to 989 billion yen, which was equivalent to 6.9% of the FY1973 initial budget. On the expenditure side, the increase from the initial budget including spending on wage increases for public workers amounted to 1.2017 trillion yen, while some expenditure was cut by 213 billion yen. On the revenue side, the increase, which mainly consisted of tax revenue, amounted to 1.5185 trillion yen, while national debt servicing was cut by 530 billion yen. In short, about 70% of the revenue increase was allocated to the increase of expenditure, and about 30% was provided by the reduction of national debt service. As is symbolized by this 530 billion yen cut of the national debt service, the FY1973 supplementary budget directly reflected the steep rise of nominal growth rates and prices. The revenue reflected a considerable increase in tax revenues while the increase in expenditure mainly consisted of wage increases for public workers. Hence, the policy intention of prioritizing demand restraint and price stability was maintained.

The Austere Budget of FY1974. At the beginning of the FY1974 budget compilation, the Cabinet decided in July 1973 that the budget request should be limited to within a 25% increase (ceiling) over the previous year as before. As the FY1974 budget was destined to be an austere one, a reduction in the budget size and the bond dependency ratio were discussed. More specifically, the restraint of public works and the promotion of social security measures became specific issues to be dealt with. Furthermore, the first Oil Crisis encouraged the government to take strong measures to contain overall demand both on the fiscal and monetary fronts. Consequently, the growth rate of expenditure on public works was maintained at zero percent compared to the previous year.

Minister of Finance Takeo Fukuda, who succeeded to the post after his predecessor Mr. Kiichi Aichi died suddenly on November 23, 1973, said in his financial policy speech, “In order to attain price stability, it is essential to restrain overall demand, above all other matters. Therefore, the government will concentrate its efforts on this one objective when it carries out fiscal and monetary measures.” As a result, in the FY 1947 budget draft, the General Account Expenditure amounted to 18.0 trillion yen and the growth rate remained 19.7% over the previous year, which was much lower than the growth rate (24.6%) in the previous year. Specifically, expenditure related to public works was contained to less than the amount in the FY1973 initial budget, while the budget was sufficiently allocated to housing and living environment facilities from the view point of improving national welfare. Regarding the increased items, most noticeably there was a record-high growth rate of 36.7% for expenditure related to social security, which exceeded the growth rate in FY1973 and became the highest in the stable growth period, except for the rapid expenditure growth for mandatory increase and the local allocation tax grants. The substantial increase in expenditure on social security was regarded as consistent with predetermined policy because the government had already showed its intention to maintain the social security budget by improvement of the pension system and increasing child-care allowance in FY1973. As a new systemic revision, the increase in benefits for the senior welfare annuity and the fatherless family welfare annuity, and the extension of the coverage of the child-care allowance were realized. Meanwhile, on the revenue front, the amount of government bond issuance was compressed at 2.2 trillion yen, and consequently the bond dependency rate was reduced.

The implementation of the FY1974 budget started at a restrained pace in the first half of the year. The government first compiled a provisional budget for ten days. Then the Cabinet decided to restrain the contract rate at a little over 20% in the first quarter, in the Cabinet approval of the restraint of budget execution. The effect of these measures appeared as stability in prices by the middle of the year. However, the Cabinet decided to maintain the policy of overall demand restraint, because the underlying demand remained strong. Although this restraining of fiscal management was recognized as an adequate policy when the prices soared and continued to rise after the first Oil Shock, the problem became an issue of timing as to when the price restraining policies, including monetary policy such as discount rate hikes, should be terminated.

From Austerity to Expansion. Immediately after the 10th election of House of Councilors on July 7, 1974, Deputy Prime Minister Takeo Miki criticized the political attitude of Prime Minister Kakuei Tanaka and resigned from his position. This was followed by the resignation of Finance Minister Takeo Fukuda and Director General of Administrative Management Agency Shigeru Hori. As a result, the solidarity of the Liberal Democratic Party collapsed. At the same time, the preparation of the FY1975 budget which shifted to an expansionary budget, moved into high gear under the leadership of Minister of Finance Masayoshi Ohira, the former Minister of Foreign Affairs.

The expansionary feature of the FY1975 budget was not included from the beginning. On the contrary, maintaining a restraining policy - such as by the reduction of budget scale, deferment of large tax cuts, and lowering of bond dependency rate - was the initial policy goal. Actually, the Cabinet approved the postponement of the budget execution on August 30 and the restraint of contracts for public works in the third quarter of the year was decided. In addition, in its recommendations, the Fiscal System Council required the government to reduce the scale of the FY1975 budget, make cutbacks in bond issuance and adjust the tax burden. In this way, a restraining approach was firmly maintained as the initial budgeting policy. However, after Mr. Miki took over the Cabinet from Mr. Tanaka, the FY1974 supplementary budget (approved on December 23) which was compiled before the FY1975 budget, inevitably became a rather expansionary one - not necessarily because of policy intention, but because of price escalation. The amount of the supplementary budget was doubled from the FY1973 supplementary budget and it amounted to 2,098.7 billion yen. Although a tax revenue of 1,612 billion yen was prepared as a part of the financial resources for the supplementary budget, there was a significant increase in expenditure caused by increasing the local allocation tax grant, adjustment of salaries for civil servants and transfer of funds to the Foodstuff Control Special Account associated with the rice price hike. Therefore, the amount of bond issuance was not reduced.

At the beginning of 1975, the economic recovery slowed down, as the effects of the austere FY1974 budget became widespread. Moreover, a significant shortage of tax revenue was expected. The slowdown of business activity, decrease of corporate profit and job uncertainty became obvious. It can be said that government policy changed from a conventional high growth one to a stable growth one around this period. In other words the government adopted an aggressive fiscal policy in order to realize stable economic recovery, as well as to cope with imbalanced growth among industries, delayed employment recovery and a large number of corporate bankruptcies. The General Account Expenditure of the FY1975 budget draft increased by 24.5% over the previous year and amounted to 21.2898 trillion yen. This growth rate was the second highest after the FY1973 budget. As for expenditure, social security-related spending including spending to enhance measures for families receiving public assistance and the elderly increased by 1.0361 trillion yen (+35.8%) and amounted to 3.9269 trillion yen. Local allocation tax grants were also significantly increased by 1.0264 trillion yen and amounted to 4.4086 trillion yen. While public work-related spending was restrained, the growth rate of natural increase expenditure exceeded that in FY1974. Therefore, the budget draft gave a strong impression, as a whole, that it was an expansionary budget.

Measures against the Significant Tax Revenue Shortfall. The overall demand restraining policy resulted in a negative economic growth rate for the first time in the postwar period. However, the signs of recession, such as the slowdown in production and increase in unemployment, were thought to be a byproduct that arose in the process of overcoming the sharp rise in prices. In the meantime, the significant shortfall in tax revenues brought about by the recession became a problem, as the recession and the stagnation became worse and more obvious.

Thus, the trend in tax revenue was different from the initial expectation in early

1975 as stated above, and the tax revenue shortage for FY1974 on a revised basis after the supplementary budget was expected to be ¥771.1 billion. With regard to the shortage, a revision of the "Cabinet order implementing the Law on National Tax Revenue Adjustment Fund" was approved by the Cabinet on April 15, 1975. This law specified that the tax revenue collected in April should belong to the year when the tax payer was liable for the tax. In other words, even though the tax revenue belonged to FY1975 according to the conventional method, it was changed to tax revenue for FY1974 if the day of the tax liability in each case was effective on a day in FY1974. Therefore, ¥433 billion was added to the tax revenue, and the tax revenue shortage for FY1974 was decreased to ¥338.1 billion. In addition, as additional non-tax revenue of ¥259.9 billion was estimated and expenditures of ¥181 billion had been unused, the tax revenue shortage for FY1974 was compensated for, and finally even some surplus was left over.

In FY1975, too, a significant tax revenue shortage was estimated and there were even predictions of a natural decrease in tax revenue, which had never happened before during the high economic growth period. For natural decreases in tax revenue, if bond revenue was applied to fiscal resources, it would depend heavily on special deficit-financing bonds. There was concern that it would have a serious negative impact on the fiscal management to follow if such a trend were to continue.

Regarding the fiscal policy in FY1975, the government had to shift their policy priority from the stabilization of prices to overcoming the recession. The government took economic stimulation measures in sequence, as follows: the first economic measure was taken in February 1975 (the facilitation of loans for small and medium companies, speeding up contracted public works contracts); the second economic measure was taken in March (the smooth execution of public works expenditures); and the third economic measure was taken in June (promotion of housing construction and the extension of loans for environmental pollution prevention works, etc). The Japanese government then took a fourth economic measure in September (additional public works and interest rate cuts, etc.), although demand for private equipment investment, consumption and exports remained stagnant. The government stance on fiscal and economic policy changed definitively from a policy to restrain overall demand to an economic stimulation policy. These positive fiscal and monetary policies, in other words, the implementation of the four economic measures and the official discount rate cut by the Bank of Japan, represented Japan's posture to tackle the various issues related to the changing international economy.

Under these circumstances, the FY1975 supplementary budget was approved on November 7. As for the expenditures, the additional budgetary correction was ¥823 billion, which included public works and hikes in civil servants' wages. On the other hand, the deducted corrections, such as a reduction in local allocation tax grants (¥1.1005 trillion), were ¥1.2747 trillion. As for the revenue side, there was a deducted correction including tax revenues (such as corporation tax and income tax) and monopoly profit from Salt and Tobacco of ¥4.0197 trillion and an additional correction, which mainly comprised of bond revenue, of ¥3.5680 trillion. Therefore, the budgetary correction decreased by ¥451.6 billion, which reflected a significant tax revenue shortage. Meanwhile, regarding the local allocation tax grants, a reduction of the three national taxes (income tax, corporation tax and liquor tax) resulted in a significant decrease in allocations from the General Account, as mentioned above, but the total amount of local allocation tax grants was secured as planned in the initial budget by taking into consideration the local fiscal management. Specifically, the requirements of the local allocation tax grants included the additional ¥41.5 billion for the hike in local civil servants' wages, other than the compensation of the reduction of ¥1.1005 trillion as mentioned earlier, so a total of ¥1.1420 trillion of the allocation was required. Therefore, the Special Account for Allotment of Local Allocation Tax and Transferred Tax borrowed ¥1.1200 trillion from Trust Fund Bureau Funds and the temporary special local distributions, and ¥22 billion in the General Account was accepted as the special treatment only for FY1975. However, borrowing for the Special Account for Allotment of Local Allocation Tax and Transferred Tax from the Trust Fund Bureau continued as a significant compensation measure for local finance for over 10 years since then. The total amount of debts also accumulated.

In the end, the tax revenue shortage of ¥3.8790 trillion in FY1975 was compensated by the supplementary budget as above, so that government bonds of ¥5.4800 trillion were issued. The government bonds included special deficit-financing bonds of ¥2.2900 trillion based on the "Law concerning a Special Treatment for Public Bond Issue for FY1975" and construction bonds of ¥1.1900 trillion. This showed that the purpose of the supplementary budget was not only as a measure against tax revenue shortage, but also by such measures as adding public works, part of the government's efforts to promote the economy. It aimed to show that the revenue shortage was too large and the issuance of special deficit-financing bonds was unusual, by issuing not only construction bonds under Article 4 of the "Public Finance Law", but also by issuing deficit financing bonds. Accordingly, since the FY1975 supplementary budget, a large scale financing system dependent on the special deficit-financing bonds was begun.

However, the government financial dependence on special deficit-financing bonds was not a sound or desirable fiscal stance, and therefore, the top priority task for the government became to restore a sound fiscal system as soon as possible.

Positive Budgeting under Large-scale Government Bond Issues. The Japanese economy started to recover at the end of FY1975, thanks to the effects of the four sets of economic measures in 1975. The basic policy for fiscal management accordingly significantly shifted to a new direction. The FY1976 budget compilation was devised to implement the Fiscal System Council's interim report on "How the administrative finance should be in an era of stable growth" in July 1975, to restrain budget expansion and to streamline expenses drastically. The guideline for budget requests was decreased from +25%, which it had been since FY1968, to +15% (See Table 1-1-1).

Table 1-1-1 Change of Budgetary Requests

Fiscal Year 36～39 budgetary request	Within the range of 50%	
Fiscal Year 40～42budgetary request	Within the range of 30%	
Fiscal Year 43～50budgetary request	Within the range of 25%	
Fiscal Year 51 budgetary request	Within the range of 15%	
Fiscal Year 52 budgetary request	General Administrative Expense 10% increase Others 15% increase	Within the range of total amount
Fiscal Year 53,54 budgetary request (approved by the Cabinet)	General Administrative Expense Business Expense 0 Others 5% increase Others 13.5% increase	Within the range of total amount
Fiscal Year 55 budgetary request (54.7.31)	General Administrative Expense 0 Others 10% increase	Within the range of total amount
Fiscal Year 56 budgetary request (55.7.29)	General Administrative Expense 0 Others 7.5% increase	Within the range of total amount
Fiscal Year 57 budgetary request (56.6.5)	0	
Fiscal Year 58 budgetary request (57.7.9)	Within − 5% (except investment expense)	
Fiscal Year 59 budgetary request (58.7.12)	Ordinary − 10% Investment section − 5%	Within the range of total amount
Fiscal Year 60 Budgetary Request Standard (59.7.31)	Ordinary − 10% Investment section − 5%	Within the range of total amount
Fiscal Year 61 Budgetary Request Standard (60.7.26)	Ordinary − 10% Investment section − 5%	Within the range of total amount
Fiscal Year 62 Budgetary Request Standard (61.7.21)	Ordinary − 10% Investment section − 5%	Within the range of total amount
Fiscal Year 63 Budgetary Request Standard (62.7.31)	Ordinary − 10% Investment section 0%	Within the range of total amount
Fiscal Year 1990 Budgetary Request Standard (63.7.15)	Ordinary − 10% Investment section 0%	Within the range of total amount
Fiscal Year 1991 Budgetary Request Standard (1.7.11)	Ordinary − 10% Investment section 0%	Within the range of total amount

(Source) "National Budget" Finance Research Council, Annual Issue (Hase Shobo)

(Note) Fiscal Year 85 ～Fiscal Year 1991: Industrial Investment Special Account other than above (NTT Stock) ¥1.3 trillion reported.

The FY1976 government budget draft restrained the General Account expenditures to ¥24.2960 trillion, or a 14.1% increase compared to the initial budget of the previous year. But at the same time, economic measures including public works had to be taken under the revenue shortage, due to the insufficient tax revenues. The expenditures were heavily allocated to public works, which was effective in creating aggregate demand. In addition, this shows the enhancement of social security measures (e.g. raising the level of lifestyle assistance and the amount of pensions, etc.) to adapt to the new economic growth pattern. In terms of revenue, government bonds issued to compensate for tax revenue shortage increased to ¥7.2750 trillion, or showed an increase of ¥5.2750 trillion over the previous fiscal year, and the bond dependency ratio was 29.9%, an increase by 20.5% points over the previous fiscal year and the highest level since World War II. Moreover, ¥3.7500 trillion or more than half of bond revenues were special deficit-financing bonds appropriated in an initial budget.

In the discussion for the budget in the Diet, the opposition parties requested the target year for, and the measures necessary for escaping from the heavy government dependence on special deficit-financing bonds. Therefore, the MOF, for the first time, proposed its “Mid-term Fiscal Outlook”, estimating revenues and expenditures up until FY1980, at the Committee on Budget of the House of Representatives on February 6, 1976. This proposal showed the target year for making the special deficit-financing bonds issuance zero for the two cases of FY1979 and FY 1980, with a high tax revenue was assumed in both cases. For the FY1980 case, in spite of the tax revenue increase, the outstanding government debt including construction bonds was estimated at more than ¥51 trillion, so a tight budget was needed. In either case, it stated that the budget needed to be compiled based on the mid- and long-term viewpoint of the “Mid-term Fiscal Outlook” proposal.

As stated earlier, government policy had shifted to one for the stable growth of the economy at the execution stage of FY1976 budget, but there was economic friction due to changes in the industrial structure such as unbalance among types of industry, the delay in employment recovery and the increase in business bankruptcy. Therefore, the economic policy, “On the Current Economic Situation and the Measures to cope with it” was decided upon by Ministerial Conference for Economic Measures in November 1976, aiming to mitigate potential frictions in the process of economic recovery and to achieve sustainable stable growth. Based on these policies, the seven measures were taken, including the promotion of public works execution, partial release for reductions in construction work for Japanese National Railways and the Nippon Telegraph and Telephone Public Corporation, the promotion of housing construction, the promotion of the private equipment investment such as in the electric power and oil refinery business, the promotion of plant exports, measures for small and medium-sized companies and employment measures. The FY1976 supplementary budget was thus approved on February 22, 1977.

As for the FY1977 budget, in which no significant natural increase of revenues was expected, the government decided to reduce expenditures to escape from the dependency on special deficit-financing bonds, and established more severe budget standards compared to those of FY1976. The budget provided for an increase in general administrative expenses while the remainder (policy-related expenditure) should be restrained to within 10% and 15% respectively for the initial budget. However, natural increase expenditures, including national debt service, local allocation tax grants, social security-related expenditures and official wages, were far in excess of those of the previous year.

Meanwhile, policymakers in some countries were insisting on “Locomotive Theory”, which claimed that the role of the United States, West Germany and Japan was to be the driving force of the world economy, after their excellent economic performance around the time of the Puerto Rico Summit Conference on June 27-28 in 1976, and thus domestic demand expansion for this purpose was reflected in Japanese fiscal policies. Consequently, the fiscal authorities in Japan, who were aiming for fiscal soundness, were also requested to achieve this task at the same time in the FY1977 budget. The government budget draft was compiled as ¥28.5143 trillion in General Account expenditures, a 17.4% increase compared to the previous year, and public works-related expenditures were increased to 21.4% compared to the previous year, under the basic policy to promote a steady economic recovery while stabilizing prices. Hence, such an aggressive budget with a tremendous amount of government bond issuance (¥7.2750 trillion in FY1976 and ¥8.4800 trillion in FY1977) was compiled, given the background of the delay in economic recovery and current account surplus that existed at the time of compiling the budget for FY1976 and FY1977. The effects of continuous public investments in positive macro policies came out gradually, and shifted in an upward direction from November 1977. The production turnover level in March 1978 exceeded the level before the Oil Crisis.

The guideline for FY1978 budget requests showed a 5% increase in general administrative expenses, while the remainder, excluding current expenses, was an increase of 13.5%. The ceiling was further restrained compared to FY1977 to cope with the fiscal crisis, and about 30% of revenue was to be covered by issuing special deficit-financing bonds for the three years after FY1975. In the meantime, faced with high demand for taking economic measures, the FY1978 budget was compiled as a 15-month budget, combined with the FY1977 supplementary (secondary) budget, including drastic measures to stimulate the economy such as housing construction. As a result of these measures, the FY1978 government budget draft was approved as follows: General Account expenditures ¥34.2950 trillion, which was a 20.3% increase from the previous year; with government bonds issued for ¥10. 9850 trillion, an increase by ¥2.5050 trillion compared to the previous year.

Japan, Germany, and "Locomotive Theory" and the Enforcement of Economic Measures. Five years after the first Oil Crisis, the economy began to be led by domestic demand again in FY1978. In the second half of the fiscal year in particular, a moderate economic recovery led by the private demand continued. This was the result of various efforts to adapt to the economic environment at home and abroad, such as the promotion of public works execution from April 1978, the declaration of 7% growth in the Bonn Summit in July, and FY1978 supplementary budget compilation (approved on October 12), based upon comprehensive economic measures taken in September 1978.

In the first half of FY1978, the economic recovery was negatively affected by a significant reduction of exports due to a drastic yen appreciation, and there was a continuous substantial surplus trend in the current account of the balance of payments. In the Bonn Summit conducted in July 1978, under these circumstances, the participant countries were talking about Japan and Germany and "Locomotive Theory". Japan made a commitment (1) to make efforts to achieve a real growth rate of 7%, which was an increase of about 1.5% points from the previous year, (2) to increase imports and restrain exports in order to reduce the current account surplus, (3) to double its Official Development Assistance within 3 years. The government decided on comprehensive economic measures, mainly comprising domestic demand expansion measures, by significantly adding public investment from a fiscal viewpoint. Then, in addition, the FY1978 supplementary budget was compiled and approved on October 13, in order to implement these measures.

The Bond dependency ratio in FY1978 remained at a high level sequentially from the previous year, because of the additions of government bond issuance for the supplementary budget. Therefore, in the process of FY1979 budget compilation, achieving fiscal soundness was an important issue from an early stage, so that the Fiscal System Council requested the government to achieve fiscal soundness by restraining the expenditure, or reducing the special deficit-financing bond, and making the guidelines for FY1978 budget request level the same as that for FY1978, as well as further consolidating subsidies. The Council also stated that Japan should conduct fiscal reconstruction by restraining expenses including administrative reform. However, the Liberal Democratic Party and business circles showed strong expectations for an economy-stimulating type of budget compilation. The FY1979 government budget draft compiled under these conditions was as follows: General Account expenditures ¥38.6001 trillion, or a 12.6% increase compared to the initial budget of the previous year. The expenditures included considerable increases, such as 20.0% increase in works-related expenditures, and 12.5% in social security-related expenditures. In terms of revenue, due to insufficient tax revenues, bond revenues were ¥15.2700 trillion, which was an increase of ¥4.2850 trillion from the previous year, and the special deficit-financing bonds were increased to ¥8.0550 trillion. The bond dependency ratio was 39.6％, which represented the peak during the "stable growth period". Among the major expenditure programs in the budget, the increase in national debt service recorded the highest among expenditures - 26.6％ - and it was a symbolic record that the amount reached ¥4 trillion.

The Target of Delivering Government Finances from their Dependence on Deficit-bonds by Fiscal year 1984. On January 31, 1979, the MOF submitted the "Medium-term fiscal outlook (on a FY1979 basis)" to the Diet as a model for Japanese government finance according to the FY1979 budget draft. This estimate was consistent with the "New Economic and Social Seven-Year Plan" which had been accepted by the Cabinet in January and it showed a model case of the fiscal outlook of FY1985 - the final year of the program - by a macro econometric method and not by summation method. However, in terms of the long term economic program, delivering government finances from its dependence on special deficit-financing bonds was targeted for FY1984 (in the program with a "target of delivering government finances from its dependence on deficit-bonds by fiscal year 1984"). Therefore, the "New Economic and Social Seven-Year Plan" was proposed by national agreement on fiscal reconstruction as being one of the most important policy targets for the new and stable growth of the economy in the early 1980s. This was because the government had to insist before the people, to obtain their consent, that it was essential to restore various financial functions, and to have them clearly recognize the side-effects, such as fiscal inflation or the sliding of welfare standards under the aging society, which would occur if the fiscal crisis was neglected.

On the other hand, according to the MOF's "Medium-term fiscal outlook" the expenditures for FY1979 were to be ¥38.6000 trillion, against ¥64.9700 trillion in

FY1984, tax revenues were to be ¥56.1500 trillion in FY1984, compared to ¥21.4870 trillion in FY1979, and as for bond revenues, construction bonds were to be ¥12.3400 trillion in FY1984, compared to ¥7.2100 trillion in FY1979, and special deficit-financing bonds were to be zero for FY1984 and had been ¥ 8.5000 trillion in FY1979. FY1984 was set as the target year to escape from dependence on special deficit-financing bonds because the redemption of government bonds in cash started in full in FY1985 for the special deficit-financing bonds issued in FY1975, and financial resources for redemption were required. This target assumed that a serious tax revenue shortage was expected during the above period.

Fiscal Policy after the Second Oil Crisis. The Japanese economy in FY1979 was clearly making steady progress toward recovery, thanks to flexible fiscal and monetary policies by the government, although there were outstanding negative issues such as a steep rise in wholesale prices and the worsening of the current account balance, owing to the crude oil price hike triggered by the unstable Iranian political situation. As for the macro economic policy, first of all, “On the Execution of Public Works” was decided upon by the Cabinet on April 6, right after the FY1979 budget was approved. As for the execution of public works, the government had to pay attention to both economic growth and prices, while maintaining the basic economic recovery by paying attention to price trends. Specifically, the target contract ratio of public works in the first half of the fiscal year was 65-70%, slightly less than that of FY1977 and FY1978 (the target ratio for the first half of each was 73%). For the second half of the fiscal year, in a Cabinet decision about the execution of public works in FY1979 in third quarter in October, the government decided upon maintaining a level of 80% completion of contract targets as in other years, the neutral execution of public works.

However, as the price trend fell into crisis after that, “On Comprehensive Promotion Measures for Price” was determined upon on November 27, 1979, so that particular care would be taken regarding economic trends in the execution of public works, in order to prevent price hikes. For FY1979 as a whole, although problems relating to the price and balance of payments still remained, autonomous economic recovery was achieved in the adjustment period after the Oil Crisis, so that the tax revenue was expected to increase again. Therefore, government bond issuance exceeded ¥1 trillion in the FY1979 supplementary budget approved on February 14, 1980.

Regarding the reduction in government bond issuance in the FY1979 supplementary budget in specific, the scale of correction was ¥1.0674 trillion, equivalent to 2.8 % of the initial budget of FY1979. Expenditures included the corrected reduction of ¥274.6

billion of existing expenditures and reserve funds for public works. On the revenue side, the balance net increase, such as tax revenues and the carried-over surplus, etc., was ¥2.2874 trillion. The total for the supplementary budget financial reserve was ¥2.5621 trillion, and of that, ¥1.3421 trillion was allocated to additional expenditure, while ¥1.22 trillion was allocated to the reduction of government bond issuance. Regarding the reduction of government bond issuance, the reduction of the special deficit-financing bonds was particularly taken into consideration, and the amount was ¥1.1380 trillion. The FY1979 initial budget estimated an enormous amount of bond revenues - totaling ¥15.2700 trillion - but the issue amount of government bonds was eventually compressed comparatively, due to the increase in tax revenues because of the economic recovery. As a result of these budget corrections, the bond dependency ratio in FY1979 declined to 35.4% from 39.6% in the initial budget.

3 The Trend in Large-scale Government Bond Issuance and Government Debt Management Policy

Government Debt Management policy after the Nixon Shock. As stated above, Japan was facing severe economic stagnation after the Nixon Shock in August 1971, and active fiscal measures were taken from the FY1971 supplementary budget to FY1973 budget. This resulted in a drastic increase in the bond dependency ratio, from 4.6% of the FY1971 initial budget to 17.0% of the FY1972 initial budget, which had been declining since FY1967.

In FY1972, the active fiscal and monetary policy was enforced by using bond revenues, while the initial budget and supplementary budget were compiled aiming at economic recovery and the adjustment of the balance of payments imbalance. In addition, 10-year government bonds (coupon rate 7.0％) were issued as long-term government bonds from January 1972, at the time of the additional government bond issuance of the supplementary budget. With the FY1972 budget, the government bond issuance was sharply increased to ¥1.9500 trillion (the initially planned amount hereinafter), but ¥250 billion of this was subscriptions by the Trust Fund Bureau Fund, and personal subscriptions by syndicate underwriting was ¥1.7000 trillion - the ratio of personal subscriptions increased to 90%, greatly exceeding the previous year. On June 24, 1972, the official discount rate was reduced from 4.75％ to 4.25%, and interest rates on deposits and savings were cut for the first time for 11 years. With this trend in low interest rates, the decrease in the long-term interest rate was getting on track, and the coupon rate of long-term government bonds was reduced to 6.5％ in July.

When the FY1973 budget was compiled, government bond issuance increased to ¥2.3400 trillion, but the bond dependency ratio was restrained to 16.4%, which was slightly restrained compared to that in FY1972. The personal subscription of the government bonds restrained at ¥1.8700 trillion, and increased subscription by the Trust Fund Bureau Fund to ¥470 billion, from ¥250 billion in the previous year. Thus, the FY1973 government bond issuance plan was different from the active one at the time of FY1972 supplementary budget. The supplementary budget to cope with the first Oil Crisis was approved on December 14, and the issue amount of government bonds was restrained to ¥530 billion with a favorable estimate of the tax revenue. In FY1973, the coupon rate of the 10-year government bonds was raised to 7% from August, in concurrence with the increase in the official discount rate. The official discount rate was increased by 2% point to 9% on December 22, while the bond coupon rate was increased from 7% to 7.75% from January.

At for the FY1974 budget, the amount of government bond issuance was ¥2.1600 trillion. It was decreased from the initial plan, but was still well above ¥1.8100 trillion, which was the amount after the deduction of the FY1973 supplementary budget. As in the FY1973 budget draft, subscription by the Trust Fund Bureau Fund for ¥420 billion, and personal subscriptions of government bonds for ¥1.7400 trillion were planned. The government bonds subscript funds by the Trust Fund Bureau for were mainly carried-over surplus. However, the Fiscal Investment and Loan Program (FILP) restrained Trust Fund Bureau Funds operation in order to be consistent with the policy to restraining aggregate demand for the FY1974 General Account, and the unused financial resource funds were applied to the subscription of government bonds. It was a fiscal policy which adjusted the operation scale of the FILP in order to cope with the economic situation, so that the flexible subscription by the Trust Fund Bureau Fund started under this intention thereafter. However, the increase in government bond issuance resulted in a slack government bond market after half of the year. In order to cope with this condition, the coupon rate was raised to 8%, from the 10-year interest-bearing bonds issued in October.

Change in the Government Bond Issuance Policy and an Era of Large-scale Bond Issuance. The FY1975 budget was compiled under the restraining aggregate demand policy, the same as for FY1974, and the amount of government bond issuance was ¥ 2 trillion, which was ¥160 billion below that for FY1974. Subscription by the Trust Fund Bureau was ¥420 billion. Personal subscriptions through syndicate underwriting were ¥1.5800 trillion.

Under these circumstances, the Minister of Finance Masayoshi Ohira admitted that there would be a tax revenue shortage in FY1975 to the Committee on Finance of the House of Representatives, on April 15, 1975, when the shortage in financial resources was highlighted. The issue here was that financial resources had to be dependent on government bond issuance under the Special Case Law conducted in FY1965, because the construction bond would not be sufficient to cover it. At worst, the shortage was as immense as ¥3.4800 trillion, so that there was a question of how to get subscriptions for the government bonds issued. It was quite a difficult challenge, which, it was thought, might last even into FY1976 and beyond for the government.

The supplementary budget for the tax revenue shortage was approved on November 7, 1975, before the government bond issuance meeting was held on October 8, when an additional issuance of government bonds was proposed by the MOF for ¥3.4800 trillion and it was approved, far exceeding the initially planned amount of ¥2 trillion. Specifically, construction bonds were ¥1.1900 trillion and the remaining ¥2.29 trillion was in special deficit-financing bond. On December 25, then, the "Law concerning the Special Treatment of the Public Bond Issue for Fiscal Year 1975" was enacted. The special measures were then taken, with the construction bonds being issued before the bill was passed, as it had been delayed from the planned date, and the special deficit-financing bonds of ¥235 billion were issued within a short time, because of the need to obtain financial resources for the public purse in December.

This was the process that resulted in the era of large-scale government bonds issuance since FY1975. However, there was concern beforehand that government bonds held by private financial institutions would increase sharply and even make smooth subscriptions difficult, if such large-scale issuance continued. Therefore, the MOF started to study measures from many aspects, such as relief of liability for private financial institutions, care for individual financial asset allocation, development of the government bond market, revision of the issuance conditions, enhancement of the bond sales system, improvement of the secondary market and issuance of a new kind of government bond, etc.

In the FY1976 budget, the government bond issuance was drastically increased to ¥7.2750 trillion, which exceeded the initial plan of FY1975 by ¥5.2750 trillion, and the revised budget by ¥1.7950 trillion. Specifically, subscription by the Trust Fund Bureau Fund doubled to ¥1 trillion, while syndicate underwriting almost quadrupled to ¥6.275 trillion. One of the major features of the FY1976 budget was the first special deficit-financing bond applied to the initial budget since World War II, and the postponement of the income tax cut. The special deficit-financing bond scale was

¥3.7500 trillion. The approval of issuance was continuously discussed in the Diet and finally approved on October 15. After the budget was revised, ¥100 billion in additional government bonds were issued as a whole. In January 1977, 5-year discount government bonds of ¥98.9 billion were issued as a measure to promote personal subscriptions. Other than that, the buying operation of the long-term government bonds was conducted by the Bank of Japan in June and December, as the slack market continued due to the large-scale government bond issues since the beginning of the fiscal year.

Large-scale Bond Issuance and the Beginning of Bond Trading in the Market. In FY 1977, the public bond issuance conditions were good, and government bond trading in the market (selling in the market) started. The government bond issuance of FY 1977 reached ¥8.4800 trillion, which exceeded that of the previous year by more than ¥1 trillion. Subscriptions by the Trust Fund Bureau Fund were planned to be ¥1 trillion, the same amount as was initially planned in the previous fiscal year, and personal subscriptions were ¥7.4800 trillion. The official discount rate was gradually reduced on March 12, April 19, and September 5, in 1977, and on March 16, 1978. It reached 3.5%, the lowest level since World War II by the end of FY 1977. The interest rate reduction that resulted was then associated with a discount rate cut, the booming of the government bond market and the 10-year interest-bearing government bond issuance conditions being updated one after another. On October 24, the first supplementary budget was approved, and the issuance of construction bonds increased to ¥251 billion, the special deficit-financing bond reduced to ¥112 billion, and ¥139 billion was added on a net basis. Moreover, the secondary supplementary budget, which was approved on January 31, 1978, included an increase in construction bonds to ¥347 billion, an increase in special deficit-financing bonds to ¥1.0190 trillion, and ¥1.3660 trillion was added as a whole. This resulted in the total amount of government bonds, after the supplementary budget, reaching ¥9.9850 trillion. The era of ¥10 trillion was close at hand.

In FY1978, subscription by the Trust Fund Bureau Fund was not planned due to a shortage in financial resources, but syndicate underwriting was applied to personal subscriptions including ¥1 trillion issuance by price competitive auction. Then the government bond market grew weaker and the yield started to rise because the market felt that the interest rate had hit the bottom. While the MOF considered the diversification of the type of government bonds, it showed the medium-term bond framework draft to the underwriting syndicate in May (e.g. 3-year interest-bearing government bond, public offering auction and the upper limit issuance for FY1978 as ¥1 trillion) and issued ¥300 billion in June. It was the first attempt of an auction issue of medium term bonds for the government debt management policy since World War II. Eventually, medium term bonds were tendered, with a far larger amount than expected. In July, the allowance system for government bond price fluctuation was established, to secure the soundness of the accounting of financial institutions, and was applied from the terminal accounts in September. However, it resulted in the weakening of the government bond market, as financial institutions' bond selling was accelerated. In order to counter this situation, ¥306.3 billion in personal subscriptions were conducted by the Trust Fund Bureau in September. Even after that, an additional issuance of government bonds of ¥300 billion (2-year interest-bearing government bonds) in the FY1978 supplementary budget, approved on October 12, was subscripted by the Trust Fund Bureau, the authorities took measures regarding the weakening government bond market by restraining the funds from syndicate underwriting as much as possible. Accordingly, subscription by the Trust Fund Bureau Fund for government bonds started to play an important role in stabilizing the conditions for absorbing government bonds.

On the other hand, government bond trading in the secondary market had started in April 1977, with special deficit-financing bonds that had no problem about conversion. After that, government bond trading gradually progressed until the abolition of self-imposed bond trading control measures held by financial institutions, in September 1995. Originally, as most syndicate underwriting-funded government bonds were bought by the Bank of Japan after one year from issuance as their buying operation account in the late 1960s to the early 1970s, there was almost no need to sell to the trading market. Likewise, the government bonds were less popular in the trading market due to their lack of liquidity compared to other public and corporate bonds, and the yield determined in the market did not correctly reflect the market credibility of the various bonds. After FY 1975, large-scale issuance of government bonds resulted in lowering the ratio of government bonds absorbed by buying operations, while, on the other hand, the government bonds held by financial institutions increased. Major city banks, which were afraid of government bond appraisal loss and selling loss, started to request the authority that they wanted to change their fund position by selling the government bonds. Then, the government gave consideration to the trading of government bonds in early 1977 and, in April, made possible the selling of special deficit-financing bonds after one year from issuance. From October, it also became possible to sell construction bonds after 1 year of issuance. The paper issued by the Study Group on Government Debt Management Policy (June 1977) pointed out the problems: 1) City banks and regional banks, in particular, showed a strong demand for the trading of government bonds due to uneven distribution of funds, the imbalance of underwriting shares and funds resources, the impact on liquidity accompanied by the increase in government bonds held, and the portfolio management problem; and, (2) Proper improvements of the bond market are required, as it is still problematic for the market to absorb a large number of trading Japanese Government Bonds at the same time, although the bond trading market is developing, and the government bond rollover system should be improved as a part of the system maintenance to accompany increasing bond fluidity. This made the MOF fully promote the improvement of the trading environment to improve the fluidity of the government bonds.

The Target of Delivering the Government's Finances from its dependence on Special Deficit-financing Bonds and the Peak of the Bond Dependency Ratio. In January 1979, the "Target of Delivering the Government's Finances from its Dependence on Special Deficit-financing Bonds by FY1984" was released, but the FY1979 budget draft being discussed in the Diet at that time included ¥15.2700 trillion in bond revenue. At the end, the FY1979 government bond issuance initially planned was ¥15.2700 trillion, and special deficit-financing bonds comprised ¥8.0550 trillion, making up the majority of the government bond issuance for the first time. The bond dependency ratio at 39.6％ was a considerable increase – of 30% - from the 9.4% it was in FY1975. Furthermore, the Trust Fund Bureau had no plan to receive subscriptions in FY1978, and started to receive subscriptions of ¥1.5000 trillion in FY1979, and the auction issue was increased to ¥2.7000 trillion, while syndicate underwriting was ¥11.0700 trillion, which was almost the same level as the previous year.

The FY1979 government bond market became more depressed than in FY1978. The 6.5% coupon rate of 10-year interest-bearing government bonds in March 1979 was raised to 7.2% in April, 7.7% in August and then to 8.0% in March of 1980, reflecting the fifth consecutive rise in the official discount rate since April 17, 1979. With a sharp increase in the interest rate, a high interest rate was expected in the future, together with an increase in financial resources, and thanks to the economic recovery, financial institutions started to sell government bonds, which worsened the government bond market. Then the MOF decided to consider the government debt management policy regarding the weakening government bond market for the first time since 1979, and released the paper, "On the present Government Debt Management Policy"(the so-called "7 Points Program") at a meeting of government debt problems in May. Under this program, the restriction of the issuance amount and the mitigation of syndicate underwriting were to be implemented, as well as absorbing more than ¥1 trillion in government bonds, by buying the bonds through the National Debt Consolidation Fund in June and buying through the Trust Fund Bureau Fund in July. It was eventually decided to reduce the government bond issuance, in order to cope with the slack in the auction market. In the fiscal year-end supplementary budget, the government bond issuance was also reduced by nearly ¥1.2200 trillion, in accordance with an increase in tax revenue.

Since the large-scale issuance of government bonds began, the issuance of government bonds exceeded ¥10 trillion in FY1978 and reached ¥15.2700 trillion in FY1979, while the bond dependency ratio reached a peak of 39.6%. The government recognized that there would be a negative impact on flexible fiscal management if such large-scale bond dependency continued. This is why it was thought that an escape from dependence on deficit-bonds would lead to stable development of the economy and improvement of the quality of public lifestyles in the future.

4 Stable Economic Growth and the Reconstruction of the Tax System

After the Report on the Long-term Tax System. In the early 1960s, the government started to reform the tax system according to a Tax Commission report. The Tax Commission compiled its “Report on the Long-term Tax System” in August 1971, which represented their concept that a “modest tax burden increase should be admitted and that indirect tax should be maintained appropriately in the tax system”. As for indirect tax, the government was required to consider expanding the tax base for individual consumption taxes and a shift to a general consumption tax. After the Nixon Shock, the government was requested at the end of every fiscal year to conduct tax reductions, especially of income tax, as a recession measure through tax reform. The following is a history of tax reform up to FY 1979, according to the report above.

Even before the “Report on the Long-term Tax System”, the slowdown in the domestic economy and the tax revenue shortage had been considered to be problematic. The government then started to consider countermeasures against the recession and the MOF examined the possibility of a tax reduction. Just then Nixon Shock occurred in August 1971, and tax reform against the recession became an urgent and critical issue, due to the huge impact on the Japanese economy. In the process of discussion at the Tax Commission in October, income tax reduction was confirmed as being needed as an immediate economic measure, and the tax was cut eventually conducted back to April

1971.

The FY1972 Tax Reform Report was compiled on December 27, 1971, and only covered a tax reduction for local tax, not national tax, but included the introduction of tax credit for aged dependents and the expansion of those applicable as tax deduction widows. The surtax rate of corporation tax continued for 2 years, and aviation fuel tax was newly introduced. The plan also showed a stance for the reexamination of the special treatment of taxation on medical fees covered by social insurance. The “Outline of the FY1972 Tax Reform”, which was approved by the Cabinet on January 25, 1972, also included the tax credit for housing acquisition requested by the Liberal Democratic Party, as well as tax deductions for small- and medium-sized companies as a countermeasure against recession and enhancement of the special treatment for pollution prevention measures, that were considered to be critical issues.

Review of Small Business Taxation and Land Taxation. In the tax reform of FY1973, the major issues considered by the Tax Commission included: the taxation of social insurance medical fees for doctors, small business taxation (the issue of introduction of entrepreneurs’ remuneration system) and separate withholding taxation on capital gains from land transfer. Among these issues, the entrepreneurs’ remuneration system had some background. Specifically, a tax deduction for family employees and wages of individual enterprises had been fully permitted in FY1968, but the Japanese Blue Return Tax Payer’s Association and the Ministry of International Trade and Industry had requested the introduction of a tax deduction for entrepreneurs’ remuneration. However, the Tax Commission opposed the introduction of this, saying that it was meaningless if entrepreneurs pay a salary to themselves, and it would be a misuse of tax a deduction for an employment income. However, this was followed by the suggestion of a reserve for the special expenses of proprietors filing blue returns in FY 1971, as an alternative measure to allow the tax deduction of an entrepreneurs’ remuneration, and deductions for blue returns in this system were introduced in FY1972, which led the way to mitigating the income tax burden of individual enterprises. Regarding the separate withholding taxation on capital gains from land transfer which came into force in FY1969 and which encouraged companies to obtain real estate, a reexamination of the land tax system was also discussed. In addition, Prime Minister Kakuei Tanaka’s campaign pledge of a ¥500 billion tax reduction drew à lot of attention from various fields as to how the Tax Commission would deal with the commitment. In the end, the FY1973 Tax Reform Report on December 30, 1972 included a reduction in income tax and inhabitant tax, but the rectification of the taxation for social insurance medical fees was postponed. The Research commission on the Tax System of the Liberal Democratic Party's "Outline of Tax Reform", issued on the day before, included the introduction of an entrepreneur's remuneration system that was excluded from the basic taxation system by the Tax Commission, and as for the land tax, it requested that the government make an immediate resolution to restrain the speculative trading of land. On January 8, 1973, the government's "Outline of Tax Reform" introduced the special treatment of the entrepreneurs' remuneration system for 5 years and presented the policy to seek an immediate resolution for land taxation. In addition, the tax reform outline of the government included tax reduction by raising various tax credit, regarding income tax, tax reduction of inheritance tax, by increasing the basic deduction by 50%, and the special treatment for welfare, anti-pollution and housing. The "Outline of the FY 1973 Tax Reform" approved by the Cabinet on January 19, 1973, upon the Report of the Tax Commission, introduced the special landholding tax as a local tax, surtax on corporate capital gains from land transaction, and the increase in the special deductions in capital gains from land transactions as a national tax, in addition to the items specified in the Outline.

Reform of Income tax and Corporation tax during the First Oil Crisis. With the 1974 tax reform, the government focused on the major reform items including a considerable raise in the lowest taxable limit for income tax from an early stage, and the authorities considered them in a study by the Tax Commission. This was because then Prime Minister Kakuei Tanaka had made a speech in the Committee on Finance of the House of Representatives in Spring 1973, saying that a drastic tax reduction should be enforced in FY1974. After that, the government started to consider a so-called "¥2 trillion tax reduction". In the discussion at the Tax Commission in Autumn 1973, a drastic increase in employment income deductions to mitigate the burden of employees was confirmed. Although the first Oil Crisis then occurred, the tax system assessment continued to be concerned with policy issues such as a desirable form of the tax burden of income tax, corporation tax and inhabitant tax. Furthermore, a report, including a discussion on indirect tax and special taxation measures, was submitted on December 21, 1973. This report said the scale of the income tax reduction could be about ¥2 trillion, through a drastic increase in employment income deductions and the expansion of the applicable income brackets. As for Corporation tax, the tax increased through a tax rate raise. While there was also the cautious opinion that the government should first watch the effects of the Oil Crisis before introducing a tax reduction, the content of the report was consistent with the initial policy of the Tax Commission's report, reflecting the strong intention of Prime Minister Tanaka and the Liberal Democratic Party.

The MOF thought that the tax structure itself could be improved by tax reforms, including income tax reduction, corporate tax rate rise and reexamination of indirect tax. In particular, the standard tax rate of corporation tax was raised from 36.75% to 40%, but it was because the authorities considered that an increase in the tax burden to companies would not affect their competitiveness in the international market, as the effective tax rate was still less than the standard for Western countries, and Japanese corporations could remain competitive in the international market. The long-term economic plan of the Japanese government (the “Basic Economic and Social Plan”) predicted an increase in the tax burden of citizens, so that the corporation tax and indirect tax hike was needed. However, the tax reform based on the “Outline of the FY1974 Tax Reform” decided upon by the Cabinet on January 11, 1974, was not enough to successfully implement the plans. In other words, owing to the price hike due to the Oil Crisis and a considerable rise in the nominal wage, income tax cut policy changed its nature to a counteractive price adjustment tax-cut. Under this condition, a tax revenue increase could not be expected due to a reduction in corporate profits.

Examination of the Act on Special Measures Concerning Taxation. The Ministry of Finance intended to proceed with the reform of the tax system for FY1974 and FY1975, and at the same time, they realized the income tax reduction and the corporation tax hike in the FY1974 reform. They then decided to consider the issues regarding the rectification of the special treatment of the taxation of social insurance and medical fees for doctors (the so-called preferential tax system for doctors) and separate withholding taxation at source on interest and dividends in FY1975. The Tax Commission’s ad hoc meeting report said that the 72% uniform rate admitted as necessary expenses in the income tax for doctors should be reformed, and the actual expense ratio and special exemptions should be combined as taxation for them. In the report of the FY1975 tax reform, dated December 27, a rise in personal exemption for the income tax, a rectification of the special treatment in the taxation of social insurance and medical fee, and a surtax on capital gain from the land trading and tax raise on the income from interest and dividends were requested. The report also requested a significant tax reduction, in order to mitigate the inheritance tax and donation tax burden hike, in conjunction with the price hike.

The objectives of the special taxation measures were wide ranging: from the encouragement of saving, the promotion of environmental improvements and regional development, the modernization of technologies and facilities, and the promotion of natural resource development, to the enhancement of the internal reserve strengthening of the constitution of business corporations. These measures were also deeply related to the profits of individual economic units. Therefore, the desirable form of the special taxation measures has been controversial since mid 1950s. The Tax Commission tried to correct as much as possible the unfairness of the tax burden and considered measures in the direction of avoiding the long-term existence of a preferential system and vested rights. This was why the authorities tried to change or abolish the special taxation measures in the discussion of tax reform at the end of every fiscal year. However, as for the preferential tax system for doctors, the Tax Commission tried to review, which was not reflected into the Liberal Democratic Party's "Outline of tax reform" approved on December 25, 1974, or in the "Outline of the FY 1975 Tax Reform" decided by the Cabinet on January 24, 1975.

A Tax System to Cope with Fiscal Policy Changes. In FY1975, while a significant tax revenue reduction was anticipated after the budget was approved, the management of fiscal policy was required to change drastically. It is well known that this was the year when special deficit-financing bonds were issued in the supplementary budget, and the bond dependency ratio increased from then onward. Regarding the tax system, the Tax Commission discussed various measures to increase the tax revenue as much as possible. The Fiscal System Council also requested a tax raise and the streamlining of expenditures. The Research Commission on the Tax System of the ruling Liberal Democratic Party (LDP), proposed the introduction of a new tax. Under these circumstances, as for the 1976 tax reform, the postponement of an income tax reduction, a review of special taxation measures and a tax increase for automobile-related taxation were proposed. More specifically, as for the special taxation measures, the focus was upon the medical treatment fees of doctors, entertainment and social expenses, and allowances. The report of the Tax Commission submitted on December 23, 1975, proposed increasing the tax revenue by rectification of the unfair taxation, under the premise that the tax burden cannot help but increase in the mid-term. After all these proposals, the special taxation measures were streamlined, 11 of them were abolished and 58 items were downsized. In addition to this, a tax rate hike on automobile-related items was requested.

This was followed by another tax reform study to escape from the dependence on special deficit-financing bonds. For instance, various new taxes such as an EC-type value-added tax were also considered. The Tax Commission raised the issue of comprehensive income taxation on interest and dividends aiming at gradual correction of the unfairness of income taxation. Regarding asset tax and consumption tax, the introduction of wealth tax or value-added tax were considered. In particular, it was considered common sense to share the load, since the indirect tax burden level in Japan was still low compared to Western countries, so that the indirect tax reform was positively considered to be the most important issue of the "Mid-term tax system". The reform of the special taxation measures was emphasized as being one of the items which anticipated a tax revenue increase, which was represented by the rectification of the special treatment in the taxation of social insurance and medical fees. In the interim report on the "Mid-Term Tax System" compiled in December, 1976, it was proposed that there was room for an income tax raise and that the introduction of a general consumption tax should also be considered. The FY1977 tax reform, according to the Tax Commission, proposed some income tax reduction through price adjustment to be taken as a counteractive tax-cut for economic recovery and the stability of lifestyles, under the common understanding that it was not the right time to implement a large tax hike to achieve fiscal balance recovery in FY 1977. On the other hand, the special taxation measure was required to increase the tax rate of income on interest and dividends and strengthening of the taxation on entertainment and social expenses.

In the discussion between the ruling and opposition parties on the FY1977 tax reform, a "tax rebate" for a tax credit type income tax was determined by legislation introduced by a Diet member. The government clearly stated that the tax reduction should not be conducted in FY1977, due to fiscal difficulties, but Prime Minister Takeo Fukuda in December, 1976, made a decision that the counteractive tax-cut against price hike needed to be implemented. Specifically, in order to cope with the fiscal difficulties, they decided to combine the income tax reduction and corporation tax hike. On a net basis, the tax reduction would exceed that of the initial year, but there would eventually be a tax hike in the following fiscal year. This was because the ruling and opposition parties ran a dead heat in the House of Representatives election in December, and the budget for FY1977 was difficult to pass, unless it reflected the opposition parties' intention regarding the budget. The MOF insisted on creating a desirable income tax system by adjusting a minimum taxable level and the tax rate, but eventually agreed to the opposition parties as a "tax rebate" could be considered as a provisional measure, at least. Its fiscal resource was the FY 1976 surplus fund, and the tax reduction implemented in July, 1977, was on a scale of ¥300 billion. These "tax rebate" type tax reductions were also implemented in 1978, but the fiscal resource was not applied to the surplus fund but the government bond issuance.

Before the 11th House of Councilors election in July 1977, the Minister of Finance

Hideo Bou showed a willingness to introduce a general consumption tax, but it was still controversial in the ruling party, from the viewpoint that the tax might worsen the economy. In the discussions of the Tax Commission for FY1978 tax reform, a consumption tax was proposed in order to solve the fiscal difficulties, while showing a tax hike type revision, including an increase in the securities exchange tax and liquor tax.

The Introduction of a General Consumption Tax. Economic policies focused on the enhancement of welfare and the expansion of social infrastructure around 1970. The Tax Commission also considered a drastic change in indirect tax, to compensate for the expanding government expenditures. Then, the focus on indirect tax reform in the early 1970s shifted to the introduction of the general consumption tax.

According to the “Report on the Long-term Tax System and the Assessment of the Contents and Progress” (1971), as stated earlier in this Section, a general consumption tax should be introduced to recover the delay in responding with a specific consumption tax, at a time when consumption behaviors were drastically changing. However, it did not mention a specific timing for when this should be introduced but only stated “these methods (higher dependency on income tax, higher burden of corporation tax and introducing a general consumption tax) should be selected by Japanese citizens at that time. After that, discussions regarding indirect tax hike were pending, due to the Nixon Shock and the two Oil Crises, but the MOF started to face a fiscal crisis campaign, as people became concerned about fiscal rigidity, due to an increase in the special deficit-financing bond in FY1975. Furthermore, after FY 1976, the “Medium-term fiscal outlook” was compiled, to show the need for a large hike in the tax burden ratio, in order to escape from the dependence on special deficit-financing bonds. Therefore, studies on general consumption tax were enhanced.

Views on the discussion to introduce a general consumption tax were, as stated above, and the Tax Commission established a working group to study technical issues in July 1976. In the “interim report” in October 1977, it was clearly stated that the existing system was limited in its capacity for fiscal reconstruction, so a general consumption tax should be introduced. The timing of the introduction, however, remained unspecified, and conditional on the unfair taxation being rectified first.

The MOF also set the introduction of a consumption tax shown in the “interim report” as a policy issue, so that the Tax Commission could continue to discuss this issue as one of the important items of FY1979 tax reform. The fiscal conditions at that time were in difficulty due to a tax revenue shortage, so the date of corporation tax revenue was postponed in the FY1978 budget compilation process. As it was expected that the severe conditions for fiscal management would last into and after FY1979, the government started a specific study on the general consumption tax in June 1978, and set the target of developing the framework of the plan by September. In this process, the outline of the general consumption tax was shown more specifically through the assessment report of the Chairman of the Tax Commission. Then, the general consumption tax draft was prepared early in September, which pointed out the difference between consumption tax and turnover tax, by exempting small businesses from the object of taxation, while maintaining the rationalization of the conventional indirect tax. The Research Commission on the Tax System of the LDP's "Outline on tax reform" also admitted the need for the introduction of the general consumption tax, and requested it to be implemented within FY1980.

The report of the Tax Commission in December 1978 (the "General Consumption Tax Outline" was attached to this report) stressed that a general consumption tax was inevitable, in responding to the "policy that should be taken through tax system in order to improve the fiscal conditions through national and local government, aiming at the sound development of Japanese economy" proposed by Prime Minister Takeo Fukuda in November 1977, and it included the specific timing for implementing the general consumption tax as January 1980. The Minister of Finance, Ippei Kaneko, in Masayoshi Ohira's new Cabinet said in his fiscal policy speech on January 25, 1979, "the imbalance of the government expenditures and revenues now has grown so large that it can no longer hope to perform the proper missions of national finance, such as the stabilization of the economy and enhancement of the standard of welfare without raising the general tax burden," and he made request for understanding to the Diet and the public regarding the new tax system. However, the opposition parties criticized the statement, saying that the government should reduce its expenditure and rectify unfair taxation before the introduction of new tax. As the day of the 35th House of Representatives Election was approaching in October 1979, not only the opposition parties but also some members of the Liberal Democratic Party opposed the introduction of a general consumption tax. This made Prime Minister Ohira express his intention to give up the introduction of a general consumption tax within FY1980. Moreover, the "Resolution on Fiscal Reconstruction" was decided upon by the Diet (December 21) in the plenary sessions of both Diet chambers of the year-end Diet, after the defeat of the Liberal Democratic Party in the General Election. The content of the resolution was that fiscal reconstruction should be achieved by the expansion of fiscal resources through cost saving, accompanied by the administrative reform, cuts in and rationalization of expenditures, a fair tax burden and a review of the existing tax system, without the introduction of the general consumption tax.

As mentioned in Chapter 2.1, the political situation prevented the acceptance of the introduction of a general consumption tax, so that the tax reform, along with the government's intended goal of achieving fiscal reconstruction, looked to remain incomplete for the foreseeable future.

Review of the Preferential Tax System for Doctors. As stated earlier, special taxation measures – including rectification of the special treatment in the taxation of social insurance and medical fees - had been discussed for years. Particularly, in the review process of the FY1979 tax reform, in line with the review regarding a general consumption tax, discussion regarding the consolidation and rationalization of the special taxation measures had progressed, and stressed the need to abolish the reserve for price fluctuation, and also said that the issue of taxation of social insurance and medical fees would be difficult to accomplish.

Under these circumstances, the FY1979 tax reform was conducted including a tax rate hike, such as a gasoline tax, and a review of the special taxation measures. Of these, as for the special taxation measures, a rectification of the special treatment in the taxation of social insurance and medical fees was finally achieved, so that the rise in the tax burden for medical treatment fees was decided with a gradual deduction rate. Specifically, necessary expenses in the income tax of doctors, which was 72% as a flat tax rate, was changed to 72% for the social security income for up to ¥25 million, 70% for up to ¥30 million, 62% for up to ¥40 million, 57% for up to ¥ 50 million, and 52% for over ¥50 million. This decision reflected the idea of the Tax Commission and the MOF that the social insurance medical's public nature should be considered for income up to ¥50 million. As for the other items, they included a tax increase on gains from the trading of securities, entertainment and social expenses, and a statutory reduction ratio of allowance for the bad debts of corporations. Thus, the tax reform in FY1979 tackled the rectification of unfair taxation, as a first step towards the introduction of a general consumption tax.

Section 2 Monetary and Financial Policy

1 The First and Second Oil Crisis and Monetary Policy

Monetary Policy before and after the First Oil Crisis. This section is about macro monetary policy operation. Table 1-2-1 shows the change in the official discount rate in this period. It shows monetary easing until spring 1973. It was because of the domestic demand expansion policy under the condition of current account surplus, in order to maintain the fixed exchange rate system (policies for avoiding yen appreciation) and concern about recession due to the yen appreciation in August 1971.

However, as the money supply increased rapidly, it advanced price hikes and land speculation, then the first Oil Crisis occurred, and the economic scene was described as “galloping inflation”. Then the Bank of Japan (BOJ) raised the official discount rate from 0.75% in April 1973 to 5.0%, took one monetary tightening measure after another, and finally the official discount rate was raised to 9.0% in December. The Ministry of Finance implemented its financing regulations. Following the restraining of real estate related loans in 1972 (“qualitative credit control”), “selective lending” was conducted at the end of 1973, upon the occurrence of the Oil Crisis. This was a guideline for financial institution loans to prioritize the emergency funds required for stabilization of public lifestyles and restrain funds suspected for use in speculation, such as for land acquisition, those buying up land and those reluctant to sell, etc. With the notification in December 1974, the regulations of large loans (for ordinary banks, a loan for one debtor should not exceed 20% of the net worth of the bank) was implemented.

In 1974, growth in productive activities turned out to be below zero and fell into stagflation. The Bank of Japan then took measures, while watching prices, to carefully shift the policy to an easy one, by cutting the official discount rate from April 1975. From 1977, because of the drastic yen appreciation, the official discount rate was further cut, and it reached 3.5% in March 1978. At the same time, the government made efforts to stop the yen’s rise in value by selling yen and buying dollars.

Monetary Policy before and after the Second Oil Crisis. The official discount rate remained low at 3.5% from March 1978, but the price of crude oil started to significantly rise again, after the resolution of the OPEC meeting conducted in the end of same year (the second Oil Crisis).

From the lessons of the first Oil Crisis, the Bank of Japan was prepared to avoid inflation and promptly went on alert. It restricted the increase of bank loans from the

Table 1-2-1 Change in Official Discount Rate (FY1970～1979)

Year/Month/Date	%	Year/Month/Date	%	Year/Month/Date	%
1970. 5.15	6.25	1973. 5.30	5.50	1977. 3.12	6.00
10.28	6.00	7. 2	6.00	4.19	5.00
1971. 1.20	5.75	8.29	7.00	9. 5	4.25
5. 8	5.50	12.22	9.00	1978. 3.16	3.50
7.28	5.25	1975. 4.16	8.50	1979. 4.17	4.25
12.29	4.75	6. 7	8.00	7.24	5.25
1972. 6.24	4.25	8.13	7.50	11. 2	6.25
1973. 4. 2	5.00	10.24	6.50	1980. 2.19	7.25

Source: Bank of Japan, *Nihon Ginko Hyakunenshi*
[One-Hundred-Years History of the Bank of Japan] (1986)

first quarter of 1979, which was followed by more restraining measures such as gradually raising the official discount rate from April 1979, as shown in Table 1-2-1 (the official discount rate was later raised by 9.0% in March 1980). Reserve requirement ratios were also raised.

Because of this prompt and bold restraining policy, the price hike was successfully controlled for finished products, while import prices and raw material prices rose considerably. In other words, home-made inflation was successfully controlled to some extent.

Change in the Financial Structure. From the end of the period of high economic growth, an historic change in the financial structure began to take place.

Firstly, the fund flow changed. With the decline in the growth rate and the end of the period of investment boost, the era of the fund shortage ended. This can be seen by the drastic reduction in fund shortages in the corporate sector. In turn, the government and overseas sectors became main fund shortage (deficit) sectors. The fund shortage of overseas sector meant the stable current account surplus of Japan. (Capital is the net flow.) The government expanded its fiscal deficit by balancing the shortage in overall demand resulting from the shrinking of business investment (increase in fiscal expenditures and sluggish growth of tax revenues).

As the growth rate decreased, the level of the increase rate of money supply also decreased. The market equilibrium interest rate, which was once raised thanks to high growth and investment, declined as well.

Fiscal deficits increased the issuance of government bonds and accumulated the outstanding amount. This brought big changes to the financial system. The large amount of government bonds was absorbed by financial institutions but holding these turned out to be a burden and there was demand to ease the restrictions on transfer. Trading the bonds held by financial institutions in the market started in 1977. This resulted in the rapid expansion of the government bond circulation market, in and after 1977. This market was the core of the unregulated rate market, which further resulted in a chain reaction. If the free financial market were to be extended, the fund supply would be shifted to it from the regulated market, when interest is high, for instance (disintermediation). In order to avoid such an occurrence, the liberalization of interest rates was required.

Monetary Policy was also affected. Major policy instruments and measures in the high growth period were operating the official discount rate, the shift in the regulated rate system which was interlinked with the rate, credit rationing to control the sufficiency level of the excess demand to the BOJ lending, whose rate was below the market interest rate, and bank loan restriction, which was a kind of moral persuasion (to show the guidelines for the increase in bank loans per quarter). The quantitative control of bank loans was important.

In connection with the government bonds circulation market, the unregulated rate market expanded. Once each market was further linked (arbitrage), the monetary policy was also shifted to one based on the interest rate fluctuation mechanism.

2 The Basic Concept of Financial Regulation and Administrative Management

The Basic Concept of Financial Administration. The Ministry of Finance recognized that the economic and financial environment was changing, from a long term perspective, and that financial institutions and administration needed to move towards a new direction.

The basic direction was stated in the speech by the Minister of Finance, Hideo Bo, in July 1977, as follows: high growth of the economy is no longer expected, but we must cope with a new economic structure. Financial institutions are required to promote efficiency with self-responsibility, under the principles of fair competition, to accomplish a public mission and meet the needs of society. The administrative bodies must abolish their overprotective policies and illogical equality.

New entries, exits and mergers of financial institutions. The following describes the actual administration. First, is the management of new entries and exits. Following the high growth period, the industrial organizations of financial institutions were stable, as shown in Table 1-2-2.

Table 1-2-2 Number of Financial Institutions

Year end	1974	1975	1976	1977	1978	1979
City bank	12	12	12	12	12	12
Foreign exchange bank	1	1	1	1	1	1
Long-term credit bank	3	3	3	3	3	3
Trust company	7	7	7	7	7	7
Regional bank	63	63	63	63	63	63
Mutual bank (Sōgo Bank)	72	72	71	71	71	71
Cooperative bank (Shinkin Bank)	476	471	470	468	466	462
Credit cooperative	491	489	488	487	486	483

Source: Research and Statistics Department, Bank of Japan, *Keizai Tōkei Nenpō* [Economic Statistics Annual] 1980

For major commercial banks, there was no change in the 12 city banks after the merger of Taiyo and Kobe Banks in 1973, including Mitsui, Mitsubishi, Sumitomo, Fuji, Dai-ichi Kangyo, Sanwa, Tokai, Daiwa, Taiyokobe, Kyowa, Hokkaido Takushoku and Saitama. The only specialized foreign exchange bank was the Bank of Tokyo. The long-term credit banks included three banks: Industrial Bank of Japan, Long-Term Credit Bank of Japan and Nippon Credit Bank. There were seven trust banks, including Mitsubishi, Sumitomo, Mitsui, Yasuda, Toyo, Chuo, and Nihon. There was no change.

Regarding regional financial institutions, the number of regional banks remained unchanged at 63. In terms of mutual banks, Hirosaki Sogo Bank and Aomori Bank merged to become Michinoku Bank in 1976, so the number of banks was reduced from 72 to 71. This gained public attention as a merger of financial institutions from different fields, as the first merger of regional bank and mutual bank. The authorities welcomed the merger as it would bring a positive effect on the regional economy. The small number of cooperative banks (Shinkin Banks) and credit cooperatives (Shinyō Kumiai) declined annually due to merger.

Regulations on Branching. At the beginning of this term, the Notification in February 1973 was the basic policy regarding regulations on branching, as follows: (1) two branches should open per bank in a year for the convenience of users; (2) the unofficial announcement of new branches should be made for 2 fiscal years at a time (e.g. 4 branches in 2 fiscal years); (3) branches in housing complexes should be accepted as extra; and (4) no change of location is accepted, except for the reorganization of excess branches. (4) was specified to cope with cases where there might be struggles and frictions with the local community, due to withdrawal from under-populated areas.

However, branch authorization in 1974 to 1976 was restrained, as an emergency measure to prevent land speculation and land price hikes.

Unofficial announcements were less restrained in FY1977/FY1978. However, administrative guidance was given that large branches in busy areas, such as in front of stations, were almost saturated, and so new branches should be located in other regions as small branches or ATMs.

This was clearly stated in a notification in FY 1979/1980. This notification said that branches should be prioritized in the category of "non-competitive", that is, with no other competitors within a distance of 500m, such as branches in non-competitive areas but with potential for a rapid increase in users, small/ATM branches or branches in housing complexes.

Managerial Indicators Regulations. Managerial indicators regulations (balance sheet regulations) were applied to the following five items:

(1) Current account ratio regulations

Current account ratio (current expenditure /current revenue) regulations are to save costs and improve the stability of financial institutions, which was particularly important in the early stages after World War II, but was abolished in 1968. However, administrative guidance was provided for the gradual decrease in expense ratios and in restraining stock dividends.

(2) Loan-deposit ratio regulations

The amount of loans was restrained to within 80% of deposits, but the amount kept exceeding this standard, in major commercial banks, in particular.

(3) Real estate ratio regulations

Commercial real estate/net worth (in a narrow sense) was controlled to within 50% as a standard, and aimed for within 40%, but the standard ratio was exceeded in major commercial banks.

(4) Liquid assets ratio regulations

Aimed for 30% or more for liquid assets/deposits, but it was unable to achieve this target until the end of the 1970s. Liquid Assets were defined as assets other than those for lending - mainly securities - but shareholding was not encouraged.

(5) Capital Requirements

Net worth (in a wide sense) /deposits aimed at more than 10% (the denominator was deposits because the net worth was assumed to be reserve requirements for the deposits) but was never accomplished, so lowered even more.

As shown above, most of the cases could not achieve the regulation target. Even despite this, no strict penalty was specified. Therefore, these may have been measures to encourage the practical improvement of the existing conditions towards the target, and not measures which strictly required the accomplishment of the standard.

Bank Inspections. The following briefly describes bank inspections in the postwar era.

Japanese financial administrations have supervision executed by administrative divisions such as the Commercial Banks Division, the Small Banks Division, etc., of the Banking Bureau and inspections executed by the Banking Inspection Department as two separate wheels. That is, the Banking Inspection Department conducts inspections in accordance with important policies, specified by the administrative divisions as required, and in turn prepares the administrative divisions policies, taking into account the facts revealed in the inspections. In terms of personnel management, different from the system in the United States where inspectors are regarded as specialists, both sections encourage personnel transfers between sections, for the development of personnel who are well-versed in both administrations. Inspections are conducted by 80 inspectors from the Banking Inspection Department and in 200-240 Local Finance Bureaus, which is far less when compared to the United States.

The Banking Inspection Department of the MOF conducted inspections, as follows.

The Inspector’s Team comprises 5-10 members. It may be more than ten members, when including those for asset assessment for the inspection of major banks. First, the team prepares for about one week. This mainly includes reviewing materials from the previous inspection, and various financial data (for the past 3-5 years) of financial institutions in the same category, area and scale. This is followed by a meeting with an administrative division to specify the conditions of the target institutions, especially issues that need to be considered, and points of focus for the inspection.

Next is the inspection at the object institution. Inspections are classified into each of comprehensive or partial inspections, and ordinary (regular) or special inspections. Comprehensive and ordinary inspections are conducted normally. Partial inspections are for specific items, such as asset assessment or corporate management checks, etc. Special inspections are not conducted regularly and are for a special purpose.

Firstly, the inspection of actual things and the site investigation are conducted. The inspection of actual things comprises 3 kinds of inspections: inspectors stay in a branch selected for the checking/cross-referencing of books for 2 days (to check ledgers/daily journals and cash balance, contacts and actuals, etc.); then there is the common items check (target industries, purpose of use of loans, terms of repayment and credit investigation for lending; presence of illegal deposits and management of bookkeeping); and the specific item check (for specific business items). On the other hand, site investigation is also to check issues picked up in the advance investigation. These inspections are also completed, with comments.

Next is the main inspection, which takes 1 week to 10 days, based on the materials provided by the financial institution or documents collected in the field inspection. It is mainly for asset assessment, especially research on loans. In particular, suspected assets and large-scale lending issues are carefully checked. The inspection is completed upon hearing from individuals who are in charge of specific items, as well as comments from the bank president and board of directors.

The inspection team holds a reflection meeting, to report to headquarters. The result of inspections is summarized in the report for circulation in the Banking Bureau.

The most important lending asset assessments are:

- Category I…… Sound assets (Unclassified assets)
- Category II……Suspect assets (with potential uncollectibles in the future)
- Category III……Where loss is suspected but the amount is not specified (50% is regarded as a loss based on the net worth assessment)
- Category VI…… Assets which are deemed uncollectible or with no value.

Category II and onward are called “Classified Assets”, and the ratio of these is called the “Classification Ratio”. The classification ratio is almost 1% for major banks, 2% for regional banks, 3-4% for mutual banks and double for cooperative banks.

Discussions in the Financial System Research Council “On Ordinary banks”. In May 1975, the Financial System Research Council was consulted by the Minister of Finance about laws and systems, such as the Banking Law. After 4 years of discussions, the council submitted a report “On Ordinary Banks”, after many assessments, in July 1979. It became the basis of the amendment of the Banking Law.

The discussions took a certain time to investigate basic and initial issues, including “Japan’s economic and financial structure in the future”, the “Roles of banks”, the “Scope of bank activities” and “Principles of the business operation of banks”. One of the reasons for doing this process was the criticism and public opinion that had been voiced against big companies and banks since the “galloping inflation”. It was said that these issues should be carefully considered after a certain time. The other was the need to review the structural change in the fundamentals of Japanese economy from the basics.

The report stated:

○ With the shift from high growth to stable growth, the financial environment is also changing, such as the shrinking in demand for funds from the corporate sector. It now requires efficiency, or making use of market mechanisms and competitive principles. At the same time, banks have social liability and a public role.

○ Therefore, financial institutions should take measures to secure their soundness to maintain the financial order and protect depositors, as well as using the interest rate function (liberalization/relaxation), relaxation of business activities, efficiency of management, specialties of each kind of institution, and conducting flexible management of administration.

○ Based on the above, a comprehensive revision of the Banking Law is appropriate. More concretely, objectives to show the basic principles, standards of license and authorization, principles for maintaining soundness (enough capital, liquidity of assets and regulation on large-size loans), disclosure regulations and stipulation on supervision and command, should be provided.

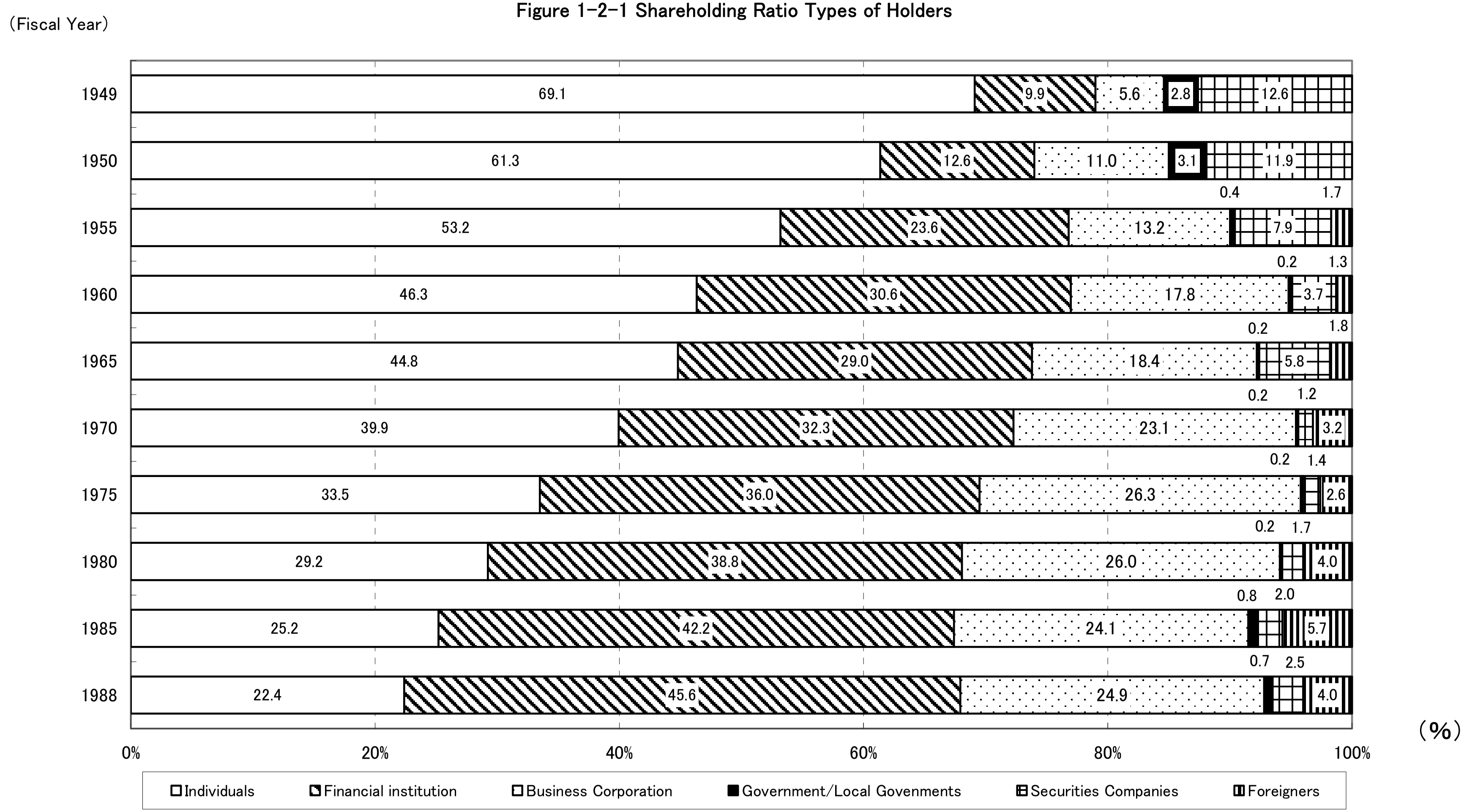
In addition, banks' activities related to securities, that is, the over-the-counter selling of newly issued government bonds and dealing (buying/selling of outstanding bonds) became a problem, as a borderline business between banks and securities companies ("*Gyosai Mondai*"). This problem was left to the Ministry of Finance for resolution.

3 Large-scale Japanese Government Bond Issuance and the Securities Market

Increase in Shareholding by Corporations and Institutions. In the stock market, the change in the shareholding structure (shareholder composition) was a big issue. As shown in Figure 1-2-1, the individual shareholding ratio, which was once no more than 70% in FY1949, after World War II, thanks to the postwar reform measures, such as the dissolution of *Zaibatsu* (family-owned conglomerates), gradually declined to 45% in FY1965, and declined to around 20% in FY1988. On the other hand, business corporations and financial institutions (institutional investor) increased instead.

Cross shareholdings between companies, especially, were raised as a topic, because these could hinder the function of stock market. The Securities and Exchange Council compiled a report in 1976 ("On the problem of change in Shareholder structure and what a securities market should be"). This report suggested that the cause of the increase in shareholdings by corporations (or institutions) was because of the following: (1) Business group formulation and stable stockholder measures; (2) Decline in yield due to an increase in issuance at the marketplace and the stable dividend scheme for

Figure 1-2-1 Shareholding Ratio Types of Holders

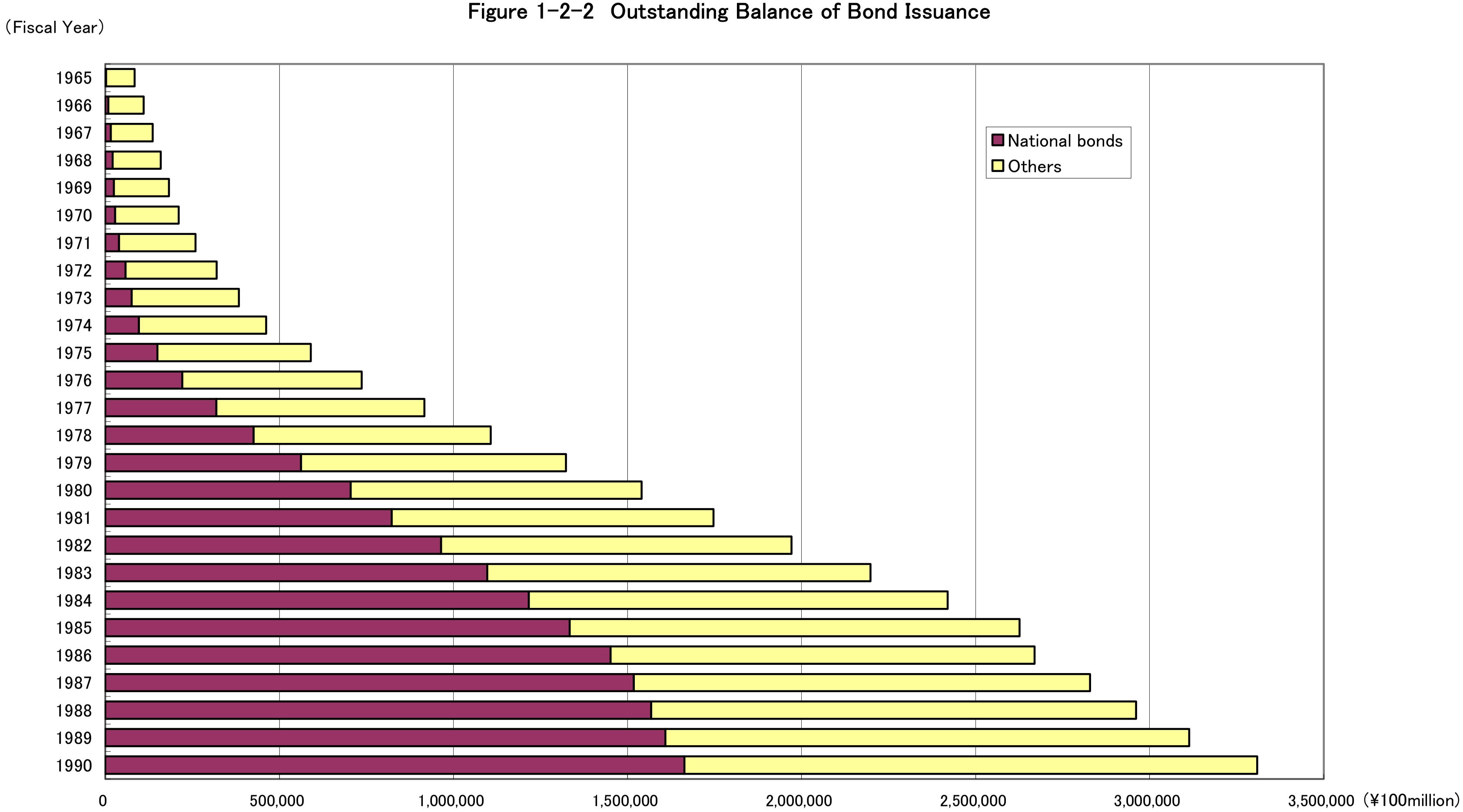


Source: National Stock Exchange, *Kabushiki Bunpu Jokyo Chosa* [A Survey of Share Ownership] stated value, which attracted fewer individual shareholders; (3) Disrespect of individual shareholders by companies and securities companies; and (4) Taxation disadvantages to individual shareholders. Therefore, the problem should be resolved by: (1) Correction of the excess shareholding of corporate organizations; (2) Restoration of the attractiveness of shareholding; (3) Improvement of the role of institutional investors; (4) Improvement of the sales attitude of securities companies; and (5) Protection of investors. Especially, importance was placed on aspect (2). In terms of (5), the fulfillment of disclosure measures and the avoidance of unfair trading were also prioritized.

Large-scale Issuance of Government Bonds and the Expansion of the Bond Market. The postwar bond market in Japan remained undeveloped in terms of both quality and quantity, including both the primary and secondary markets. In particular, the government bond market had no market rate to be referred to on issuance, so that bonds were issued by the financial authorities at a rate lower than the probable market rate. They would thus make a loss if sold on the market. In reality, however, there was an underwriting syndicate composed of financial institutions. They did not bear a great loss since the Bank of Japan conducted a buying operation for these bonds one year after issuance.

However, since the supplementary budget in FY1975, government bond issuance increased and outstanding bonds rapidly increased, as shown in Figure 1-2-2, which could not be handled by the buying operation as before. Trading Japanese Government Bonds in the market started in April 1977, and a secondary market was established in April 1979 (large-scale transactions conducted over-the-counter were brought into the stock exchange.) Since then, as shown in Table 1-2-3, the bond circulation market has been expanding rapidly, led by government bond transactions. After this large issuance of the government bonds, the bond market developed greatly and not only supplied liquidity but also became a large regulated rate market, which was a driving force for interest rate liberalization.

Figure 1-2-2 Outstanding Balance of Bond Issuance



(Source) Bond Underwriting Association of Japan, *Gendai Nihon No Koshasai Shijo* [Bond Market in Modern Japan] (1986)
Koshasai Nenkan [Bond Almanac] 1991.

Table 1-2-3 Trading Volumes of Over-the-Counter Bonds

(¥100million, %)

Fiscal Year	Total	Government Bonds	Ratio of Government Bonds
1965	23,892	0	0.00
1966	28,321	411	1.45
1967	33,672	1,768	5.25
1968	51,349	2,433	4.74
1969	62,954	3,006	4.77
1970	90,981	4,343	4.77
1971	119,260	3,008	2.52
1972	168,610	5,196	3.08
1973	233,277	10,774	4.62
1974	384,290	17,112	4.45
1975	566,589	12,936	2.28
1976	725,367	32,677	4.50
1977	1,358,900	221,164	16.28
1978	2,014,573	697,383	34.62
1979	2,262,199	1,128,873	49.90
1980	2,854,593	1,663,681	58.28
1981	3,049,119	1,951,860	64.01
1982	3,415,085	2,332,934	68.31
1983	4,391,393	3,167,083	72.12
1984	8,380,231	7,235,556	86.34
1985	25,933,971	24,521,915	94.56
1986	36,138,530	34,125,643	94.43
1987	52,051,074	50,055,429	96.17
1988	41,820,500	39,797,076	95.16
1989	35,891,167	34,380,929	95.79
1990	33,512,145	31,957,578	95.36

Source:Bond Underwriting Association of Japan, *Gendai Nihon No Koshasai Shijo* [Bond Market in Modern Japan] (1986), *Koshasai Nenkan* [Bond Almanac] 1991

Administrative Guidance. Under the license system, since 1968, the establishment and location change of a sales office, and the promotion of smaller sales office (to a branch) was specified by the Minister of Finance. This restrained the uncontrolled increase of branches, especially by taking care to avoid excessive competition between large and small/mid businesses, so that local securities companies were prioritized.

As stated earlier, administrative guidance for balance sheet regulation was conducted, from the perspective that preventative administration - which takes measures before occurrence of problems - was desirable. In order to do this, it was necessary to standardize the account settlement rules (account titles/accounting treatment). In May 1971, the Japan Securities Dealers Association the industry group worked on achieving a standard by issuing a resolution of the board of directors meeting. The administrative bodies also issued the basic notification, the “Standard of Account Settlement of Securities Companies” in August 1972, to increase profit reserves and to achieve sound assets.

Table 1-2-4 shows the settlement of accounts of securities companies. Their business activity was expanded, especially in the bubble economy. Most of their revenue was commissions received, including brokerage fees, which often fluctuated. Profits on the sale of securities in share dealing fluctuated more. Losses and profits for such trading was not stable.

The sales attitude of securities companies was also criticized from time to time. The notification on an “Investor-Oriented Sales Attitude” issued in December 1974, pointed out that it is regrettable to see cases “with excessive competition and inducement with less emphasis on investor’s profit, and some securities companies lose their credibility to investors, due to a lack of investor-oriented attitude in sales”, and directed as below:

① Investor-oriented trading (according to an investor’s intention and condition): strictly refrain from providing an investment advisory or recommendation based on the security company’s decision.
② Refrain from excessive use of credit dealing.
③ Develop underwriting services.
④ Particular care should be taken for trading: enhancement of customer management system and the in-house assessment.
⑤ Improve the sales performance evaluation: only turnover - commission is not desirable as an assessment standard, as it could lead to an improper sales attitude. Put more emphasis on other standards.

Table 1-2-4 Settlement of Securities Companies

(¥100 million, %)

Accounting term	Commission fees (a)	Brokerage Commission	Securities dealing profit	Financial account balance (b)	Marketing costs and Administration costs (c)	Ordinary profit and loss	Corporate tax , etc.	Profit and loss for this term	Sales account (a)−(c)=(d)	Current account (d)+(b)	Current account ratio
1974.9	3,711	2,440	2	582	3,993	342	210	268	−282	300	106
1975.9	4,257	2,695	554	630	4,572	892	546	396	−314	316	106
1976.9	5,760	3,875	785	667	5,609	1,623	761	732	151	818	113
1977.9	6,441	4,118	1,404	766	6,484	2,152	1,247	1,132	−43	723	110
1978.9	8,255	5,426	1,217	767	7,493	2,764	1,448	1,426	762	1,529	119
1979.9	8,830	6,181	247	879	7,765	2,229	1,034	1,157	1,066	1,945	123
1980.9	8,741	6,202	596	1,097	8,277	2,185	1,161	997	464	1,561	116
1981.9	10,442	7,765	767	1,235	9,512	2,947	1,640	1,329	930	2,165	119
1982.9	8,487	5,255	1,146	1,232	9,368	1,549	779	812	−881	351	103
1983.9	12,431	9,011	1,657	1,544	11,430	4,220	2,414	1,631	1,001	2,545	119
1984.9	15,227	10,802	2,086	1,792	13,518	5,612	2,894	2,469	1,739	3,501	123
1985.9	19,404	13,991	3,462	2,173	16,436	8,631	4,795	3,429	2,968	5,141	127
1986.9	30,552	23,840	4,533	2,439	21,685	15,783	8,873	6,350	8,867	11,306	146
1987.9	41,102	31,157	4,549	3,240	26,879	21,969	11,274	10,172	14,221	17,461	160
1988.9	38,430	27,436	2,277	3,701	27,381	16,812	8,211	8,249	11,049	14,750	148
1989.3	22,190	16,591	2,627	1,964	15,124	11,639	6,236	4,856	7,066	9,031	154
1990.3	45,085	31,143	3,365	5,247	31,693	21,675	11,130	10,039	13,392	18,639	152

Source: Ministry of Finance, *Okurasho Shokenkyoku Nenpo* [Annual Report of the Securities Bureau, Minisry of Finance] each year.

Securities Inspections. Annual security inspections were conducted under the Securities Exchange Law. The inspectors were 150 (full-time) and 68 (concurrent) in 1974, or 218 inspectors in total. The number of inspectors was quite small compared to the U.S.'s SEC. The inspection emphasized the soundness of assets, fiscal conditions and internal controls. There was a special monitoring system established in 1974 to monitor companies about whose corporate management there are concerns on a regular basis. This was to check small and mid-sized companies governed by Local Finance Bureaus and prevent financial difficulties and bankruptcy. In terms of companies needing to be monitored, some with potential were reconstructed under strict administrative guidance and, if this was difficult, merger was recommended.

4 Increased Popularization and the Insurance Business

The Postwar Insurance Business and Administration. The postwar insurance business was reconstructed after severe damage due to the war, but further developed thanks to the high economic growth of Japan. Insurance was rapidly popularized, in line with the improvements in income level. In terms of life insurance, Japan became the world's No. 1 country for the amount held to the national income, which exceeded the United States. Policyholders increased with popularization. The assets of insurance companies become huge so that insurance companies became an important shareholder/investor for stocks (they also became huge U.S. stock investors, afterwards).

At the same time, the insurance business was the most stable amongst those of all financial institutions under strict restrictions. The postwar Japanese financial system is often characterized as being a "convoy system". Insurance was the most typical business in this sense.

Under the policy of separating each financial business, life insurance and non-life insurance businesses were strictly separated from each other and from other financial institutions. There were almost no new entries, and the structure of these industries remained unchanged. In terms of life insurance, a "20-company system" was retained for years, but Ryukyu Life Insurance joined the category in 1972, with the reversion of Okinawa, and the system became known as the "21-company system". Other than that, there were a few new entries from overseas (including joint ventures). Non-life insurance has had a "22-company system" for a long time. In particular, two insurance business associations functioned strongly, due to the characteristics of insurance, such as the necessity of data-sharing of insurance accident data based on the "law of great numbers" and the required credibility and stability of companies for customers. Insurance contracts were set uniformly. Companies only competed with each other by offering slight differences in products. The premium, the price of insurance, was also mandated to be uniform under the permission of the authority, through the Fire & Marine Insurance Rating Association of Japan for non-life insurance. Even for life insurance companies, the rate was almost uniform. In other words, there was little price competition. Moreover, the rate was also determined, including the premium loading rate for a certain profit for insurance companies and the net premium rate in terms of non-life insurance, so that all insurance companies were guaranteed the stability of their businesses. Therefore, competition was only for quantitative expansion, the increase of sales, and saving costs.

This system, though, changed fundamentally after the drastic reform of the Insurance Business Law in 1995.

The basic law before 1995 was the 1939 Insurance Business Law. Therefore, the actual insurance administration guidance was made through notifications based on detailed reports by the Insurance Council. Therefore, it was just a notification-based administration, or a so-called “Council Administration”. The supervisory authority was the Insurance Department, of the Banking Bureau in the Ministry of Finance.

The Insurance Business in the Stable Growth Era. Even though the period of high growth ended, the trend of the insurance business was to keep growing at a high pace. It drastically increased in the bubble economy in the late 1980s. The postwar trend shift occurred in the mid to latter 1990s, after the collapse of bubble economy, as the insurance market ripened and it was nolonger natural to grow.

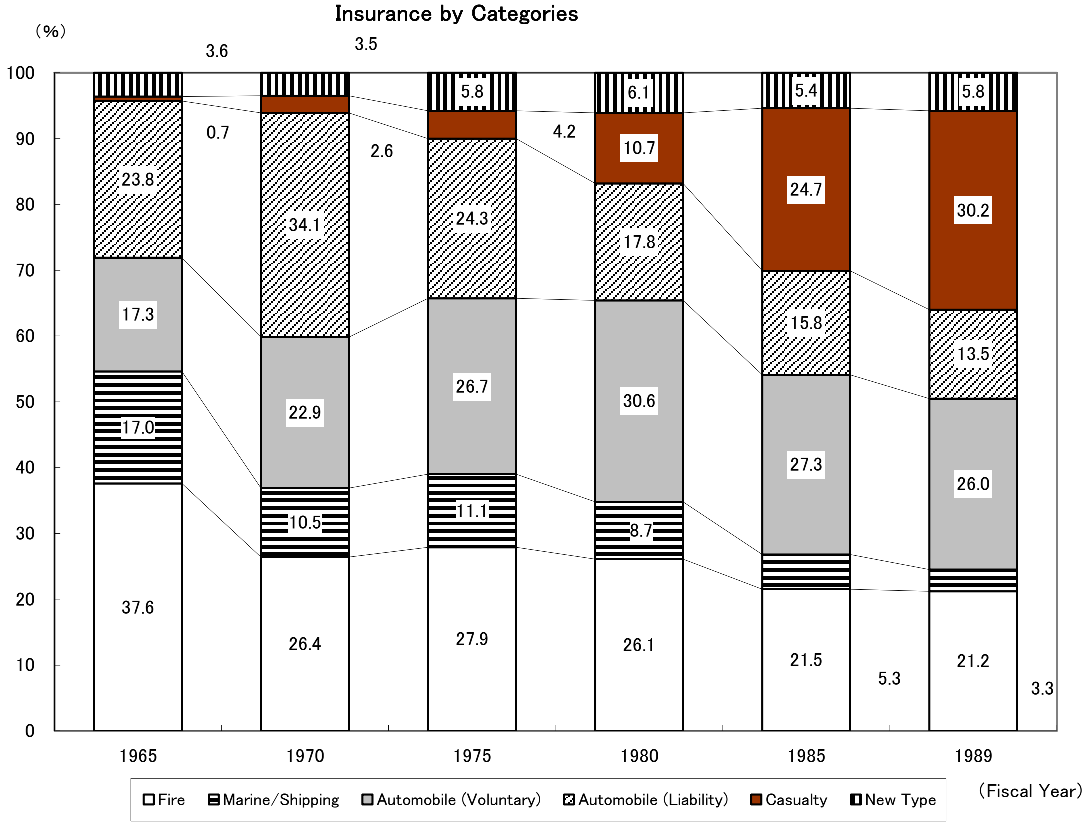
The number of contracts for life insurance gradually increased from 7.28 million at the end of FY1974 to 44.27 million at the end of FY1989, which was an increase of 6.1 times. The amounts of contracts also increased from ¥206 trillion to ¥1404 trillion, a large increase of 6.8 times. The total assets of life insurance companies also increased more than 10 times in the period, from ¥11 trillion to ¥116 trillion. This shows that the market expansion and popularization continued.

The number of contracts for non-life insurance increased from 100 million at the end of FY1974 to 310 million at the end of FY1989, an increase of 3.0 times, the amount going from ¥608 trillion to ¥4279 trillion, an increase of 7.0 times. The total assets of non-life insurance companies even increased from ¥3.3 trillion to ¥23.8 trillion, a large increase of 7.1 times. This also shows that market expansion and popularization continued.

Under the market expansion, popularization, and protection by regulations, insurance companies in this period still competed for quantitative expansion, i.e. expansion of their sales channel and network, as well as increase in market share.

The expansion of the insurance business during the bubble economy was remarkable and striking, but it was part of the boom in speculation. For instance, as shown in Figure 1-2-3, which shows the composition of the net premium for non-life insurance products, the proportion of fire, marine and automobile liability insurance, which were major products in the past, declined, but automobile insurance (voluntary insurance) became a major product. Casualty insurance also increased in the 1980s, which was outstanding in the bubble era. This was because the dramatic rise in funding type insurance with a special contract for a saving plan (repayment on maturity). This represents how the bubble economy affected insurance products, to cause them to seek a high yield return. The type of life insurance which increased in the bubble economy was ordinary endowment insurance, whole life insurance and individual annuity insurance. The major cause of this increase was the progression of the aging society but there was also an expectation of profitability, as single payment endowment insurance and variable insurance were popular. As Figure 1-2-4 shows, the assets of life insurance companies, the amount of loans which were popular in the past decreased, and cash and deposits (especially specified trust funds and foreign currency deposits) became popularized.

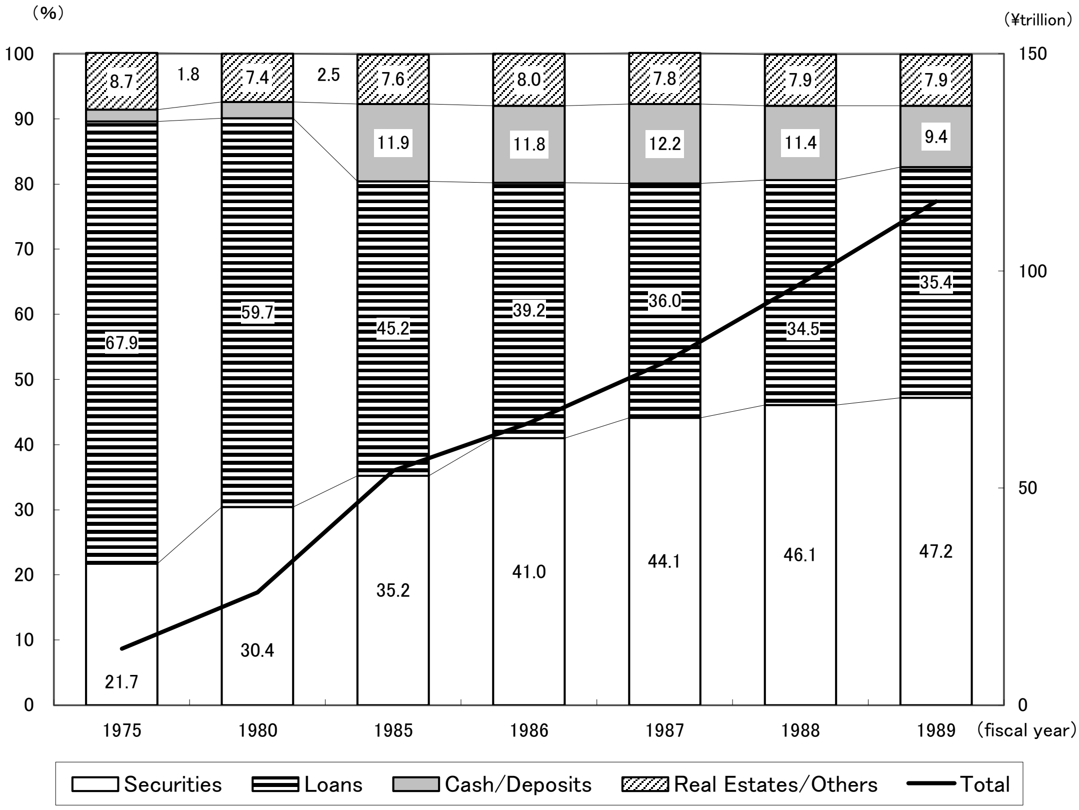
Figure 1-2-3 Distribution Ratios of Direct Net Premium of Non-Life Insurance by Categories



Source: Yoshio Maya "Insurance Business", The Society for Industrial Studies of Japan, *Sangyo Nihon Sangyo*shi [History of the Postwar Japanese Industries] (1995 Toyo Keizai Shinposha)

Securities investments (mainly in stock) also increased. In this way, the bubble economy affected the insurance business, so that it was damaged from the huge loss of stocks after the collapse of the bubble economy. Securities investments by non-life insurance companies also increased, but stock investments did not increase so much because this business is not so long-term as life insurance and investments were restricted by regulations. Therefore, the damage after the collapse of the bubble economy was less than that to other financial institutions.

Figure 1-2-4 Total Assets and Distribution Ratios of Life Insurance Companies



Source : Yoshio Maya "Hokengyo (Insurance Business)", The Society for Industrial Studies of Japan, Sengo Nihon Sangyoshi [History of the Post war Japanese Industries] (1995, Toyo Keizai Shinposha)
Note : Cash and Deposits include Call Loan and Cash Fund Trust.

Administration of the Life Insurance Business.

Emphasis on a Customer-Oriented Policy. With the improvement of living standards, customer's needs and the protection of their rights were emphasized. Moreover, because of the turmoil before and after the first Oil Crisis, people started to be keen on the protection of their lives. Therefore, the Social Policy Council's report in February 1973 also emphasized the viewpoint of customer protection for the insurance business. Under these circumstances, the Insurance Council also raised this issue and provided guidelines in the report issued in June 1975, "On the Desirable Form of the Insurance Business in the Future". Major items raised in this report were variations in insurance products and premium options, the provision of simple and accurate information, the improvement of the recruitment system (life insurance: agent; non-life insurance: agency), and the reflection of customer needs and complaints, especially in the case of mutual company type life insurance.

Improvements to the Agent System. The agent system, which was the major distribution channel for life insurance, was raised as an issue to be considered as its turnover (change of staff) occurred frequently, so there were problems of unskilled agents and "obligated and forced recruitment".

Upon receipt of the Insurance Council report, the Ministry of Finance gave guidance to the companies by providing detailed instructions. In October 1975, the MOF requested that companies assign an executive to be in charge of the improvement of the recruitment system, as well as the review of the standard of sales pamphlets. In March 1976, a 3-year improvement plan was proposed. Companies received a memorandum from the MOF in August reminding them they needed to achieve the upgrading ratio of more than 15% of the field staff to key employees in the case of large companies, or more than 10% for small and mid-sized companies, by the end of FY1978, and to achieve a continuance rate for new contracts of more than 84% for large companies and more than 80% for small and mid-sized companies. Some insurance companies could not achieve these targets.

Administration of the Non-life Insurance Business

Customer-oriented Policy. For non-life insurance companies, the MOF provided guidance including on the early introduction of a premium increment system in the midterm against inflation, and the introduction or improvement of new products and services to meet customer needs.

Improvement of the Agent System. Regarding agents, the major sales channel of non-life insurance, there was an increase in new agents, especially automobile insurance agents, and an accompanying increase in their abolishment. Non-insurance companies implemented various measures, including enhancement of qualifications and training systems, in order to cope with the specific issues raised by the Ministry of Finance and the items pointed out in the Insurance Council report.

Improvement of Insurance Company Management. To improve corporate management systems of insurance companies, it was particularly necessary to reflect the intentions of members (customers) of the mutual life company type insurance companies. As of the end of FY1974, 6 out of 21 life insurance companies were mutual companies, which occupied nearly 95% of the amount of contracts and total assets. Mutual companies were intermediate corporations, neither public corporations nor business corporations. Their Members' (equivalent to policyholders) general meeting was the best organization to make decisions. However, as it was practically difficult to hold a general meeting, a representative members meeting took place, instead. However, the selection of representatives was also criticized as it was formalized (most of them were important people). Therefore, the Insurance Council report proposed the selection of representatives from a wider range of members, the improvement of the councilors meeting in the same manner, and the fair operation of the representative members' meeting, such as by using an observation system for the meeting and having an informal gathering of policyholders. The Life Insurance Association of Japan also prohibited representatives from serving for over 3 terms and the double assignment of representatives for more than two companies.

Section 3　External Economic Policy

1　The Shift to the Floating Exchange Rate System and the Two Oil Crises

The Dollar Shock and the Smithsonian Agreement. On August 15, 1971 (August 16, Japan Time), the U.S. President Nixon announced the dollar defense package ("New Economic program") to cope with the worsening balance of payments and inflation of the United States, and ceased trading between gold and dollar. This was the end of the Bretton Woods international monetary system, 27 years after it was established, in July 1944. The exchange rate of 360 yen per dollar, which started in 1949, also ended. In and after September 1971, the major countries (G10) discussed the international currency adjustment issue, aiming at reconstructing the fixed exchange rate system, and an agreement was made at the Smithsonian Meeting (in Washington) on December 18. The agreement included: (1) a change in the exchange rate for foreign currencies; (2) the expansion of the fluctuation range of the exchange rates to 2.25% above and below the target rate (which was a 1% of range against parity); (3) the United States set the official price of gold at $38 per ounce (which was $35; the devaluation range of the dollar would be 7.89%); and (4) the United States suppressed its import surcharges. According to this agreement, the yen was appreciated to the dollar by 16.88%(7.66 % for gold), to ¥308 per dollar.

The Shift to the Floating Exchange Rate System. By the multilateral adjustment of the Smithsonian Meeting, the major currencies returned to a fixed rate, but the exchange market remained in confusion. The U.S. government had no strong intention to protect the new exchange rate (Central Rate) nor to intervene the exchange market.

In Europe, the EC countries started to unify. In April 1972, the EC made the fluctuation range of the currency in the region to half of the fluctuation range specified under Smithsonian Agreement, at 2.25%. The intervention was made for each EC currencies (the so-called "Snake in the Tunnel").

However, U.K. had to disengage from the Snake (joint floating of EC countries) and shift to an individual floating system on June 23, two months after the agreement. In 1973, a currency crisis reoccurred as the Italian lira adopted the dual exchange rate system on January 22 (an exchange rate system which applied the floating exchange rate only to capital transactions), while the Swiss franc changed to a floating exchange rate system on the following day, the 23rd. In early February, there was drastic speculation, with selling of dollars and buying of marks.

The U.S. government faced this situation and again moved towards the adjustment of the currencies. From February 7 to 12, 1973, Paul Volcker, the Under Secretary for Monetary Affairs of the U.S., traveled to Japan and European countries for discussions. Volcker visited Japan first and talked with the Minister of Finance, Kiichi Aichi. In the Aichi-Volcker talks on February 8, the United States proposed to raise the value of the yen by 9% and devalue the dollar by 9%, but Japan insisted in disagreeing with the yen appreciation, and therefore no consensus was reached on this issue. Volcker flew from Japan to Europe for discussions with the Finance Ministers of four European countries on February 11. Japan also closed the Tokyo Exchange Market on February 10 and dispatched a special advisor to the Ministry of Finance, Takashi Hosomi, to Europe. After a series of discussions, Japan agreed to the fluctuation rate in a range from 257 to 264 yen per dollar. On February 13, the Secretary of the Treasury Schultz announced a 10% devaluation of SDR parity to dollar. The Minister of Finance Aichi also announced the shift of the yen to the floating exchange rate system, effective February 14.

Even after the devaluation of dollar, the dollar crisis continued. This led to large-scale dollar selling on March 1, and closing of the exchange market of European countries on March 2 (it reopened on March 19; the Tokyo Exchange Market was closed during the same period). On March 9 and 16, talks between 14 countries, including G10, took place in Paris and the floating exchange rate system was agreed upon. Therefore, EC countries shifted to the floating system on March 19.

As stated above, the dollar devaluation under the Smithsonian Agreement was insufficient to stabilize the exchange market. The currency exchange adjustment was finally completed upon the shift to the floating exchange rate system in March 1973.

Examination of the Reform of the International Monetary System. After the termination of the exchange of U.S. gold reserves for dollars, countries gradually shifted to the floating exchange rate system, but various countries and the IMF tried to reconstruct the international monetary system.

In the Smithsonian Meeting, it was decided to study the reform of the international monetary system after the termination of the exchange of U.S. gold reserves for dollars from a long-term perspective, in the framework of the IMF. According to this, on July 28, 1972, the IMF decided to establish the Meeting of Committee of Twenty (C20) for the “reform of international monetary system” (effective September 28). The new organization known as C20 was established because developing countries were critical about international monetary problems being solved only by the industrialized countries and the U.S. was concerned about the large influence of the European countries in G10.

In the IMF Annual Meeting (Washington) from September 25 to 29, 1972, an agreement was made that the reform of international monetary system would be accomplished within three years, and countries started to work on the reform of international monetary system.

C20 prepared and submitted a first draft of the “Outline of Reform” to the IMF Annual Meeting. This draft proposed the basic plans to revise the system “based on stable but adjustable par values and floating rates recognized as providing a useful technique in particular situations” and with “SDR becoming the principal reserve asset”, but a specific currency rearrangement system issue remained pending.

C20 was supposed to complete its efforts on the international monetary system by July 1974, but the schedule was delayed due to the Oil Crisis that occurred in October 1973. C20 Rome Meeting in January 1974 confirmed that its reform efforts would be completed by June. The summary was prepared and the “Outline of Reform” was submitted to C20 (Washington) conducted on June 12 to 13. The basic points were the same as the first draft submitted to the Nairobi Annual Meeting, and the controversial points remained unsolved, but it focused on measures for the immediate Oil Crisis.

The First Oil Crisis and Oil Money. The Fourth Middle-East War began on October 6, 1973 between Egypt, Syria and Israel. Arab oil-producing countries intended to use oil as a diplomatic measure, to lead an advantageous international situation for them. With the hike of crude oil, the price per barrel, which was $3.01 before the war broke out, reached $11.65, four times the previous price, in January 1974.

Due to the steep rise of crude oil, non-oil producing countries suffered from considerable trade deficits, due to which the international balance of payments pattern changed significantly. The developed countries’ economies faced the trilemma of current account deficit, inflation, and economic slowdown. In 1974, OECD developed industrial countries recorded nearly $27 billion of current account deficit and the real growth rate of G7 countries (on average) dropped from 6.2% in 1973 to 0.2% in 1974 and -0.3% in 1975. The current account deficit of non-oil producing developing countries reached $24.5 billion and $38.5 billion in 1974 and 1975, respectively

In contrast, oil-producing countries (OPEC countries), which were mostly Arab oil-producing countries, enjoyed a current account surplus of $59.3 billion and $27.3 billion in 1974 and 1975, respectively, and achieved a tremendous amount of foreign currency revenues.

Therefore, it was essential to circulate the oil money obtained by the oil-producing countries smoothly in the international market to resolve the confusion of the world

economy.
Political circulation promotion measures were taken by the IMF and the OECD.

The IMF established an oil facility in order to circulate the oil money to developing countries with less debt capacity. This was a fund system to provide oil to the IMF countries who had a deficit in terms of their balance of payments in 1974 and 1975 (decided on June 13, 1974). From 1974 to early 1976, the oil facility of IMF was no more than 6% of OPEC's excess fund, which was estimated at about $10.2 billion, which was too small to play a key role in circulation of the oil money. Meanwhile, the mutual monetary support agreement (OECD Monetary Support Fund Agreement) of 23 OECD countries was established on April 9, 1975. The Japanese government was reluctant to use such deliberate circulation measures through an international organization, as they emphasized market-based circulation from the standpoint that there should be many options for circulating the oil money. Japan also stepped away from the United States, which was trying to unite the industrialized countries to fight against the oil-producing countries.

In reality, the circulation through the Euro Market and the U.S. Market was conducted more smoothly than expected.

The Kingston Accord and IMF Reform. It was difficult to design a scenario for the international monetary system from a long-term perspective after the first Oil Crisis, so G20 had to concentrate on short-term reform to cope with the floating exchange rate system.

C20's final report, "Outline of Reform", was submitted to the IMF Annual Meeting conducted in Washington from September 30 to October 4, 1974. It stated that the floating exchange rate system had to be maintained provisionally, while it was proposed to provide a stable and adjustable parity system, using SDR as the major reserve currency.

After the dissolution of C20, the reform of the monetary system shifted to the topic of an "Interim Committee of the Board of Governors on the International Monetary System" (the structure was the same as G20) and was agreed on January 8, 1976 (the Kingston Accord).

The Second Amendment of the Article of Agreement on IMF was adapted in April 1976, according to the accord above, and enforced on April 1, 1978. This amendment left countries to choose an exchange rate system using their free discretion, while gold reserves were demonetarized.

G5 and Summit. In the early 1970s, industrialized countries started to call for a new opportunity for talks.

G5 (Group of Five: Five major industrialized countries Minister of Finance Meeting) became the major opportunity for talks among the industrialized countries, in terms of international monetary and macro-economic policy. G5 started in April 1973 in the Whitehouse Library, to talk about the international monetary problems among the Secretary of the Treasury Schultz of the United States, Finance Minister Giscard d'Estaing of France and Finance Minister Helmut Schmidt of West Germany. Just before the IMF and the World Bank Annual Meeting in September 1973, the Minister of Finance Aichi proposed to hold a 5-country Minister of Finance Meeting, the motive of which was to hold the first Finance Minister talk of 5 countries (G5), with the participation of Japan, the United States, the United Kingdom, Germany and France) on November 24 to 26. The participants initially were the Finance Minister and deputies of Finance Minister, but later the Central Bank Governor started to participate in the talks. The meetings and discussions were kept secret, until they were announced at G5 in September 1985 of Plaza Accord. Talks for the international monetary problems among the industrialized countries were G10 (10-country Minister of Finance Meeting) and WP3 (OECD, Working Party on International Cooperation) but G5 (Italy and Canada joined in 1986, making it G7: 7-country Minister of Finance and Central Bank Governor's Meeting) played an extremely important role as an opportunity for policy coordination, especially after the Plaza Accord.

President Giscard d'Estaing of France and Prime Minister Schmidt of West Germany took the initiative to hold a Summit (Economic Summit) to discuss the issues of currency, trade, and energy related topics. The first summit was held in Rambouillet in France. After this, the summit was held annually, as an opportunity for the member countries to talk about economic issues.

"Locomotive Theory". In the process of recovery from the first Oil Crisis, the "Locomotive theory" represents the contrast of the successful recovery of Japan and West Germany and the delay in the recovery of the U.K., France, and Italy. The economies of the industrialized countries started to recover in the middle of 1975, but the road ahead was still rocky for the U.K., France and Italy, and their current accounts got worse in 1976. The economies of these countries finally recovered from autumn 1977 to 1978.

Although the United States moved towards economic recovery from early 1975, ahead of the other countries, inflation got worse in 1978 due to tax reductions, and economic stimulus policy, such as the expansion of fiscal expenditures. A high trade deficit was also recorded in 1977 and 1978. In contrast to these countries, Japan and West Germany showed favorable performance in terms of trade, the inflation rate and the growth rate. With such a gap between the economic recovery of the industrialized countries, there was criticism of Japan and Germany, which enjoyed a considerable surplus in their balance of payments.

In the foreign market in 1976, there was anticipation for yen appreciation, and in the United States, people talked about a "Dirty Float" (Japan's intentional yen depreciation).

In the IMF and the World Bank Annual Meeting in September 1977, Japan and Germany were criticized because of their surplus. Other countries insisted that they should increase domestic demand by taking measures to stimulate the economy. Then, from autumn 1976, the "Locomotive Theory" was introduced. This theory stated that Japan, the United States and Germany should conduct their domestic demand expansion policy in order to be the driving force for the recovery of the global economy.

In the London Summit in May 1977, the coordination of Japan, the United States and Germany as the "locomotives" of the world economy was discussed. As Prime Minister Helmut Schmidt of West Germany was concerned about the inflation, he strongly opposed the expansion policy, and the specific figures on the growth rate were not reflected in the communiqué, but Japan and West Germany promised to make efforts to achieve the growth target. In the Bon Summit in July 1978, West Germany agreed to take an additional measure equivalent to 1% of GNP, while Japan made an official commitment to 7% growth.

President Carter's Dollar Defense package. The dollar depreciation rapidly proceeded in the second half of 1978, and as concerns were raised about the U.S. economy, the United States started to take defensive measures for the dollar.

On November 1, 1978, President Carter announced a dollar defense package, as follows: (1) the United States would take cooperative intervention measures with West Germany, Japan and Switzerland. The Department of the Treasury and the Federal Reserve Bank would provide $30 billion for the exchange rate intervention ($15 billion for the swap line extension, $10 billion for foreign currency-bonds, and $5 billion for withdrawal of the IMF reserve tranche and SDR selling); (2) the Department of the Treasury would increase gold selling; and (3) the U.S. would raise the official discount rate and the deposit reserve requirement ratio (the official discount rate rose from 8.5% to 9.5%).

The Second Oil Crisis. While primary commodity prices started rising in the middle of 1978, a movement to usurp the king escalated in Iran. This led to the Islamic Revolution in February 1979. OPEC then decided to raise the crude oil marker price by 10% on average, in the middle of December 1978, against the political uncertainty of Iran, which triggered the second Oil Crisis.

In June 1979, OPEC raised the standard crude oil price to $18 per barrel. The United States froze the assets of Iran retained in the United States as after the occupation of the American Embassy by Islamic students on November 4. Both countries broke off economic relations, and the crude oil spot price reached $40 per barrel. The crude oil price rose to three times the regular price by 1981.

The Tokyo Summit (June 28 and 29, 1979) was an energy summit, where the countries spent most of the time discussing energy related issues. The biggest achievement of this summit was the agreement on a specific target for petroleum consumption and import savings per country.

2 Outline of the external economic policy

Current Account Deficit Caused by the Oil Crisis. Japan's current account had been in surplus since 1968, but experienced a deficit of $100 million in 1973 and $46 billion in 1974, respectively, because of the price hike in imported crude oil after the first Oil Crisis ($19 billion in 1972, $32.5 billion in 1973, and $53 billion in 1974) (Table 1-3-1).

Table 1-3-1 Balance of Payments (IMF basis)

($million)

Year	Current account	Trade Balance	Exports	Imports	Long term capital account
1970	1,970	3,963	18,969	15,006	△ 1,591
1971	5,797	7,787	23,566	15,779	△ 1,082
1972	6,624	8,971	28,032	19,061	△ 4,487
1973	△ 136	3,688	36,264	32,576	△ 9,750
1974	△ 4,693	1,436	54,480	53,044	△ 3,881
1975	△ 682	5,028	54,734	49,706	△ 272
1976	3,680	9,887	66,026	56,139	△ 984
1977	10,918	17,311	79,333	62,022	△ 3,184
1978	16,534	24,596	95,634	71,038	△ 12,389
1979	△ 8,754	1,845	101,232	99,387	△ 12,976
1980	△ 10,746	2,125	126,736	124,611	2,324
1981	4,770	19,967	149,522	129,555	△ 9,672
1982	6,850	18,079	137,663	119,584	△ 14,969
1983	20,799	31,454	145,468	114,014	△ 17,700
1984	35,003	44,257	168,290	124,033	△ 49,651
1985	49,169	55,986	174,015	118,029	△ 64,542
1986	85,845	92,827	205,591	112,764	△ 131,461
1987	87,015	96,386	224,605	128,219	△ 136,532
1988	79,631	95,012	259,765	164,753	△ 130,930
1989	57,157	76,917	269,570	192,653	△ 89,246
1990	35,761	63,528	280,374	216,846	△ 43,586

Source: MOF, Zaisei Kinkyu Tokei Geppo [Ministry of Finance Statistics Monthly] No 186,199,244,255,278,290,521

Note:
1. SDR distribution for 1970 was $122 million, $128 million in 1971 and $160 million in 1972 included.
2. "Trade Balance" excludes processing deal expenses and commission trading (net acceptance) in and after July 1979
3. "Long Term capital account" excludes bond repurchase trading in and after 1979

Exports developed without problems in spite of the Oil Crisis. Therefore, the current account soon turned to a surplus. The current account deficit bottomed out during January to March 1974, and then it was improved. It showed a marked improvement in 1975, and turned out to have a significant surplus in 1976.

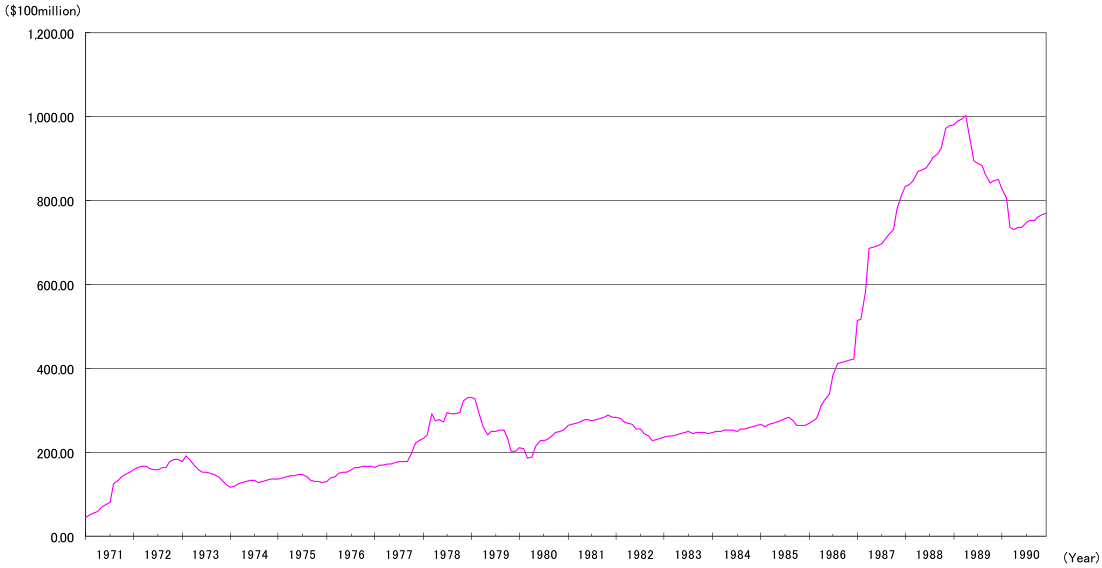
In 1976, the industrialized countries' economic recovery progressed, as Japanese exports of motor vehicles, electric appliances, steel and ships to the United States and European countries increased. Exports also increased substantially in 1977 and 1978, in spite of the drastic yen appreciation. The trade surplus was extended to $17.3 billion in 1977, and the current account also represented substantial surplus by 1978.

However, the second Oil Crisis occurred in December 1978, and a considerable current account deficit of $87 billion was recorded in 1979.

The long-term capital account recorded constantly excessive debt, but the scale shrunk to $270 million in 1975, because the capital outflow had been limited since November 1973. The capital outflow further worsened after 1976, and it recorded excessive overflow in 1978 and 1979.

Foreign Exchange Reserves and Foreign Asset Deficit Balance. Exchange reserves suddenly increased by 3.5 times during 1971, and recorded $15.2 billion by the end of the year (Figure 1-3-1). In particular, immediately after the Nixon Shock, large-scale dollar selling occurred, therefore the Bank of Japan conducted buying support

Figure 1-3-1 Foreign exchange reserves (1971-1990)



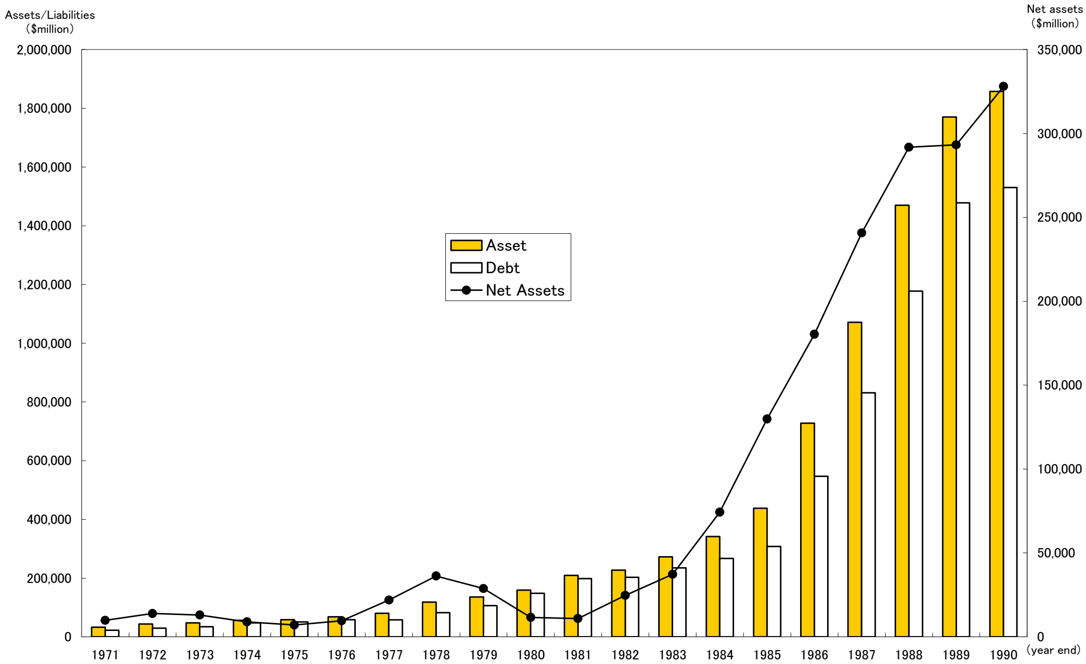
Source: *Ministry of Finance (MOF), Ōkurashō Kokusai Kinyūkyoku Nenpō* [Annual Report of International Finance Bureau, Ministry of Finance]

to the level of nearly $4 billion. In spite of the Smithsonian revaluation in 1972, exports recorded a substantial surplus while the exchange reserves reached $19 billion, by the end of February 1973 (the peak before the first Oil Crisis). In 1973, it rapidly declined, reaching the level of $11.5 billion by the end of January 1974. From 1976 to the end of 1978, there was a drastic increase in Japan’s exports and buying support for the dollar by the foreign exchange authorities, the exchange reserve kept increasing. The exchange reserve reached $33.1 billion in January 1979, but it started to decrease due to the occurrence of the second Oil Crisis.

External assets increased 4.1 times from the end of 1971 to the end of 1979 (Figure 1-3-2). External liabilities increased 4.6 times in the same period. The amount of Net external assets (external assets minus external liabilities), decreased from 1973 to 1975 due to the Oil Crisis, but started to increase by 1978. However, it again decreased in 1979, due to the negative effects of the second Oil Crisis. Through this period, net assets increased 5.3 times from $9.7 billion at the end of 1971, to $28.7 billion at the end of 1979.

Regarding the external assets, long-term assets including loans and securities investment strikingly increased from 1976, and the composition of assets was changed, from short-term to long-term type. In contrast, the ratio of short-term liabilities gradually increased in the liabilities composition.

Figure 1-3-2 International Investment Position of Japan



(Source) Bank of Japan (BOJ) Kokusai Shushi Tokei Geppo [Balance of Payments Monthly], MOF, Zaisei Kinyu Tokei Geppo [Ministry of Finance Statistics Monthly] No. 508, 521

Trend in the Exchange Rate. The yen appreciation proceeded to reach ¥254/$ on July 9, 1974, after the shift to the floating exchange rate system in February 1973. After that, the Bank of Japan made an intervention at ¥265/$ under the agreement between Japan and the United States, as setting a proper rate in a range from ¥257 to 264/$. Then, the exchange rate was stabilized in a range from ¥260 to 270/$ (Figure 1-3-3).

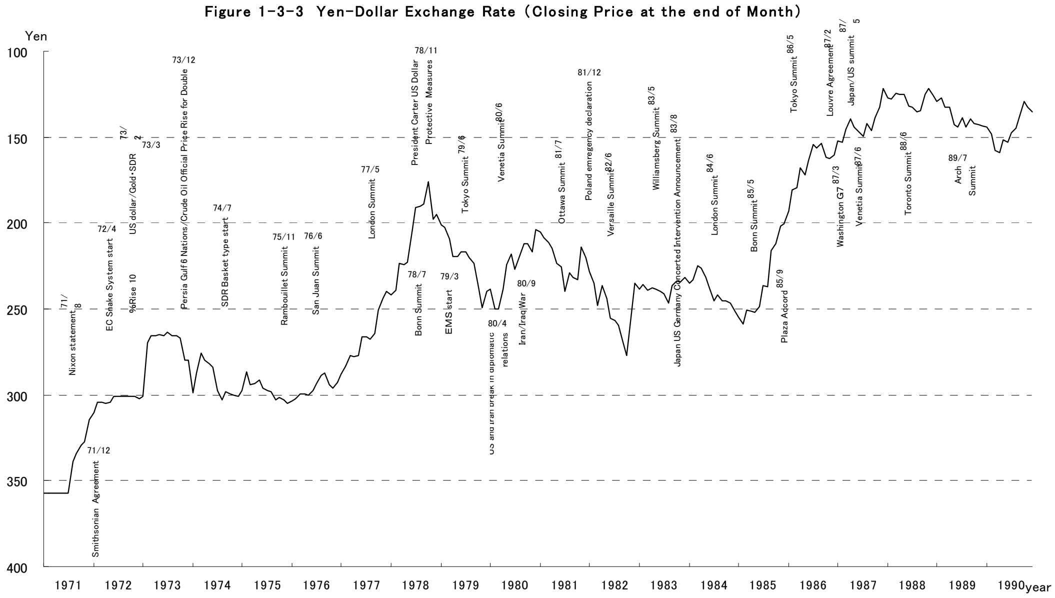
However, once the Oil Crisis occurred, large-scale yen selling and dollar buying started. Therefore, the yen was depreciated from ¥270/$ on November 1, 1973 to ¥300/$ on January 9, 1974, resulting in more than 10% in yen depreciation within 2 months, in spite of the active intervention by the Bank of Japan. The yen recovered to ¥273.50/$ on March 28, 1974, but reached a record low since the start of floating exchange rate system of ¥303.40/$ on August 22.

The yen bounced back to ¥285/$ on February 25, 1975, but Japan’s exports became sluggish, while the United States’ economy recovered. The yen depreciation gradually progressed to ¥306.85/$ on December 8, 1975, a record low since the start of floating exchange rate system. The yen bottomed out in December 1975, and started to move towards yen appreciation, but the pace was extremely slow during 1976.

Under these circumstances, Japan’s exports to the United States suddenly increased, mainly in motor vehicles and electric appliances, in 1976. However, the United States claimed that this was because Japan artificially controlled the exchange rate for its export-led economic recovery.

A drastic yen appreciation occurred from early 1977 to the end of October 1978. In 1977, the trend of yen appreciation further accelerated and reached ¥238/$ on December 15, from ¥290/$ earlier in the year. The yen appreciation further accelerated in 1978, to reach ¥200 at the end of July, and reached the record high of ¥176 on October 31.

Figure 1-3-3 Yen-Dollar Exchange Rate (Closing Price at the end of Month)



Policies for Avoiding Yen Appreciation. Japan’s external economic policy had to be changed, as was required to cope with the changes in the world economy in the 1970s, such as the shift to the floating exchange rate system and the two oil crises.

The target of Japan’s external economic policy before the Oil Crisis was to avoid yen appreciation. With the mark revaluation in October 1969, the parity adjustment by other countries and the flexibility of the foreign exchange market were the key items on the agenda for the international society to consider. However, in Japan, there was a strong public view that it was necessary to avoid yen appreciation, which could have negative effects on the export industry, and therefore that the rate of ¥360/$ was desirable.

In May 1971, when the currency crisis occurred in Europe and the mark shifted to the floating exchange rate system in May 10, foreign exchange rate speculation became rife regarding yen revaluation. The government decided on its primary yen measures ("*Comprehensive Economic Measures*") on June 4, with an eight-point program for yen appreciation. The U.S. President Nixon then declared the termination of gold and dollar exchange on August 15, so that world currencies provisionally went into the floating exchange rate system (on August 28, for Japan).

After the reopening of the exchange market, Japan made an active market intervention, in order to minimize the yen devaluation. The Smithsonian Agreement in December 1971 devalued the yen parity by 16.88% to ¥308. However, this currency adjustment was not effective to restrain the current account surplus of Japan, so that there was a further demand for yen appreciation. Therefore, the government specified secondary yen measures, with a seven-point program on May 20, 1972, followed by a third set of yen measures the "five-point program" ("*External Economic Emergency Measures*") on October 20, to avoid the revaluation of yen.

On May 20, 1972, the secondary yen measures with the seven-point program ("On the active promotion of External Economic Policy") provided specific measures for the use of foreign currency, such as foreign currency deposits to foreign exchange banks and import finance and overseas investment finance expansion by the Export and Import Bank of Japan. Foreign lending facilities for Japanese residents with foreign currencies were established in August 1972 for the residents of Japan under the current law, which was to promote imports and external investment.

The third set of yen measures with the five-point program on October 20, 1972 consisted of: (1) an increase in imports; (2) making exports more appropriate; (3) liberalization of capital; (4) expanding economic cooperation; and (5) fulfillment of welfare. This five-point program aimed at promoting fiscal measures to progress the purposes of social capital and security, and the liberalization of trade and foreign exchange market. Laws associated with these programs were enacted on November 13 as the "Package Law for the adjustment of external economic relations". The third set of yen measures was to alleviate pressure on Japan from foreign countries and the exchange rate stabilized at ¥296-297/$.

The stable yen rate did not last long. On February 14, 1973, Japan shifted to the floating exchange rate system. The government still thought about returning to a fixed exchange rate system but tried to apply a managed floating system with a stable rate of around ¥265/$, by making thorough interventions in the market. As a result, the exchange rate stabilized in a range from ¥264-266/$, until the occurrence of the Oil Crisis.

The First Oil Crisis and Promotion of Capital Inflow. With international monetary instability, the government enhanced regulations on overseas short-term capital in February 1972, in order to avoid an inflow of speculative funds for potential yen appreciation. On February 25, the regulation on advance payments for exports was reapplied, and strengthened on June 29. The reserve requirement ratio for the free yen account rate was also raised on July 1. The scope of regulations on the conversion of foreign currency into yen was expanded to all exchange banks. For long-term capital, the issuance of foreign bonds by private enterprises was basically terminated in February 1971.

However, upon the occurrence of the Oil Crisis at the end of October 1973, when the exchange rate dropped sharply and the current account went into deficit, the government completely changed its exchange policy of restricting the inflow and promoting the outflow of foreign currencies, in the background of the balance of payments surplus.

After October 29, 1973, in order to prevent the depreciation of the yen after October 29, 1973, the policy authorities started market intervention by dollar selling. Yen conversion regulations were eased after an interval of six years, and the free yen account was not covered by the yen conversion regulations from December 17. The regulation on the fund for advance payments for exports was also abolished in February 1974. In December 1973, permission for foreign bond issuance was also resumed. Restrictions on the outflow of capital were also planned and foreign currency lending for Japanese residents was adjusted and downsized in December 1973.

Yen depreciation stopped provisionally until April 1974. However, the yen started to devaluate again from April 1974, and therefore the MOF introduced an “emergency yen defense package” from late July to August, including the deregulation of advance payments for exports, the expansion of the yen conversion regulations on foreign banks in Japan and the abolishment of the limitation of short-term government securities, which was almost the complete abolishment of the short-term regulations.

Because of the significant deregulation of short-term capital, Japanese banks started to compete for the Euro dollar. Euro dollars outstanding drastically increased from $6.7 billion in September 1973 to $19.1 billion in June 1974. In July and August 1974, the interest rate on a dollar from Euro Market by Japanese foreign exchange banks had a premium of 2% (“Japan Premium”). The MOF and the BOJ were afraid of the economic instability of the foreign exchange bank and issued guidance to the foreign exchange bank to restrain its loans (overseas loans) in foreign countries.

Dirty Float Theory. Japan enjoyed an economic recovery from mid 1975. It was supported by an increase in exports. The United States government criticized Japan, as if Japan was controlling the foreign exchange rate towards the yen depreciation ("Dirty Float Theory").

C.F. Bergsten (fellow of the Brookings Institute) criticized Japan's yen depreciation in Congress in June 1976, which triggered pressure on the foreign exchange rate for yen appreciation. In August 10, the Under Secretary for Monetary Affairs E.H. Yeo visited Japan and stressed the responsibility of surplus countries and encouraged the Minister of Finance, Masayoshi Ohira, and the Bank of Japan Governor, Teiichiro Morinaga, to make an exchange rate adjustment.

The Ministry of Finance opposed the yen appreciation, as the current account surplus was not because of structural reasons but provisional. However, in the Japan-U.S. summit talks in March 1977, the U.S. President Carter claimed that Japan should be liable for the exchange rate in the global politics. Even in the OECD Ministerial Council in June, Japan's yen depreciation was strongly criticized by other countries.

Promotion of Imports and Domestic Demand Expansion. The government proposed external economic polices one by one, to achieve a balance of the external economy and the economic growth from increase in domestic demand.

On September 3, 1977, the external economy related section of the "Comprehensive Economic Measures" was materialized as "On the Promotion to The External Economic Measures" in the Ministerial Conference for Economic Measures on September 20. It comprised the following: (1) active participation in the Tokyo Round Negotiations; (2) the promotion of imports; (3) the encouragement of reasonable exports related to industries; and (4) the promotion of capital transactions and economic cooperation.

In the IMF and the World Bank Annual Meeting conducted in late September, the managing director of the IMF Witteveen pointed out that Japanese domestic demand and the increase of imports were not sufficient, so other economy stimulus measures should be added to increase domestic demand, and internationally opinions were voiced that Japan should proceed with reforming its external economic policy. In the foreign exchange market, yen appreciation rapidly developed since late September and reached ¥240/$ in the Tokyo Market on December 15, 1977, for the first time.

Under these circumstances, Prime Minister Fukuda stated in November that the Japanese government was taking provisional measures as follows: (1) emergency imports of at least $3 billion to be conducted for uranium, crude oil and foodstuff for assistance; and (2) tariff-cut of computers, automobiles and color films, etc. On November 17, the MOF and the BOJ announced regulations against short-term fund inflows, in order to prevent the inflow of speculative funds, as follows: (1) termination of public offering of the government short term securities that induced speculation by foreign investors in the foreign exchange market; (2) increase in the deposit reserve requirement ratio against an increase of free yen deposits (50% of the reserve ratio would be applied to deposits of an amount above average in October).

In order to take active measures to open up the market, the Ministerial Conference for Economic Measures was held on November 29. The Ministerial Conference for Economic Measures determined on a policy of actively promoting the market opening and the basic policy of the "External Economy Measures (individual measures)" (eight points to reduce the surplus). The eight points included active participation in the GATT Tokyo Round Negotiations, expansion of the allocation of the remaining import restricted items, expansion of imports, and promotion of economic cooperation. On December 12, the Japan-U.S. trade negotiations were held (the Ushiba-Strauss talks), and a resolution was obtained in January 1978.

The foreign exchange market was stable for the time being, the but yen appreciated rapidly again in March 1978.

The government announced import promotion measures, with a four-point program on March 11, 1978, and the strengthening of regulations on short-term capital on March 15. And the government decided upon the "Comprehensive Economic Measures" by which a growth rate of 7% was achieved within FY1978 and the current account surplus was reduced to $6 billion (seven points program for domestic demand expansion and surplus reduction) on March 25.

From April 1978, the policy authorities' foreign exchange market intervention policy changed towards acceptance of yen appreciation. The BOJ did not make any interventions in the market from April to May. Prime Minister Takeo Fukuda committed to the following at the Bonn Summit on July 16–17: (1) achieving 7% growth in FY1978; (2) restraining exports in FY1978 below the level of the previous year; and (3) increasing Official Development Assistance (ODA) to double the level within three years.

On September 2, in order to achieve a 7% growth rate within FY1978, comprehensive economic measures were decided upon to compensate for the decrease in export quantities caused by yen appreciation, with a domestic demand expansion policy for ¥2.5 trillion yen. For the external economy, emergency imports and economic cooperation was to be promoted, and emergency imports of around $4 billion in total would be implemented in FY1978. Then, when the United States announced its dollar defense package on November 1, the tendency for yen appreciation was finally stopped.

3 Liberalization of Foreign exchange and External Finance/Security Services

Abolishment of the Foreign Exchange Concentrating System and the Establishment of the Dollar Call Market. As the exchange reserve increased, there was demand for relaxation of the foreign exchange management system. To meet such demands, the government abolished the foreign exchange concentrating system and opened the dollar/call market in 1972.

The foreign exchange concentrating system was established to enable the government to centralize and allocate a small amount of foreign currency in the postwar era for foreign exchange control. However, this system became gradually unsuitable to the conditions of the time in the early 1970s. Therefore, the foreign exchange concentrating system was abolished and Japanese residents were not required to sell foreign currencies obtained in external transactions to the foreign exchange bank etc., from May 8, 1972.

On April 17, 1972, the Tokyo Dollar Call Market was established. Before the market launch, the conventional exchange management system hindered financial institutions in Japan from trading the dollar freely and short-term foreign currency funds were only managed by the Euro Market or the U.S. Federal Fund market. This system contributed to the development of the Tokyo Foreign Exchange Market, as the foreign currency flow could be completed in a flexible manner between the foreign exchange banks.

Amendment to the Foreign Exchange Control Law. Almost 30 years had passed since the “Foreign Exchange and Foreign Trade Control law”(the so-called “Foreign Exchange Control Law”) was enacted in 1949, and the Foreign Capital Law was enacted in 1950. Therefore, it was not only obsolete under the situation of the times, but also gave the impression to foreign countries that Japan was still a very closed country with an old system. In January 1978, Prime Minister Takeo Fukuda announced his intention to revise the Foreign Exchange Control Law, from being “basically restricted and exceptionally free” to “basically free and exceptionally restricted” for international fund transaction, and with this the revision of the Foreign Exchange Control Law and the Foreign Capital Law was begun.

It progressed at a rapid pace: the new Foreign Exchange Control Law (the “Law concerning the partial amendment of Foreign Exchange and Foreign Trade Control

Law") was promulgated on December 18, 1979 (enforced December, 1980). The Foreign Capital Law was abolished.

The new Foreign Exchange Control Law stated the principle of free external trade and minimum restrictions, which were to be executed only when they were required for the normal development of external trade. As current trading had been liberalized in 1964 when Japan became a member of the IMF, this new law liberalized capital trading. Capital trading was basically free in usual conditions, but the Minister of Finance would be entitled to implement "emergency restrictions" for abnormal conditions such as balance of payments disequilibrium or a drastic change in the foreign exchange market.

This law allowed free external lending and internal lending of funds in normal conditions. Securities' trading became freely available through the designated securities companies. Securities issuance and offering could also be freely conducted with prior notice. Inward direct investment and technology contracts could also be freely conducted with prior notice. Trading of services was also free, with some exceptions. The restrictions on foreign currency deposits in foreign exchange banks in Japan by Japanese residents were abolished and they were allowed to use the service freely in normal conditions.

Likewise, most of the regulations on the foreign exchange control were abolished, except the exchange management through the foreign exchange bank ("Tamegin-Principle") which would implement prompt and appropriate regulations for emergencies.

Establishment of Japanese Foreign Exchange Banks for the Overseas Market. Many Japanese banks started offering their services overseas in 1971 to 1974 but the pace of spreading overseas declined in 1975 and onward, due to the international monetary instability caused by the first Oil Crisis. At the end of 1979, there were 127 branches and 73 local corporations.

Foreign currency or yen-denominated based loans by Japanese foreign exchange banks to non-residents in Japan were called the external loans (or overseas loans). Since around 1970, quite a number of Japanese financial institutions started to go abroad. In around 1973, Japanese banks' overseas branches and local corporations entered into the Euro Dollar Market and obtained funds from the Euro Market mainly for syndicate loans, (large loans by loan syndicate comprised of domestic and foreign banks) to actively provide external loans. Therefore, the loans of Japanese banks overseas branches started to focus on mid-term and long-term loans for non-residents, not short-term trading finance as in the past.

As Japanese banks competitively introduced Euro funds, there were issues raised in 1974 including the Japan Premium and worsening of the short-term fund position of foreign exchange banks. Thus, as the regulations on overseas loans were enhanced, overseas loans declined from 1975 to 1976 temporarily. However, the rules of the overseas loans of Japanese banks was deregulated from 1976 to 1977, and the overseas loans rapidly increased in 1978 and 1979, so that the local loan balance at the end of 1979 reached nearly $36 billion.

These developments relating to the overseas loans of Japanese banks temporarily suffered from a loss due to the outbreak of the second Oil Crisis. Due to the increase of funding risk and country risks related to expansion of debts of the non oil-producing countries, the business environments of Japanese banks were worsened. Therefore, the Ministry of Finance requested Japanese bank branches to restrain their overseas loans in October 1979, and eventually substantially banned mid-term and long-term foreign currency-denominated loans.

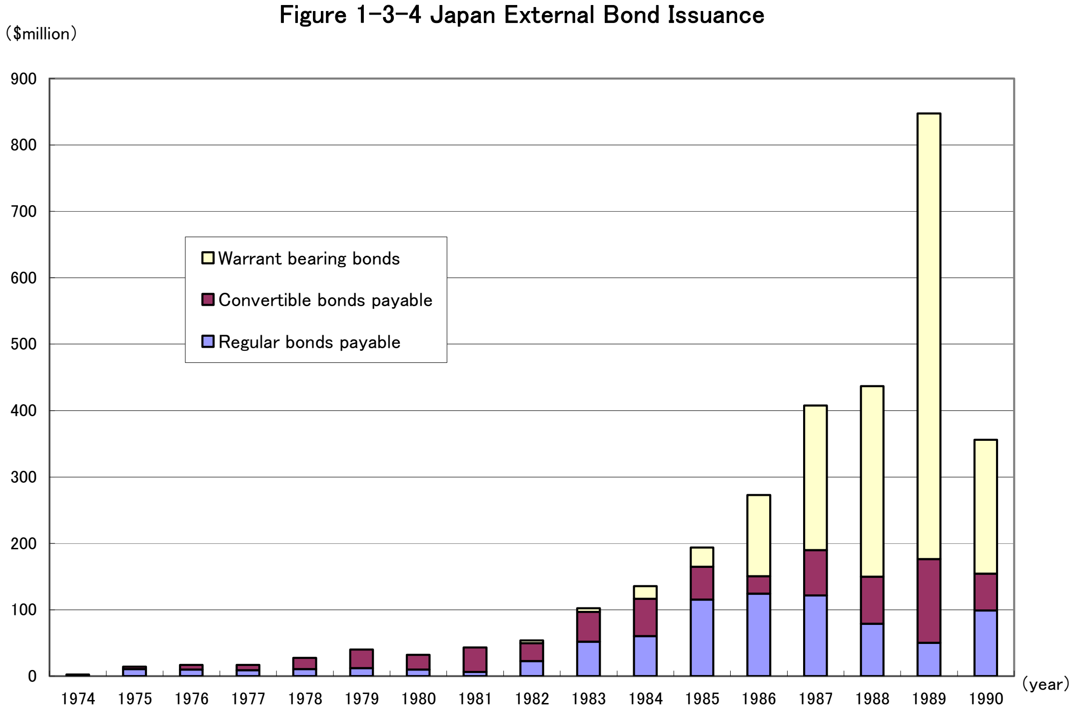
Increase in Foreign Bond Issuance by Japanese Private Enterprises. The balance of payments surplus surged in the late 1960s and the early 1970s. When external economic frictions occurred, the government considered external bond issuance by Japanese enterprises as not being favorable, as it might increase the exchange reserve. The MOF basically banned the issuance of foreign bonds by private enterprises in February 1971.

The banning of foreign bond issuance continued until December 1973.

When the balance of payments worsened due to the first Oil Crisis, the MOF gradually deregulated the issuance of foreign bonds. In December 1973, Japanese enterprises were permitted to issue foreign bonds only if the funds would be used for overseas business activities, and even permitted overseas funding of domestic business activities on a case-by-case basis, in November 1974. With the progress of the deregulation of foreign bond issuance, bond issuance by Japanese companies in foreign countries rapidly increased in 1975 to 1976 and 1978 to 1979 (Figure 1-3-4).

Japanese securities companies also started to open their bases overseas in around 1972 and 1973 thanks to the development of European Bond market. As of December 1979, 12 securities companies had 69 overseas bases.

Figure 1-3-4 Japan External Bond Issuance



(Source) Same for as Figure 1-3-1

Issuance of Yen-denominated Foreign Bonds and Euro/Yen Bonds. The first yen-denominated foreign bonds (Samurai Bonds) were the first Asia Development Bank bonds (¥6 billion) issued in December 1970. In 1972, Samurai Bond issuance was promoted as one of the policies for avoiding yen appreciation. Later, foreign bond issuance was limited temporarily, due to the outbreak of the first Oil Crisis, but Samurai Bond issuance resumed in 1975. In particular, when the Ministry of Finance deregulated the Samurai bond issuance level in May 1977, Samurai Bond issuance was activated in 1977 and 1978.

The issuance of Euro Yen bonds was approved in March 1977, and the first bonds were issued in May as European Investment Bank Bonds (EIB) for ¥10 billion. The Ministry of Finance considered that Samurai Bonds should be mainly issued in the Tokyo Market, so that issuance was available but limited to international financial institutions which experienced issuing bonds in the Tokyo Market for the time being.

Outward Direct Investment. Outward direct investment was fully conducted in the late 1960s, especially in FY1972, and the amount reached $2.338 billion - about 2.7 times of the amount of the previous year. Although it reached $3.494 billion in FY1973, it started to decline due to economic slowdown and regulations on the capital outflow after the first Oil Crisis. It was finally restored to the level of FY1973 in 1978 (Table 1-3-2).

Table 1-3-2 Outward/Inward Direct Investment

($100million)

Fiscal Year	Outward	Inward
1972	23.38	–
1973	34.94	1.67
1974	23.95	1.54
1975	32.80	1.67
1976	34.62	1.96
1977	28.06	2.24
1978	45.98	2.35
1979	49.95	5.24
1980	46.93	2.99
1981	89.31	4.32
1982	77.03	7.49
1983	81.45	8.13
1984	101.15	4.93
1985	122.17	9.30
1986	223.20	9.40
1987	333.64	22.14
1988	470.22	32.43
1989	675.40	28.61
1990	569.11	27.78

Source: Same for as Figure 1-3-1

Completion of the Liberalization of Direct Investment. “Capital Liberalization” (Direct Investment Liberalization was known as “Capital Liberalization” at that time) started in 1967. It started with the first liberalization in July 1967, and continued until the fourth in August 1971. The policy was changed in May 1973 from 50% to 100% liberalization in principle. Furthermore, the retail business was liberalized on June 1, 1975. When the renewal period of the 17 businesses was completed, on May 1, 1976, the liberalization of direct investment was thereby completed. (Inward direct investment was changed from the advance notice system to the after-the-fact system in 1992).

Inward direct investment after that was slow, even despite liberalization, and only remained at the level of no more than $1 billion until 1986. In late 1980, the scale reached $2-3 billion (Table 1-3-2).

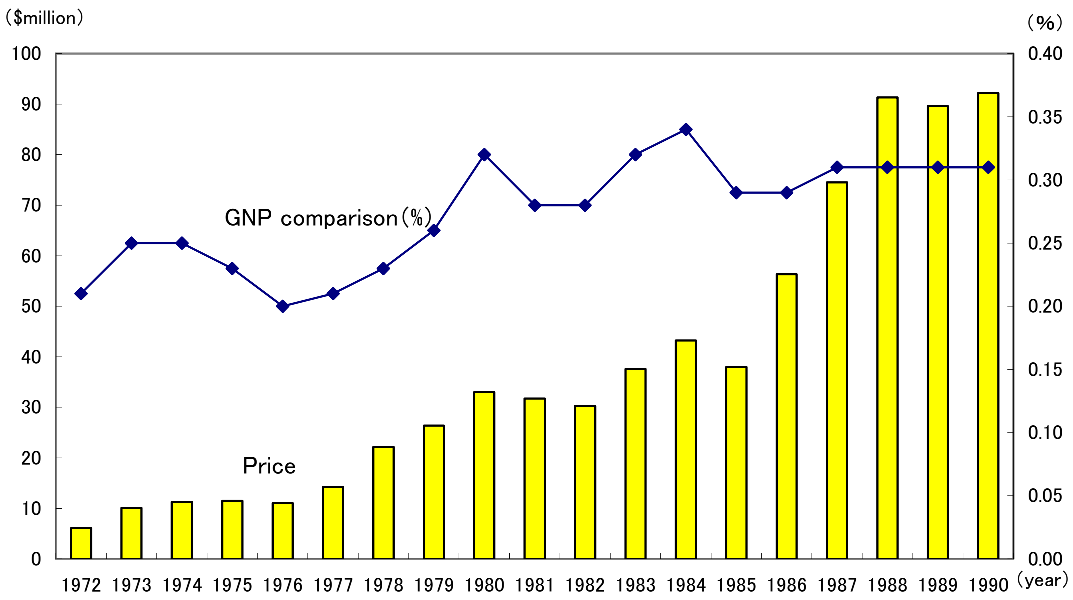
4 Foreign Exchange Cooperation gains Momentum

The "New International Economic Order" (NIEO). In the 1970s, developing countries started to have an influence on international society. This was led by the strong unity of developing countries in trying to overcome the economic gap (the so-called "North-South problem"), resource nationalism through the saving of resources after the Oil Crisis and the emergence of NIES (the "newly industrialized economies").

The perspective of the developing countries was clearly represented in the declaration of a "New International Economic Order (NIEO)", adapted in the sixth special session of the United Nations General Assembly for Resources on May 1, 1974. In addition, the 3rd 77-country ministers' conference (comprised of developing countries) conducted from January to February 1976, adapted the declaration and action plan based on the NIEO ("Manila Declaration").

First Medium-term Target for ODA. Japan's ODA (Official Development Assistance) increased 3.6 times from $611 million in 1972 to $2.215 billion in 1978. However, due to the worsening balance of payments after the first Oil Crisis, the total amount of ODA remained unchanged from 1974 to 1976, which again started to increase in and after 1977. GNP ratio of ODA declined from the peak in 1967. Therefore, GNP ratio of ODA in 1978 was only 0.23% (Figure 1-3-5).

Figure 1-3-5 Official Development Assistance



(Source) Same for as Table 1-3-1 No 362, 386, 436, 484

The Council of Foreign Exchange Co-operation submitted the report “On the Promotion of Development Cooperation in the Future” to Prime Minister Takeo Miki on August 18, 1975. This report stated that the development assistance policy’s direction and guidelines should be clarified, as Japan was increasingly dependent on developing countries in terms of energy, resources, and foodstuff.

After the submission of the report, the Council of Foreign Exchange Co-operation conducted a follow-up and submitted an opinion, “On the Radical Reform of Official Development Assistance”, to Prime Minister Miki on August 31, 1976. This opinion suggested that the government should promote foreign economic cooperation as Japan was being criticized for its delay in implementing economic cooperation in international society, and set the target of, by 1980, raising Japan’s ODA to 0.36%, which was the average of the 17 DAC countries.

On September 2, 1978, the Ministerial Conference for Economic Measures decided to double the level of official development assistance given in 1977 within 3 years, as the “First medium-term target for ODA”. Prime Minister Takeo Fukuda visited six Southeast Asian countries in August 1977 for the improvement of mutual relationships. On the last day of the visit to Southeast Asian countries (August 18), Prime Minister Fukuda announced “Japan’s Southeast Asian Policy” (the “Fukuda Doctrine”) in Manila. This “Fukuda Doctrine” showed the determination of Japan “keep peace and not to become a military superpower”. In establishing equal, cooperative relationships with ASEAN countries, Japan was determined to conduct a Southeast Asian policy aiming to contribute to peace and prosperity of the entire Southeast Asian region.

5 Multilateral Trade Negotiations in the Tokyo Round

A Uniform Tariff Cut in 1972. The Customs Tariff Council submitted the report “On the desirable form of the Tariff Policy in the Future” based on the topics of a “cooperative commercial trade relationship” and the “harmony of industry and welfare” in December 1972. This report contained topics including the promotion of an international lateral division of action, consideration of domestic price and pollution issues, rather than the domestic industry protection represented by the tariff reform in 1961, based on the fact Japanese industries had started to gain the international competitiveness.

From the viewpoint of reducing the surplus, the “third yen measures” on October 20 proposed actions to expand imports, including a flat rate tariff cut of 20%, and the improvement of preferential tariffs. Since November 22, the tariffs for 1865 items were cut, according to the tariff cut policy for steel and industry products and agricultural processed products. This was a large-scale reform to cover 80% of the entire taxable articles, or 45% of the total import amount, equivalent to 1925 articles in the Kennedy Round.

The Tokyo Round Talks Start. In the GATT Session in November 1971, Japan proposed holding a new international round. This was why the Tokyo Round negotiations were held following the Kennedy Round. On September 14, 1973, the “Tokyo Declaration” was adopted in the GATT Tokyo Minister’s Meeting, for the official launch of negotiations.

While the Kennedy Round (1964-67) was mainly concerning tariff cuts, the Tokyo Round negotiations were categorized into various topics, including tariff cuts, the mitigation/abolition of non-tariff barriers (NTB), and the reconsideration of safeguards.

The Tokyo Round Negotiations. It was difficult to proceed with the Tokyo Round negotiations as scheduled, to end within 1975, due to the first Oil Crisis occurring right after the start of negotiations.

At this time, the “Basic Policy for the Tokyo Round negotiations” was decided by the Cabinet in Japan for the facilitation of the negotiations. For smoother negotiations, a uniform tariff cut was made before the Tokyo Round negotiations were conducted, in FY1978 (so-called “advanced implementation of tariff reduction”).

On April 12, 1979, the Tokyo Round negotiations were successfully closed, and the results of the negotiations of the Tokyo Round were approved by the GATT Session held on November 26 to 29.

As the tariff-cut issue had already been discussed in the Kennedy Round and made favorable progress, the Tokyo Round negotiations were mainly to abolish non-tariff barriers. As a result of the talks, the total of eight codes (agreements/protocols) were prepared: (1) Agreement on subsidies and countervailing measures; (2) Anti-dumping code; (3) Standard agreement; (4) Agreement on technical barriers to trade; (5) Agreement on tariffs and trade; (6) Protocol to the agreement on tariffs and trade; (7) Agreement on import licensing procedures; and (8) Agreement on trade in civil aircraft.

Preferential Tariffs. As one of the solutions to issues relating to the gap between industrialized countries and the primary commodity exporting countries, a general preferential tariffs system was suggested. This would allow industrialized countries to apply for a low tariff rate or abolish tariffs without asking for mutuality, regarding commodities imported from developing countries. Many industrialized countries were not positive about the concept as it was against the basic principles of GATT, in terms of freedom, equality, and no discrimination. However, the final agreement was made in the UNCTAD in 1970, with the background of the worsened situation of the North-South problem. The EC, Japan and the United States started to implement the policy in and after 1971.

Japan introduced the preferential tariff system in August 1971, to reduce tariffs on agricultural products depending on the conditions of the domestic industry, and applied zero tariffs to most mining and manufacturing products. The preferential tariff system was updated annually, for the addition of items and the further reduction of tariff rates.

Chapter 2: Fiscal and Monetary Policies under International Economic Friction

Section 1 Fiscal policy

1 Changes to the Fiscal Reconstruction Policy

The Summer Review and Tentative Calculation of the Frame. With the formation of the second Masayoshi Ohira Cabinet on November 9, 1979, Noboru Takeshita was appointed as the Minster of Finance, after Ippei Kaneko, and a new step was taken toward the fiscal reconstruction target named the "Target of Delivering the Government's Finances from its Dependence on Deficit-bonds by Fiscal Year 1984". The Ministry of Finance, in the meantime, had already started an advance assessment of FY1980 budget compilation with the other ministries in May, as the government bond dependency ratio in the initial budget FY1979 was a record high of 39.6%. This was known as the "Summer Review". The Summer Review was regarded as a task which was an entire Cabinet project, as it was approved by the Cabinet. The ultimate theme was to consider how to rationalize and restrain expenditures, to reduce the issuance of government bonds. For instance, items of expenditures included obligatory expenditures such as local allocation tax grants and national debt service. As the problems of the debt accumulation of the "3Ks" (Kome: Rice; Kokutetsu: National Railways; and Kenkohoken: National Health Insurance) and pensions were reviewed, the ministries were requested to thoroughly check and correct their expenditures. Therefore, how to reduce or rationalize the expenditures gained a lot of attention, while they once tended to focus on the amount or increase rate of expenditures in the budget compilation. In terms of the guideline for the budget requests of FY1980, the general administrative expenses was restrained to be equivalent to the budget of the previous year and the remainder was restrained within 10% of it.

To consider the prospective for budget compilation and fiscal reconstruction, an estimation of the fiscal condition FY1980 (tentative calculation of the budget frame) was announced in November under the circumstances that the FY1980 budget was in an extremely difficult phase in terms of both revenue and expenditure. In terms of revenue, the large-scale Japanese Government Bonds issuance had reached its limit due to the increase in the interest rate. Expenditures far exceeded ¥1 trillion only for national debt service and local allocation tax grants. Then, in order to disclose the facts to the mass media and the public to make them understand the current fiscal situation, the MOF announced (the "Case A" and "Case B" budget frame) to reduce the government bond issue by ¥1 trillion in the FY1980 budget. Case A was to significantly reduce the natural and semi-natural increase in general expenditures and shrink the amount of increase in general expenditures to one third of that of FY1979. In Case B, it would be necessary to increase taxes to cover the shortage in tax revenues which could not be made up only by the natural increase in revenue. Therefore, the MOF tried to find a practical solution by referring these extreme cases (“Case A” and “Case B”) and planned to reduce ¥1 trillion in government bond issuance.

In addition to these efforts, the Fiscal System Council also showed their acknowledgement that drastic rationalization and reduction of expenditures would be necessary for the fiscal reconstruction in their “Report on problems of public bond, reduction and rationalization of government expenditures” on December 19. Moreover, the “Resolution on fiscal reconstruction” was adopted in the Diet on December 21, so that fiscal reconstruction was planned to build a sound fiscal foundation through cost saving by administrative reform, reduction and rationalization of expenditures and a fair taxation, and not by the introduction of a general consumption tax.

In the end, the FY1980 government budget draft was compiled under these circumstances, and the general account expenditure was ¥42.5888 trillion, a 10.3% increase compared to the previous year. The bond revenues were ¥14.2700 trillion. With the draft, the increase in expenditure was strictly restrained to the lowest level since the FY1959 budget (an 8.2% increase), and the reduction and rationalization of government expenditures were severely limited by keeping general public works (excluding disaster reconstruction costs) at the same level as the previous year, reducing subsidies (as far as possible) and carrying out administrative reform, such as reducing the number of civil servants. As for revenues, an increase in tax revenues was expected so that it showed a reduction of ¥1 trillion in government bond issuance as planned (special deficit-financing bond was reduced by ¥570 billion), which was a successful first step towards the further reduction of government bond issuance that had been increasing since FY1975. It should be noted that the general expenditures of the budget frame were restrained to a 5.1% increase compared to the previous year, but it was still the lowest for over 20 years, although the bond dependency ratio remained high as 33.5%, a 6.1% point decrease from the previous year. Accordingly, the FY1980 budget was the starting point for taking big steps towards a fiscal reconstruction policy.

On implementing the FY1980 budget, the same expenditure control policy was maintained as that for the initial budget, such as restraining the target contact ratio for public works in the first half of the year to no more than 60%. However, while prices were stable around spring, there were signs of economic slowdown, which required the government to watch both price stability and economic growth. The government started to change its policy in the autumn, to one of increasing the target ratio of public works for the three quarter of the year by 30% compared to the previous year and adopted an easy money policy. These measures contributed to prevent economic slowdown in the second half of the fiscal year.

The Budget for the First Year of Fiscal Reconstruction. As for the FY1981 budget compilation, the government started its Summer Review in May, aiming at full-scale fiscal reconstruction. In this Review, the “Target of Delivering the Government’s Finance of Dependence on Deficit-bonds by Fiscal Year 1984” was followed. It showed strict conditions regarding fiscal reconstruction, including a reduction of government bond issuance by more ¥2 trillion compared to FY1980 and making the increase rate of general expenditures 0% in principle, even though a natural increase of tax revenue was expected. Furthermore, the guidelines for budget requests were restraining, as general administrative expenses were not to exceed those of the previous year, and the increase for the remainder was to be restrained to no more than 7.5% compared to the previous year. As for revenue, the Tax Commission submitted “A Report on Tax Measures to Improve the Fiscal Position” in November for the reassessment of the “beneficiaries pay” principle and the review of taxation from the viewpoint of fiscal reconstruction. The “Outline of FY1981 Tax Reform” proposed a considerable increase in national and local tax according to the report, and aimed to reinforce the tax burden measures, which reversed the postwar common sense on tax reform, which used to mean tax reduction.

The FY1981 government budget draft compiled under these circumstances included ¥46.7881 trillion of general account expenditures, a 9.9% increase from the initial budget of the previous year, which achieved the only single-digit increase for the first time in 22 years, since FY1959. The budget cut various items such as public investment, the number of civil servants, rice prices, national railway works, and measures for local government finance, and increased tax revenue, due to the tax reform of corporation tax, stamp tax and liquor tax as well as a natural tax, which significantly contributed to the result. Therefore, construction bonds remained unchanged from the previous year but the special deficit-financing bonds were significantly reduced by ¥2 trillion. As a result, bond revenues and the bond dependency ratio were reduced to ¥12.2700 trillion and 26.2% respectively. Furthermore, the increase rate of general expenditures was 4.3%, which was the lowest for the first time in 25 years, though 0% could not be achieved, as had been proposed by the Summer Review.

Therefore, the FY1981 budget prominently showed the intention of the government to reduce public bonds by ¥2 trillion from the beginning of the budget compilation, in what was eventually called the "Budget for the First Year of Fiscal Reconstruction". The MOF published its "*Saishutsu Hyakka (Expenditure Review)*" (July 1980) as fiscal reconstruction measures in part of a nationwide campaign in order to ask the public for understanding and cooperation on the rationalization and efficiency improvement of expenditures. In this year, the "Medium-term Trial Estimate of the National Budget" replaced the "Medium-term Fiscal Outlook", and required adjustment of the balance between revenues and expenditures and application of an accumulation method in order to accurately reflect the fiscal conditions.

In spite of the strong intention of the government to reform, with its "Budget for the First Year of Fiscal Reconstruction", tax revenues were not obtained as expected, due to the delay in the recovery of domestic demand during the implementation phase of the budget. This tax revenue shortage actually became worse towards the end of the fiscal year. The following is a review of the history of the process toward fiscal reconstruction.

From Zero Ceiling to Minus Ceiling. The FY1981 budget was another step toward fiscal reconstruction, by restraining expenditures and large-scale tax increases. However, in the FY1982 budget compilation, the government could not anticipate an increase in tax revenues due to an economic recession, and the general consumption tax had not yet been approved under the "Resolution on Fiscal Reconstruction". Therefore, it was still extremely difficult to restrain government bond issuance. Under these circumstances, the ministries were requested to strictly review their entire budgets, and a zero percentage gain policy (a "Zero Ceiling") was applied. Prior to the FY1981 budget request, the Minister of Finance, Michio Watanabe, revealed the hardship of government finance saying, "We should be reminded that the outstanding after issuance of government bonds by the end of FY1984 will exceed ¥100 trillion, even if we succeed in escaping from dependence on deficit-financing bonds by FY1984 and maintain the issuance of government bonds of Article 4 (construction bonds) at the same level as before". The Second Ad Hoc Commission on Administrative Reform (known as the "Second Ad Hoc Commission"), which was established in March 1981 to achieve administrative and fiscal reform, as the basic policy of Zenko Suzuki's Cabinet, proposed that the reduction of expenditures and promotion of fiscal reconstruction were the urgent issues for reform, in the first report of the commission on July 10, as well as specific measures for reform under the current policy of the "Reconstruction of Public Finances without Relying on Tax Increases". In the FY1982 budget preparation, a Zero

Ceiling was applied on quantitative budgetary restriction. On the other hand, the first report of the Second Ad Hoc Commission was for the qualitative restriction. In addition, the “Current Basic Policy on Administrative and Fiscal Reforms” was determined based on the first report of the Second Ad Hoc Commission on August 25, and the so-called “Special Case Law concerning Administrative Reform” integrating the 36 laws was enacted. This special law specified an overall policy concerning various expenditure reduction measures for fiscal reconstruction. It included the consolidation and rationalization of all subsidies, the reduction of treasury contributions to the welfare pension funds, class reorganizations in schools and restraining the increase in the number of school teachers as well as increasing the flexibility of the legal loan rates of government related financial institutions.

The FY1982 government budget draft, which was compiled in the mood of promoting the government-led fiscal reconstruction, restrained the general account expenditures to ¥49.6808 trillion or a 6.2 % increase compared to the initial budget of the previous year. The general expenditures increase rate compared to that of the previous year remained at only 1.8%. These were the lowest rates since FY1955 and 1956, and the budget for these years had been known as the “¥1 trillion budget”.

The expenditure cut was realized by restraining public works-related expenditures to the same amount as that of the previous year, and reducing grants in accordance with the first report of the Second Ad Hoc Commission. As for the revenue side, the bond revenues were ¥10.4400 trillion, which was ¥1.8300 trillion less than the previous year, so that the bond dependency ratio decreased to 21.0%, which was less than that of the previous year. The issue amount of government bonds decreased from the previous year, which was ¥1.561 trillion and ¥269 billion for the special deficit-financing bonds and construction bonds, respectively. These reduction plans of government bond issuance were based on the tax revenue increase anticipated for over ¥4 trillion. In terms of FY1982, most of the revenue was considered to be a natural increase in the tax revenue.

While the pace of the economic recovery remained slow, the FY1981 tax revenues dropped significantly, so that the government decided to make a supplementary budget to cope with the reduction in tax revenues (approved on February 17, 1982). In order to tackle the tax revenue reduction, special deficit-financing bonds of ¥375 billion and construction bonds of ¥255 billion for disaster reconstruction were issued, so that as a result, the intended reduction of government bond issuance by ¥2 trillion in FY1981was downsized eventually. Moreover, with anxieties for the prospect of the economy in FY1982, the government faced difficulties in its FY1983 budget compilation from the start.

The Fiscal Emergency Declaration. The guideline for FY1983 budget requests was to achieve a 5% decrease except in special cases (Minus Ceiling). However, in spite of such measures to restrain expenditures, the government could not restrain the government bond issuance adopted until FY1982 in its budget compilation, because of insufficient tax revenue. In the meantime, the Second Ad Hoc Commission submitted a report for the secondary phase in 1982 to specify measures toward the “Reconstruction of Public Finance without Relying on Tax Increases”. Particularly, the third report in July 1982 (the basic report) proposed the privatization of Japanese National Railways, Nippon Telegraph and Telephone Public Corporation, and Japan Tobacco and Salt Public Corporation (Japan’s major three public corporations). The Fiscal System Council also tried to show a path to achieve fiscal reconstruction by submitting the expenditure reduction list.

In this process, the revenue shortage in the FY1981 settlement account became obvious, which eventually led to the “Fiscal Emergency Declaration” and the announcement of the resignation of Prime Minister Suzuki. As for FY1981 tax revenue, the tax authority was concerned that it might be far less than the initial amount estimated (¥32.2840 trillion). The government also revised the tax revenue downward in the FY1981 supplementary budget, which was approved in February 1982, but the tax revenue prospect as of the settlement in spring 1982 grew worse, as a shortage of more than ¥2.8 trillion became clear, compared to the revised budget of FY1981. The government explained that this was because of the worldwide economic stagnation, and particularly the economic slump following the sharp decrease of exports after December 1981, and the fall in general prices beyond its expectations. In July 1982, it was finally decided to compensate for the revenue shortage of ¥2.4948 trillion in the settlement of FY1981 by using ¥242.3 billion from the Settlement Adjustment Fund, established in FY1977, and ¥2.2524 trillion from the National Debt Consolidation Fund, through the Settlement Adjustment Fund. In August, the Minister of Finance, Michio Watanabe, announced that there would be ¥5-6 trillion shortage in tax revenue compared to the initial budget in FY1982, and that special deficit-financing bonds would need to be additionally issued. However, it would be necessary to restrain bond issuance at the ¥3 trillion level, at which acceptance by the market would be possible, by downward adjustment of the current expenditure, restraining the wages of civil servants and limiting additional fiscal demands, as well as cutting local expenses. This was followed by Prime Minister Zenko Suzuki’s announcement of the “Fiscal Emergency Declaration” on September 16. He described the fiscal conditions as “unprecedented difficulties” and an “emergency”, saying that the government needed a thorough review and cut of expenditures, the suspension of fixed rate transfers from the General Account to the National Debt Consolidation Fund and limiting of the wages of civil servants, as well as additional issuance of special deficit bonds to overcome the fiscal difficulties. Consequently, Prime Minister Suzuki announced his resignation on October 12.

Upon the resignation of Prime Minister Suzuki, Yasuhiro Nakasone won the Liberal Democratic Party presidential election. The Nakasone Cabinet was formed on November 27. Under the governance of the new Minster of Finance, Noboru Takeshita, the FY1982 supplementary budget was prepared (approved on December 25) to compensate for the decline of tax revenue by ¥6.1460 trillion, by the reduction of current expenditures, the reduction of local allocation tax grants, the suspension of fixed rate transfers from the General Account to the National Debt Consolidation Fund and issuance of special deficit-financing bonds. This was followed by the FY1983 government budget draft being submitted to the Cabinet. The budget draft represented the lowest increase rate since the “¥1 trillion budget” (FY 1955), with a 1.4% increase compared to the initial budget of the previous year, including General Account expenditures at ¥ 50.3796. The general expenditures decreased by ¥500 million. The restraint of the expenditures continued along the policy of Second Ad Hoc Commission, while public works-related expenditures remained unchanged from the previous year, and the foodstuff control expenditures and subsidies for Japanese National Railways decreased. The increase rate of social security-related expenditures was at the lowest level (a 0.6% increase) since they were categorized as major expenditures in FY1955. However, in spite of the efforts to restrain the expenditures, the bond revenue reached ¥13.3450 trillion with an increase of ¥2.9050 trillion, due to the shortage in tax revenue as announced in the “Fiscal Emergency Declaration”. The bond dependency ratio eventually increased again to 26.5%.

Revision of Fiscal Reconstruction Targets. The “Medium-term Trial Estimate of the National Budget” proposed in the Diet session for the FY1983 budget, indicated neither the target of delivering the government’s finances from its dependence on deficit-bonds in FY1984, nor provided a new target year. Even though the Cabinet had changed from Suzuki to Nakasone, fiscal reconstruction was still one of the most important issues. Therefore, it had been anticipated that the government would provide a new target year and make efforts to achieve fiscal reconstruction.

The guideline for FY1984 budget requests showed targets of -10% for current expenditures and -5% for investment expenditures in general expenditures in principle. As the government debt outstanding exceeded ¥100 trillion by the end of June, such a minus ceiling policy was applied in order to quickly respond to the stringent fiscal conditions. Then, the long term economic plan (the “Outlook and Guidelines for the Economy and Society in the 1980s”) was finalized by the Cabinet in accordance with the Economic Council report in August 1983, providing guidelines for the management of the economy and public finance. One of these measures was to set the basic objective of the fiscal reform to end its special deficit-financing bond dependency by “FY1990”. This was a change in the fiscal reconstruction target of “delivering the government’s finances from its dependence on deficit-bonds by fiscal year 1984” stated in the “New Economic and Social Seven-Year Plan” and meant the beginning of another phase of new fiscal reconstruction.

The government finalized its Comprehensive Economic Measures for economic promotion by the expansion of domestic demands October 21, 1983. While these measures were being taken, there was still an ongoing, fixed policy of expenditure reduction for fiscal reconstruction. On December 29, the Administrative Reform Council submitted a request to make the amount of general expenditures less than, or the same as, those of the previous year. The Fiscal System Council also made a similar proposal. After this process, the FY1984 government budget draft included general account expenditures of ¥50.6272 trillion, or a 0.5% increase compared to the initial budget of the previous year, which restrained the increase in general expenditures, as well as limiting individual items such as public works and foodstuff control expenditures. The increase rate of social security-related expenditures, which was the biggest among general expenditures, was also strictly restrained, through measures for the reform of medical expenses, such as increasing the burden to the beneficiaries of the government-managed national health insurance. However, the tax revenue did not rise dramatically in spite of the tax increase, and the amount of bond revenues decreased by only ¥665 billion (special deficit-financing bonds decreased by ¥525 billion) to ¥12.6800 trillion. The bond dependency ratio remained at 25.0%, which showed a slight reduction from the previous year. The FY1983 supplementary budget (approved on February 24, 1984) dealt with disaster measures and the tax reduction to be conducted within the fiscal year, but additional issuance of special deficit bonds was avoided, by saving the current expenditure and applying the net surplus of FY1982 to the revenue.

Japan went through a long-lasting economic slump for 3 years after the second Oil Crisis, and FY1983 was the year in which its full-blown economic recovery began. In particular, Japan enjoyed an increase in exports to the U.S., caused by the recovery of the U.S. economy from the latter half of FY1983. Japan’s domestic demand also tended to recover, such as in private equipment investment. In FY1984, the highest growth rate since the first Oil Crisis was recorded at 5.7%, because of the stable economic recovery mainly caused by the boost in domestic demand, although it was slightly affected by the economic slowdown of the United States in the second half of the year. Under these circumstances, the FY1984 supplementary budget (approved on February 13, 1985) posted a considerable increase in revenues from corporation tax and securities transaction tax, and other revenues. Regarding expenditures, while additional costs such as obligatory expenditures and disaster reconstruction expenses were the major items, a reduction in current expenditures and reserve funds was also included. Regarding the supplement of government bonds, construction bonds were added, but the bond dependency ratio for the supplementary budget was equivalent to the initial budget at 25.0%.

Since Ohira Cabinet's target (set in 1979) for fiscal reconstruction to deliver the government's finances from its dependency on special deficit-financing bonds in FY1984 could not be achieved, the target year was changed. The Ad Hoc Commission on Administrative Reform-proposed the "Reconstruction of Public Finance Without Relying on Tax Increases" in March 1983, which was maintained as the basic policy of the government, so that efforts were continuously made to cut and rationalize expenditures.

2 Government Debt Management Policy in Fiscal Reconstruction

Measures Taken for the Target of Delivering the Government's Finances from its Dependence on Deficit-bonds. As mentioned earlier, the issuance of government bonds in the FY1980 budget was ¥14.2700 trillion, which was ¥1 trillion less than that of the previous fiscal year. This reduction of ¥1 trillion was enabled by limiting the issuance of both construction bonds and special deficit-financing bonds at the same time. Special deficit-financing bonds were reduced for the first time compared to the initial budgets. As market acceptance of government bonds was growing more difficult, bonds held by the Trust Fund Bureau were increased by ¥1 trillion compared to the previous year to ¥2.5 trillion, and the acceptance by the market was reduced by ¥2 trillion, to try to balance the environment for the issuance. On the other hand, the government debt management policy in and after the early 1980s was operated under unprecedented conditions. Hence, the bond dependency ratio which surged after FY1975 hit a peak of 39.6% in FY1979, and then started to decline from FY1980. Furthermore, although the "Fiscal Emergency Declaration" (of September 16, 1982) was a setback, the trends of a low bond dependency ratio and less issuance of government bonds continued until the end of the “bubble economy”.

In the FY1981 budget, the government bond issuance decreased by ¥2 trillion compared to the previous year, to ¥12.2700 trillion. In addition, the bonds held by the Trust Fund Bureau increased by ¥1 trillion, to ¥3.5000 trillion, so that the acceptance by the market decreased by nearly ¥2 trillion. In the FY1982 budget compilation, the government bond issuance decreased by ¥1.8300 trillion, to ¥10.4400 trillion, with the momentum for promoting fiscal reconstruction. The amount of bonds held by the Trust Fund Bureau was the same as that in FY1981. As the acceptance by the market of government bonds was difficult, the bonds held by syndicate underwriting was decreased preferentially, in the same manner as in FY1981. However, in FY1982, the tax revenue fell well below the expected amount by the middle of the fiscal year, so that a large amount of government bond issuance was required. The FY1982 supplementary budget (approved on December 25) included the additional issuance of government bonds. However, as this amendment resulted from the reduction of expenditures such as the suspension of the fixed rate transfer of the national debt and the reduction of the local allocation tax grants, the Trust Fund Bureau became incapable of holding government bonds by providing loans to the Special Account for Local Allocation Tax Grants. Therefore, the government bonds needed to be additionally issued, although they still could not make up the shortage of tax revenue. Due to this situation, the issuance of government bonds in FY1982 increased to ¥14.0447 trillion yen, exceeding the amount of the previous year by ¥1.1448 trillion.

The government bonds issuance of the FY1983 budget was for ¥13.3450 trillion, which was an increase from the previous fiscal year of ¥2.9050 trillion. The bonds subscripted by the Trust Fund Bureau reached ¥3.7000 trillion yen, which was more than that of the previous fiscal year by ¥200 billion, and the acceptance by the market was planned to be ¥ 9.6450 trillion. In the middle of the fiscal year, the government debt outstanding at the end of June 1983 exceeded ¥100 trillion yen, and the “Target of Delivering the Government’s Finance of Dependence on Deficit-bonds by Fiscal Year 1990” was newly set in August. With the shortage of tax revenues, the government recognized that fiscal reconstruction was a urgent task. In the FY1984 budget, the government bond issuance was shrunk by ¥12.6800 trillion from the previous fiscal year, which was followed by the trend of decreasing government bond issuance throughout the stable growth period.

Meanwhile, a new problem was raised in FY1984 of how to deal with the refunding of the government bonds, which would begin in full from FY1985. “Refunding” means redemption of the expired government bonds by using the resources obtained by newly issued government bonds (refunding bonds). Regarding the large volume of refunding for the government bonds, in accordance with the Conference on the Problems of Government Bonds whether or not front-loading of refunding should be implemented was considered by the MOF, but it was not implemented eventually. In the end, the issue amount of refunding bonds was ¥3.2727 trillion for FY1982, 4.5145 trillion for FY1983, and 5.3603 trillion for FY1984. The amount in FY1984 was not so much of an increase on that of the previous year. However, it was ¥8.9573 trillion in FY1985, which literally created a rush of government bond issuance, when including those newly issued.

Suspension of the Fixed Rate Transfer of National Debt Service. The “Special Account Law for the National Debt Consolidation Fund” specified that the amount equivalent to 1.6 % of the government debt outstanding at the beginning of the previous fiscal year would be allocated to the National Debt Consolidation fund. However, as mentioned earlier, with the FY1982 supplementary budget, this fixed rate transfer had been suspended. This is because the tax revenue was far below the initially expected amount, so that a large amount of government bonds needed to be issued. In spite of this, the National Debt Consolidation Fund had sufficient accumulated resources, which meant that it did not affect the government bond redemption even when the fixed rate transfer was suspended. The proposal of the suspension of the fixed rate transfer was passed for consultation to the Fiscal System Council in September 1982, and it was accepted as an inevitable measure. The government enacted the “Law concerning the Special Measures of Fund Resources to be Transferred to the National Debt Consolidation Fund for Fiscal Management in Fiscal Year 1982” to suspend the fixed rate transfer for the government bond redemption. Accordingly, the fixed rate transfer was suspended under the special law each year from FY1983 to FY1989.

This suspension of the fixed rate transfer emerged as a big problem under the government debt management policy at that time. This was because that it was likely to continue into the following year and beyond, though it had been an emergency measure in FY1982. In such a case, the National Debt Consolidation Fund was expected to bottom out as early as FY1984. In practice, the fixed rate transfer was suspended since the issue of a large number of government bonds, including the special deficit-financing bonds, was requested, even with cost-cutting and rationalization of expenditures in FY1983. The consolidation fund could keep its liquidity to cope with the redemption of the government bonds even though the fixed rate transfer would be suspended in FY1983. Furthermore, although the fiscal conditions required the government to issue a large amount of government bonds, including special deficit-financing bonds, even with the cutting and rationalization of expenditure for FY1984 budget compilation, the National Debt Consolidation Fund was not so crucial as to negatively affect the redemption of government bonds without the fixed rate transfer. Therefore the fixed rate transfer was suspended as an inevitable measure.

The Allowance for the Refunding of the Special Deficit-financing Bonds. Although the construction bonds were to be redeemed under the 60-year redemption rule from the beginning, it was hoped that special deficit-financing bonds would not have be issued and that the balance could be shrunk as early as possible, so that they could be redeemed in cash (to pay the loan off in cash within 10 years of the maturity date) without issuing refunding bonds. The “Special Deficit-financing Bond Law” also specified that the refunding bonds should not be issued.

However, if special deficit-financing bond redemption was to be conducted in cash and delivering the government’s finances from its dependence on special deficit-financing bonds was to be completed as intended by “FY 1990”, an extreme cost cut or an increase of the tax burden, or both, might be inevitable as a national policy. This might give rise to a negative impact on the national economy and the public livelihood. Therefore, the article restraining the conversion of traditional “Special Deficit-financing Bond Law” was abolished, as the resources for the special deficit-financing bond redemption would inevitably be obtained through the issuance of refunding bonds. More specifically, in the “Law concerning Special Measures to Secure Funds Necessary for the Fiscal Management for Fiscal Year 1984”, the article restraining the conversion of special deficit-financing bonds issued in FY1984 and earlier was abolished, and in addition, it was regulated that as few refunding bonds for special deficit-financing bonds would be issued as possible, by taking the fiscal conditions into consideration, and even if issued, efforts should be made to reduce the balance. With this policy change, the important thing to consider was how long it would take to implement the cash redemption of the special deficit-financing bonds, whose conversion would be allowed. It was recognized, however, as being difficult to achieve, because the special deficit-financing bonds should be reduced at an early stage, and their redemption should be completed within the specific term in principle. Consequently, it was determined to apply the 60-year redemption rule as a basis for the special deficit-financing bond redemption, since the reserve of the resources to reduce the bonds was based on the same redemption rule as the construction bonds.

The Progress of Government Bond Liquidity. The trading trends of Japanese Government Bonds in the market were described in the Chapter 1.1. In addition to the increase in government bonds held by financial institutions, there was progress in liquidity in and after FY1980. From May 1980, government bonds were allowed to be sold after listing (after 7-9 months from issuance). From April 1981, selling was also allowed in the beginning of the fourth month after bond issuance.

This deregulation of bond trading was implemented as financial institutions, and especially major banks, needed to sell a large amount of government bonds constantly, because their fund position had become worse due to the slowdown of deposits at that time. Thus, underwriting syndicates had requested that the MOF abolish the restrictions on the trading of government bonds in the market. The MOF also positively accepted deregulation as it realized that the secondary market needed to be extended for smooth trading, as well as to sell the government bonds easily in the market. In turn, as financial institutions needed to sell the bonds in order to hold new government bonds, as a large amount of government bonds was continuously issued in the 1980s, the MOF decided to leave it to the discretion of financial institutions as to whether to sell the government bonds 7-9 months passed after their issuance, as a part of a five-point program ("On the Present Government Bonds Policy"). However, even after the deregulation, financial institutions still requested the further shortening of the selling term, or the abolition of the regulation. Although there was a controversy, since many said it was unnatural to set a limitation on selling securities once they were issued, the MOF was reluctant to further shorten the selling term or to abolish the regulation, since the selling limitation was an effective measure to constantly reduce the large amount of government bonds.

Consequently, the MOF sought to resolve this issue by a gradual system reform, and deregulated the selling limitations in and after June 1985, eventually abolishing the regulations in September 1995.

3 Principles of the Reconstruction of Public Finance without Relying on Tax Increases and the Tax System

The Examination of the Introduction of a Green Card System. After it was decided to postpone the introduction of a general consumption tax, priorities were placed on how to secure tax revenues, as well as rectifying the unfair taxation before the introduction of a new tax. In practice, the tax reform plan in FY1980 was expected to increase tax, thanks to the economic recovery, so the government carried out the consolidation and rationalization of special taxation measures, and deductions for employment income and land and house taxation, without making a major tax increase. In the meantime, regarding the interests and dividends tax that had been discussed for years, it was decided to change the category to comprehensive taxation in FY1984, in accordance with the results of a review by the Tax Commission, so that the introduction of a so-called “Green Card” was decided upon for those who have a small amount of savings. It was also decided to extend the term of validity of elected separate withholding taxation at source on interest and dividends, until the change of system to the comprehensive taxation started.

The introduction of a Green Card system was considered because there was a controversy in and out of the government that the interest and dividends income should be changed to comprehensive taxation for fairer taxation. In 1970, it was decided to implement the elected separate withholding taxation system at the end of 1975. Then in 1975, the term was put off until the end of 1980. Just before that time, the Tax Commission made a final review regarding the status change of the taxes to comprehensive taxation, in the special tax committee in June 1979. In this committee, there was a consistency of opinion that a tax payer identification number system would be the most appropriate way to solve the issues, but it was still unclear whether they could obtain the agreement of the public. The Green Card system was finally accepted in December 1979. This system was to apply a Green Card for the identification of users only for savings. The government had been considering a comprehensive income taxation at source on interest and dividends for years, and thought that the Green Card would be a solution for the fair taxation of those who had a small amount of savings. The Tax Commission’s report in December stated that the system was the most practical and effective measure for identification and saving accounts integration for both non-taxable savings and taxable savings.

In either case, this proposal was decisive in introducing the system, and through the amendment law of the income tax law, promulgated on March 31 1980, it was decided to introduce the Green Card system effective January 1, 1984. However, this system was revealed as being incomplete and allowing inappropriate use (tax-exempted savings beyond the limitation) and caused criticisms from various fields, including the political parties. Eventually, it was not implemented. In the end, the system was abolished in 1985, after the 3 years of pending since the FY1983 tax reform.

The Massive Tax Increase in FY1981. The interim report compiled by the Tax Commission on November 7, 1980, was “A Report on Tax Measures to Improve the Fiscal Structure”. The main difference from the previous interim report in 1977, was that it strongly requested the government to restrain expenditure, as well as to provide a limitation on the increases tax burden and propose additional options to increasing the tax burden. In the elections of the House of Councilors and House of Representatives on the same day in June 1980, the ruling party secured power, but plenty of tax revenues were not expected from the viewpoint of economic condition. There was also concern about a massive tax shortage emerging around autumn. Under these circumstances, the Tax Commission interim report triggered a massive tax increase policy toward the FY1981 tax reform. In January 1981, the “Outline of FY1981 Tax Reform”, intended to increase the tax revenue by ¥1.544 trillion for an average year, including corporation tax, liquor tax, sales tax, stamp tax and securities transaction tax, which was to increase tax revenues as much as possible within the framework of the existing tax system (Overall Tax Increase). For instance, the tax reform represented increases of tax by 2% points for corporation tax, 24% for liquor tax, in principle, and 0.55% for securities transaction tax, in terms of stock certificates from 0.45%. Although an income tax reduction was promised in the decision of the Chairman of the House of Representatives in March 1981, it was appropriated as a resource for the tax reduction in the FY1981 supplementary budget by the surplus funds after the reduction of the special deficit-financing bond issuance in the settlement in FY1980. This tax reduction was only for ¥2,000 per average family of two parents and two children, and was called the “Ramen tax-cut” that the tax cut was only good for buying four bowls of Ramen noodles for the members of a family.

The FY1981 tax reform was a drastic one, as stated above. However, in the following year FY1982, the tax reform was not so drastic, as it only included the consolidation and rationalization of the special taxation measures and a downsizing system of the postponement of corporation tax payment. While there was no major reform in FY1983 either, there was also a consideration of the basic policy the “Reconstruction of Public Finance without Relying on Tax Increases”, proposed in the first report of the Ad Hoc Commission on Administrative Reform (July 1981).

The Report Entitled “The Desirable Form of the Tax System in the future”. This report (the interim report after November 1980) submitted by the Tax Commission on November 16, 1983, stressed that it would be necessary to recover the fiscal soundness of the national and local governments, as well as fiscal strength, in order to maintain the stability and fullness of Japan’s economy in the aging society to come. It proposed that immediate measures be taken to correct the abnormal conditions of the tax revenue, accounting for only 64% of the expenditures of the FY1983 budget, due to Japan’s vulnerability in terms of recovery in this term, and it also suggested that particular attention be paid to the close relations between tax items and to expanding the tax base to rationalize the indirect tax system. In terms of the individual tax items, income tax, for instance, needed to be reconsidered to ease the public's sense of an increased tax burden, as its tax threshold remained unchanged since 1978. As for the taxation on capital gains, it was proposed only to retain the land tax reform in FY1982 as the basic system for long-term stabilization, and to maintain the taxation on gains from the transfer of securities unchanged until a sound system for securities trading was obtained, before the shift to comprehensive taxation.

In March 1981, the Ad Hoc Commission on Administrative Reform launched a policy of administrative reforms called the "Reconstruction of Public Finance without Relying on Tax Increases". The government made efforts for fiscal reconstruction under this policy, aiming for administrative reform and the reduction of expenditures. Therefore, no major tax reform was conducted in FY1982 and FY1983. This meant that no income tax reduction was conducted either. Tax reductions were conducted almost every year until the early 1970s, but it remained unchanged for some years in late 1970s. In the Diet session for the FY1983 budget, the income tax reduction issue gained a lot of attention as an important political issue, with the background of demands for tax reduction mainly among employment income earners. No tax reduction was implemented in the FY1983 tax reform, but the government promised a large scale tax reduction in FY1984. However, as fiscal conditions were still heavily dependent on government bonds and fiscal reconstruction was underway, such a large-scale net tax reduction was impractical. Therefore, in fact, the government intended to launch the full-blown income tax reductions with an increase in corporation, liquor and petroleum taxes.

The tax reform under the circumstances described above included the income tax reform as proposed by the "interim report" and the corporation tax reform. In terms of income tax, the tax threshold increased from ¥2.015 million to ¥2.357 million since FY1981 for the employment income earners of a married couple. The brackets for the income tax rate were also simplified from 19-10% for those with income under ¥600,000 to 75% for those with income over ¥80 million, to 15-10.5 % for those with income less than ¥500,000 to 70% for those with income over ¥80 million. These reforms to the income tax structure were made since 1974, aiming to ease negative feelings about the tax burden caused by (so-called) Bracket Creep. As the immediate implementation of a large-scale income tax reduction was a promise by both the ruling and opposition parties, the ¥870 billion income tax reduction was implemented, which was the second largest in scale next to the “¥2 trillion tax reduction” in FY1974. On the other hand, the standard corporation tax rate increased by 1.3% to 43.3% for retention, and 33.3% for dividends in FY1984. In terms of indirect tax, liquor tax was raised by about 20% on average, and the petroleum tax was also raised from 3.5% to 4.7%.

Suspension of Discussions on General Consumption Tax. Prime Minister Masayoshi Ohira stated in a press conference in July 1979 that Japan’s fiscal reconstruction would require escaping from its dependence on deficit-bonds or reducing expenditures, and if the tax revenue was still short, an increase in income tax, or the introduction of a general consumption tax would be necessary. However, as shown in Chapter 1.1, the 35th House of Representative elections in October focused on the general consumption tax, so that criticism occurred from both ruling and opposition parties. In the “Resolution on Fiscal Reconstruction” in December, it was decided not to depend upon the general consumption tax for fiscal reconstruction but to restrain expenditures for fiscal reconstruction.

Then, the discussion on a massive indirect tax was not discussed openly for a while. In the interim report in November 1983, an extension of the taxation base was proposed to rationalize the aforementioned indirect tax system, but no specific proposal was made by the Tax Commission, because the Second Ad Hoc Commission’s report, the “Reconstruction of Public Finance Without Relying on Tax Increases” was still the basic principle of the fiscal policy. On the other hand, the difficulties in achieving fiscal reconstruction within the current taxation system were also recognized again. Minor tax reforms were also made every year in order to secure tax revenues, but these were no longer effective enough.

Thus, the “distortion” or “imbalance” between the real economy and the existing tax system was realized, and, therefore, Prime Minister Yasuhiro Nakasone requested the Tax Commission to work on a “Drastic Review of the Tax System” in September 1985. The report on a “New Type of Indirect Tax” was submitted to the Prime Minister in October 1986 (see Chapter 3.1.4). Before then, in the FY1985 tax reform report, the Tax Commission proposed that this was the time to study a drastic reform of the overall tax system, and stated that partial revisions would not be sufficient to make a fair tax burden between income, asset and consumption. This report also proposed that the government should make efforts to seek understanding and cooperation from the public on this issue. Thus, the long path of preparation for the introduction of a general consumption tax was finally nearing an end.

Section 2 Monetary and Financial Policy

1 Start of Financial Liberalization and Increased Flexibility

A Request to Japan from the United States. The new Banking Law was promulgated on June 1, 1981, and enforced on April 1, 1982. In line with this new law, the annual "Measures for the Liberalization and Increased Flexibility of Financial Regulations" started from FY1981 (the first year) to FY 1985 (the sixth year). The Financial System Research Council also proceeded with a basic review of the liberalization and globalization of financial administration. This was further promoted by an external force: a request of Japan from the United States, which gained attention from autumn 1983.

The request was made suddenly, before President Reagan's official visit to Japan, in November 1983. In response, Prime Minister Yasuhiro Nakasone requested the secretariat to make a specific schedule for financial liberalization. During President Reagan's visit, both countries agreed to establish the Joint Japan-U.S. Ad Hoc Group on the Yen-Dollar Exchange Rate, and Financial and Capital Market Issues (the so-called "Japan-U.S. Yen-Dollar Committee"). The group then published its "Report by the Working Group of Joint Japan-U.S. Ad Hoc Group on Yen/Dollar Exchange Rate, Financial and Capital Market Issues" (known as the "Yen-Dollar meeting report"). At the same time, the Ministry of Finance of Japan published a document entitled, "The Current Status and Future Prospects for the Liberalization of Financial and Capital Markets, and the Internationalization of the Yen" (known as "Current Status and Future Prospects"). Follow-up meetings were also conducted continuously. This activity can be said to have had an effect of accelerating the timetable of liberalization, or the timing of its implementation.

In the Working Group of Japan-U.S. Yen-Dollar Committee, the background to the United States' stance was as follows. It saw Japan's financial and capital market as exclusive, and the internationalization of the yen as still insufficient, so that there was still low demand on the yen and the yen's rate was at an unfair level, which had eventually led to the imbalance of current accounts between Japan and the United States. The MOF of Japan disagreed with this logic and insisted that the dollar appreciation and yen depreciation were related to the United States' high interest rate and considerable amount of fiscal deficit. From the viewpoint of economics, the MOF of Japan's objection seems to have been fair. The exchange rate is determined upon the demand and supply of the currencies of various countries (currency-denominated assets). It is hard to determine how the demand and supply of currencies or the exchange rate would be affected by a country's financial and capital market conditions, or how closed or open it is. For instance, if the yen were to be further internationalized, the demand for the yen may increase in the international market, but it could also lead to an increase in its supply in the market, therefore, there would be no conclusive result on this. In addition, liberalization should be progressed separately from such discussion.

Discussions on trade friction and a wide range of demands on Japan reached a peak in the "Japan-U.S. Structural Impediments Initiative Talks" in 1989 to 1990. In these talks, discussions were held on how the Japanese market was closed as a whole, and how Japan's investment/savings balance (over-saving: small fiscal deficits and the over-saving of private sectors, which means a shortage of investment) was one of the causes of the current account surplus towards the United States. However, this logic was still insufficient from the viewpoint of economics. First, the balance of payments is multi-faced, so it is meaningless to talk about only two countries. There is no specific reason why the current account would be affected by how open or closed a market is. For instance, even if Japan's imports were forced to increase for some reason, the exchange rate would be changed by yen depreciation, and set off the effect of current account deficit (reduction of surplus) as if it was intentional. Moreover, the investment/saving balance and the current account are simply in a de facto balance relationship, and it is not a one-way relationship. As the balance can only be made in the two countries, it is hard to say that the domestic situation of one country is the cause of a trade imbalance. Therefore, the current account balance (result) could not be changed only by controlling the domestic factor (cause) of Japan.

However, the request from the United States certainly had a great influence.

The "Yen-Dollar Meeting Report" and "Current Status and Future Prospects". As mentioned above, the "Yen-Dollar Meeting Report" and the MOF's document "Current Status and Future Prospects" were published on May 30, 1984. "Current Status and Future Prospects" stated the comprehensive concept and policies, and the "Yen-Dollar Meeting Report" described specific measures and case studies, mainly referring to interests of both countries.

"Current Status and Future Prospects" stated as follows:

- Financial liberalization is inevitable because it is the basis for stable economic growth. And it is basically desirable to achieve efficiency. Liberalization is steadily progressing and will continue in the future.
- The internationalization of the yen is interrelated with the liberalization of

financial and capital markets, and these policies should be progressed in balance.

- Expansion of the deposit insurance system, and the promotion of merger/partnership and disclosure - these liberalization-related measures should be taken.

The “Yen-Dollar Meeting Report” stated as follows:

- As for the yen-dollar exchange rate, Japan insisted that the major cause of dollar appreciation was the high interest rate of the United States, and that the fiscal deficit is related to this. The United States did not agree with this.
- Japan’s financial liberalization has steadily progressed. It will further progress voluntarily, vitally and progressively.
- Specific items will be studied, including Japan’s interest rate liberalization, capital trading liberalization, liberalization to allow access to foreign institutions to Japanese money and capital markets, and the promotion of direct investment.

Measures that were subsequently taken related to this are described in Chapter 3.2.

Trends in Macro Monetary Policy. As stated above, Japan’s official discount rate decreased to 3.5% in March 1978, as the finance was eased in order to cope with the recession after the first Oil Crisis and the yen appreciation in 1977-1978. However, when the second Oil Crisis occurred at the end of the year, the BOJ raised the official discount rate to 4.25% in April 1979, which was followed by a series of interest rate raises and monetary tightening policy measures.

As shown in Table 2-2-1, the monetary tightening policy continued even into 1980, and the official discount rate was eventually raised to 9% in March 1983, for the first time since 1973. As a result of these agile tightening measures, by May 1980, the economy showed signs of inflation, so that the official discount rate was decreased to 8.25%, and it was gradually reduced after that.

The BOJ, in the meantime, remained cautious about monetary easing. One of the reasons was that the interest rate had surged due to strong monetary tightening measures in the United States for restraining inflation, since around 1980. The difference between the interest levels in Japan and the United States widened and funds flowed into the United States (yen selling/dollar buying), which led to a trend of dollar appreciation/yen depreciation. Under these conditions, the reduction in interest rates had accelerated the yen depreciation, and there were concerns that this would lead to criticism of Japan’s expansion of its current account surplus. However, the global recession affected Japan’s domestic economy and demands for an easy money policy increased. Measures for increasing Japan's domestic demand were also requested, to prevent trade friction between the two countries from getting worse, but Japan was reluctant to launch a fiscal policy, as they were still in the middle of conducting fiscal reconstruction. Therefore, the government mainly applied monetary policy to stimulate demand. Then, a gradual reduction of interest rates and an easy money policy were executed. The official discount rate reached 5.0% in October 1983. In fact, it did complicate the economic variable (the practical target) that the government was supposed to be watching, and on which they were basing their monetary policy.

Table 2-2-1 Change in the Official Discount Rate (FY1979～1983)

Year/Month/Date	%
1980. 2.19	7.25
3.19	9.00
8.20	8.25
11. 6	7.25
1981. 3.18	6.25
12.11	5.50
1983.10.22	5.00

Source : Bank of Japan, *Nihon Ginko Hyakunenshi* [One-Hundred-Years History of the Bank of Japan] (1987)

2 Measures for Liberalization and the Increased Flexibility of Financial Regulations

The Basic Direction of Financial Administration. In the first half of this period, "On the Working of the Ordinary Banks and Reform of Banking System" studied by the Financial System Research Council, was fulfilled as an amendment of the Banking Law (a comprehensive revision of the 1927 Banking Law, so-called the "New Banking Law") (promulgated in 1981; enforced in 1982). Revisions of various pertinent regulations, such as the Mutual Bank Law and the Shinkin Bank Law, were also conducted. Commencement of handling of government bond public offerings (1983) and dealing of government securities (1984) by financial institutions were also big topics for discussion.

Liberalization and internationalization further progressed. With the start of service for NCDs (Negotiable Certificate of Deposits) in 1979, the liberalization of interest rates was begun. Many new financial commodities and services emerged. In terms of administration, the “Liberalization and Increased Flexibility of Financial Regulation Measures” started in FY 1981, upon amendment of the Banking Law. For internationalization, capital trading, liberalized by the new Foreign Exchange Control Law (promulgated in 1979; enforced in 1980), was booming.

The authorities intended to implement liberalization and the increased flexibility of financial regulations in a progressive and gradual manner. It was thought to be difficult to maintain conventional domestic regulations due to internationalization, and also hard to avoid the liberalization of interest rates in Japan, due to the expansion of the government bond market. In addition, mergers or partnerships of companies should also be progressed, because new products and services across the industries also emerged thanks to the deregulation. However, it should not be drastically progressed, in order to avoid confusion. It was thought that the government should aim at soft-landing for the changes.

The Banking Bureau once tried to take the lead in progressing liberalization against the strong resistance of parties who enjoyed vested rights, but it took a lot of time to make the changes. Liberalization of interest rates was finally completed in 1995. Business field regulations remained unchanged in this period. The administrative guidance included deregulation to restrain the conventional quantitative expansion but strengthen the regulations on the authorization of new commodities and services. Liberalization and the increased flexibility of financial regulation measures had the same effect, as new detailed regulations were added annually. Therefore, the relationship between administrative guidance and the reaction of private sectors remained unchanged and as it was.

Enactment and Enforcement of the New Banking Law. The Financial System Research Council’s report on “How Ordinary Banks Should Be and Reform of the Banking System” report was issued in June 1979, but it required complicated adjustment. Then, the New Banking Law draft was finally submitted to the Diet after 2 years in April 1981, enacted in May, promulgated in June and enforced in April 1982.

The biggest issue was the one related to the city banks: it was argued that 1) the categories of securities-related services for banks should be widened; 2) the strengthening of the banking regulations and orders should be opposed; 3) the legislation of the regulations on large loans should be opposed; and 4) the legislation of disclosure should be opposed. For the authorities, 2) was an unexpected misunderstanding. They intended to eliminate arbitrariness and improve the transparency of the system by legislating, but could not make the private sectors understand this. In the end, facilitation of talks between the authorities and city banks relied upon the Liberal Democratic Party and the Ministry of Finance, and agreement was finally reached in April 1981.

Hence, the Banking Law was finally amended for the first time in 50 years.

Various Amendments Related to the New Banking Law. With the amendment of the 1927 Banking Law, a tremendous number of amendments were made to the pertinent laws. The Banking Law provided the basic legal character of the financial regulations, which had a ripple effect on 26 other related laws which needed to be amended (corresponding revisions).

Regarding securities-related services that had been postponed, handling of long-term interest-bearing government bonds, government-guaranteed bonds and local government bonds by financial institutions (offering newly issued bonds) started on April 1, 1983. In addition, handling of medium-term bonds, purchasing the bonds upon request and handling of discount government bonds by financial institutions were permitted from October 1983. Dealing in government securities by financial institutions (buying and selling of issued bonds) started in June 1984.

New Entries, Exits and Mergers of Financial Institutions. In this period, the number of financial institutions was stable, as shown in Table 2-2-2. There were 12 city banks, 1 foreign exchange bank, 3 long-term credit banks and 7 trust banks, which remained unchanged. The number of regional banks increased by 1, to 64 in total, in 1984, while the number of mutual banks decreased by 2, to 69, because of the conversion of the Nishi-nippon Sogo Bank into an ordinary bank and the merger with the Takachiho Sogo Bank. The number of Shinkin banks decreased every year and reached 456. After that, the number remained unchanged. The number of credit cooperatives decreased every year, and reached 461 in 1984.

Table 2-2-2 Number of Financial Institutions

Year End	1980	1981	1982	1983	1984
City bank	12	12	12	12	12
Foreign exchange bank	1	1	1	1	1
Long-term credit bank	3	3	3	3	3
Trust bank	7	7	7	7	7
Regional bank	63	63	63	63	64
Mutual bank (Sōgo Bank)	71	71	71	71	69
Cooperative bank (Shinkin Bank)	461	456	456	456	456
Credit cooperative	476	473	468	468	461

Source : Research and Statistics Department, Bank of Japan, *Keizai Tōkei Nenpō* [Economic Statistics Annual] 1985.

The following are the major cases of financial trouble of financial institutions and the countermeasures taken. In March 1982, Tokyo Shinkin Bank's financial trouble emerged but the bank recovered with a deficit in settlement of accounts and no dividend upon making arrangements to avert a financial crisis. In September 1982, the Daiichi Kangyo Bank's Singapore Branch faced the loss of its foreign exchange dealing, as a risk related to overseas activities. In 1983, Jitsugyō Shinyō Kumiai (Osaka)'s large bad loans were revealed. The Kinki Finance Bureau of the MOF and parties concerned consulted on this issue and preserved the bank, with rescue funds of ¥20 billion from National Federation of Credit Cooperatives, ¥3 billion from the Osaka Federation of Credit Cooperatives, ¥3 billion from Osaka Prefecture and ¥2.5 billion from Daiwa Bank. Then, the bank was merged with Houtoku Shinyō Kumiai in December 1984 (it became Osaka Shinyō Kumiai in 1985).

Regulations on Branching. In this period, a 2-fiscal year unofficial notification was conducted.

In FY1981 and 1982, the voluntary discretion of financial institutions was emphasized based on the New Banking Law, which: 1) restrained the number of general branches; 2) emphasized small automated branches; 3) promoted the consolidation and integration of branch patterns; 4) introduced the branch transfer system; and 5) encouraged care to be taken for regions with no (or few) financial institutions. 4) meant that, under the system, a bank should divide 1 ordinary branch into 3 small branches, or divide 1 small branch into 3 automated branches, which would widen the voluntary discretion of financial institutions. The regulations regarding locations (distance from existing branches) were eased as well. Relocation was also allowed for four branches in 2 fiscal years.

In FY1983 and 1984, the policy of leaving decisions to the voluntary discretion of each financial institution was continued. Expansion of small automated branches, increased flexibility of CD (cash dispenser) installation out of branches (ATMs were also authorized), and flexibility of relocation (in the same economic bloc; this meant the abolition of regulations on relocation within the jurisdiction of the Local Finance Bureau).

Measures for the Liberalization and Increased Flexibility of Financial Regulations.
Regulations regarding managerial indicators were organized, under the range of notifications related to the amendment of the Banking Law, into the following 4 operational indicators:

1) Loan-deposit ratio: aiming for an average balance for the period of no more than 80%
2) Capital Requirement: aiming for a deposit balance for the period of 10% or more
3) Liquid assets ratio: aiming for 30% or more of total assets
4) Commercial real estate ratio: aiming for no more than 40% and up to 50% in the capital account

Upon the amendment of the Banking Law, the Banking Bureau announced its "Measures for Liberalization and Increased Flexibility of Financial Regulations" in June 1981 and implemented in 6 sets of measures. They mainly included the following: in the first set of measures (FY1981), the deregulation of the dividends of financial institutions, cancellation of guidance and requests by authorities on the self–regulation of advertisements, and the launch of a study on the abolition of the "3 Bureau Agreement" (restrictions on the securities services of Japanese banks in foreign countries). In the second set of measures (FY1982), the expansion of the services of associate companies and the increased flexibility of regulations for large loans. In the third set of measures (FY1983) included the deregulation of using funds from foreign bonds which were issued by overseas affiliates, the diversification and liberalization of housing loans, and the expansion of the NCD issuance limit. The fourth set of measures (FY1984) included the liberalization for the entry of foreign financial institutions to the Japanese market, the expansion of credit card related services, authorization to establish associated companies for the money-lending business, the deregulation of NCD issuance and the start of a swing service (automatic fund transfer between time deposits and ordinary deposits).

In addition to this, the evaluation method for bonds was changed, as a revision of the accounting standards of financial institutions.

For the evaluation of listed securities, the lower market method, under the uniform accounting standards of 1967, was adopted (evaluating the lower value of the acquisition value and the actual cash value). However, due to the price collapse of the so-called 6.1% government bonds, a tremendous amount of appraisal loss occurred. Therefore, the authorities changed the system to the selective option of the lower market method or the cost method. from March 1980. The important thing here is how one thinks about this issue. In this issue, there were two opposite opinions: that it was unsound for financial institutions to hold latent loss and they should disclose the actual conditions as an actual cash value (the opinion supporting the lower market method), and that it was inappropriate for corporate performance or management due to a short term fluctuation of market price (supporting the selectivity method). The authorities then decided to apply the selectivity method, based on the latter opinion, and for the reasons that it would be inappropriate to encourage repetitive selling for benefits only to compensate losses, or to distort the system as unlisted bonds gain popularity because they do not count the appraisal loss. As a result, financial institutions decided whether to select either the cost method or the lower market method.

The Money Lending Control Law. Since the early 1970s, the number of money lending business institutions rapidly increased and the number of such applications reached 200,000 cases by the end of FY1981. Most of them were consumer finance companies, called *Sala-Kin* (Salary Man Kinyū: money lending for businessmen). This became a social issue in the late 1970s, as some of these companies conducted illegal acts, such as excessive money lending, demanding high interest rates, or using violence in the collection of money. The Small Banks Division of the Banking Bureau dealt with these issues, and in April 1983, two so-called money lending control laws, the “Money Lending Business Control Law” and the “Law Concerning the Partial Amendment of the Law Concerning the Regulations for Receiving of Capital Subscription, Deposits and interest on Deposits” (the so-called Laws of Subscription) were enacted (promulgated in May and enforced in November). The points of these laws were as follows: 1) a change from the easy conventional post application system to an advance registration system, with penalties on unregistered businesses; 2) the reduction of penalty interest to an annual rate of 40.004% (the cap interest rate under the conventional Law of Subscription was 109.5%); 3) the prohibition of excessive advertising and excessive lending: compulsory indication of lending conditions, such as interest rates, and compulsory issuance of contract documents, and regulations on collection of money (no violent verbal or physical actions should intimidate people's privacy or business); and 4) regulations on supervision and administrative disposition.

Discussions of the Financial System Research Council. The Financial System Research Council resumed in May 1982, and established the "Subcommittee on the Desirable Form of Financial Liberalization in the Future", to study financial liberalization. Its primary interim report, "Current Status and a Desirable Picture of the Financial Liberalization in the Future" in April 1983, stated that there were various opinions from the experts, and summarized the discussion of the subcommittee as follows.

- ○ Financial liberalization is inevitable and desirable in principle, but it needs to be dealt with progressively. Its scheduling is difficult so that each specific issue should be resolved separately.
- ○ Liberalization of interest rates on deposits should start from large loans for institutional investors and corporations, which should be followed by small loans on a flexible and progressive manner.
- ○ The regulations of the financial business need to be made more flexible, while taking into account of soundness of financial institutions, which should be regarded in terms of specifics.
- ○ Maintaining the financial system is the main premise, therefore the inspection and a deposit insurance system need to be reinforced.
- ○ Quantitative control is being phased out, and monetary policy should be diversified and flexible and utilize interest rate functions.

3 Increased Flexibility of the Securities Market and Administration

Trends of the 4 Major Companies and Acquisition. The following is a review of the trends of industrial structure, as a premise of administration for the securities business.

In terms of stocks trading, the share of the four major securities companies (Nomura, Daiwa, Nikko, and Yamaichi) remained at the 40% level. There was a trend for the increase in shares of the semi-major securities companies. For public and corporate bonds, the share of the four major companies was even higher at around the 60 to 70% level. However, there was an oligopoly by the major and semi-major companies during the bubble economy, as the semi major companies expanded their share. As for underwriting, while the four major companies had 80% initially, semi-major companies expanded their share (gradually increased) as well. The share of the four major companies was high in underwriting, public and corporate bonds, and stock trading, in that order. But the semi-major companies also increased their share in each of those categories. This was because of increase in quality of the semi-major companies, due to the mergers of companies.

Administrative Guidance. As for regulations on branching, policies which prioritized areas with no branch and carefully considered competitiveness between the major (and semi-major) securities companies, and local small and medium securities companies for areas with existing branches, were emphasized.

As for sales attitude, the notification “On Issues to be Considered for the Current Management of Securities Companies” was issued in June 1980. The points were as follows: 1) a reassessment of public and corporate bond exchange (e.g. there were companies incapable of adjusting to the rapid expansion of the bond market); 2) the establishment of a sound corporate management system (e.g. an increase of net worth; efforts to restrain the debt ratio and to restrain excessive services related to credit transactions in trading stocks); and 3) the reinforcement of in-house management systems to self-impose the restrictions made by laws, the administration and securities trade groups.

Inspections of Securities Companies. The operating procedure for the inspection of securities companies was amended in 1980, to include not only pointing out incorrectness (point-out inspection) but also to take the viewpoint of guidance, as part of the supervisory administration, by fully assessing sales attitudes, corporate management and finance, and actively and effectively conducting inspections by the minimizing necessary documents and providing a copy of the inspection report to the companies which were inspected when administrative division guides them.

In this period, there was a trend of a widening difference in profitability between companies, so that some local securities companies were in corporate management crises. Some could not adapt to the expansion of the market, led by companies in Tokyo, and some faced conflicts within the company, under a family-business type corporate management. In the case of Takagitei Securities (June 1980), which was the first case of the revocation of license after the introduction of the license system (the Securities and Exchange Law Article 35), it had a large capital deficit due to reckless management.

4 The Mature Insurance Market

The 1979 and 1981 Insurance Council Reports. The survey conducted by the Japan Institute of Life Insurance in July 1982 showed that the ratio of households who had life insurance contracts was more than 90%. As it showed, the life insurance market in Japan had entered into a mature phase.

Under these circumstances, the Insurance Council submitted its 1979 report “On the Desirable Form of the Insurance Business in a Structurally Changing Economy and Society”. This report mainly made proposals regarding life insurance, including three major proposals, such as the promotion of efficiency, bringing out the public and social nature of insurance, and the improvement of asset management. Of these, the promotion of efficiency, it was suggested, needed to alter the postwar insurance business and insurance administration. The 1979 report was based on the recognition of the following: the government had needed a system of protection and uniform regulation in order to reconstruct and foster the insurance business, which was weakened after the war, but the insurance business was now fully developed. The insurance business had to cope with its new environment of a mature society. Therefore, it needed to seek a way to achieve self-responsibility and competitiveness, moving away from the policies of protection and uniform regulation.

Next, the Council summarized a 1981 Report (“On the Desirable Form of the Non-Life Insurance Business in the Future”) for non-life insurance. This report focused on the issues relating to the nature of non-life insurance, which are quite unique as they need cooperation, “an extreme and uniform approach to business operations”, as well as the promotion of efficiency (in terms of premium rates, products and sales), bringing out the public and social nature of insurance, and the improvement of asset management.

The insurance administration of this period proceeded based on the proposals in these reports.

The Efficiency of Management. First, in terms of life insurance sales, it was necessary to improve the agency system. Although the “Three Year Improvement Plan” had been implemented since FY1976, the MOF further issued a notification to guide the implementation of a three year plan, for the establishment and improvement of the second offer system from FY1979, and a third three year plan from FY1982. For the non-life insurance agency system, it was pointed out that the knowledge and business capability of agencies were not sufficient to cope with the popularization of non-life insurance and the incentive system for agencies that specialized in mass insurance. Then, according to the notification "On a Basic Outline of a Non-insurance Offering System" in June 1980, a new non-marine agency system was established, including rules for raising the rank of agencies specializing in mass insurance.

Secondly, it suggested the development and improvement of new products in order to meet consumer needs to improve and diversify the product descriptions.

Thirdly, it suggested using the rating system of the Insurance Rating Association for non-life insurance, to use the mechanism of flexibility of the rating (e.g. range premium rate, standard premium rate system, etc). This required a strict rating review and there were also reduction of some ratings based on this review.

Bringing out the Public and Social Nature of Insurance. Insurance is based on the laws of large numbers and is required to maintain reliability and soundness, because as a business it has a wide range of customers and a deep relationship with national welfare, and providing assets for the future. In this regard, the authorities classify the insurance business as having a public and social nature.

From this viewpoint, firstly, the need to improve the policies of disclosure and the provision of information were pointed out in particular. Specifically, it was seen as necessary to grasp important information through questionnaires and the collection of complaints.

Secondly, so-called "moral risk" (fraudulent or excessive acquisition of insurance amount) measures were requested by the authorities in order to secure reliability of people. The authorities proposed to providing a system to execute an appropriate survey of the actual conditions, while paying full attention to personal privacy and use opportunities to exchange information.

Efficiency and the Increased Flexibility of Asset Management. The authorities proposed to expand the categories of asset management and make them more flexible, while restraining loans for "*Sala-Kin*". In addition, a voluntary agreement within the industry was reached to deal carefully with foreign securities investments carrying a high exchange risk.

Section 3. External Economic Policy

1 The Trends of the World Economy

Economic Conditions of the Industrialized Countries. In the United States, Ronald Reagan, who had advocated the return of "Strong America", beat President Carter and won the Presidential Election in autumn 1980. The Reagan Administration advocated reviving market mechanisms by the achievement of small government as the basis of their economic policy. In order to achieve this objective, a large-scale tax reduction policy was implemented and deregulation was promoted. "Reaganomics" (the economic policy of the Reagan Administration) then achieved a big success in restraining inflation. However, it was still hard to revive a "Strong America", as the United States faced difficulties with the "twin deficits" of fiscal deficit and balance of payments deficit in terms of its economy. The trade deficit continued to expand into the early 1980s, and the United States became a debtor country in 1985 for the first time since the World War I.

The European economy also faced a slowdown. The real growth rate of twelve EC countries was at the 3% level in the late 1970s, but it shifted down to 1 to 2% in the 1980s. The unemployment rate jumped from the 3% level in the mid 1970s to 10% in 1985. The increase rate of consumer prices remained at over 10% since the 1970s. The economic slump in the U.K. and France was particularly severe.

Against such conditions, Japan overcame the second Oil Crisis without severe consequences and achieved a growth rate of 3 to 5% in the early 1980s, which was overwhelming to other industrialized countries. Japan's imports also significantly increased in the period, mainly for heavy and chemical products. The trade surplus in 1984 reached $44.2 billion. External investment showed dynamic development for both indirect and direct investments. Consequently, the external net asset amount reached $129.8 billion in 1985, to make Japan the world largest creditor country.

Summits and Alliances of Industrialized Countries. The Venice Summit in 1980 was held in the middle of the second Oil Crisis. Therefore, it was decided to make the priority of the Summit how to deal with the inflation which had resulted from the second Oil Crisis. The declaration indicated a solution to the issues by combining a short-term overall demand management policy, a mid- and long-term income policy and a supply policy. For the oil problem, the objective was set as being to reduce the excessive dependency on oil among the energy demands by saving oil consumption and developing alternative energies.

The main agenda of the Ottawa Summit in 1981 was the macro economy. Some countries demanded that the United States correct the excessive rise in the interest rate of the United States, which was one of the main factors that were restraining the economic policies of other counties.

In the Versailles Summit of 1982, the European countries and Canada strongly criticized the high interest rate of the United States. Against the instability of the foreign exchange market, the "Statement of International Monetary Undertakings" was issued, to announce that G7 countries would start discussing the effects of the foreign exchange market by doing surveillance (mutual surveillance) among the major countries regarding their foreign exchange rates.

Prior to the Williamsburg Summit in 1983, G7 (the 7-country Minister of Finance and Central Bank Governor's Meeting) was held on April 29, 1983 in Washington and a "Statement on Intervention Study" was announced. The statement suggested that additional measures were necessary to achieve the stability of the foreign exchange market, as economic policy operations were not sufficient to prevent the occurrence of unregulated conditions in the market. Accordingly, while it was claimed that an intervention policy would be required, it also pointed out the limitations of an intervention policy. In the summit in May, there were quite a many negative opinions about President Mitterrand of France's ideas about target zones (a system to restrict the fluctuation of major currencies within a certain range). As a result of summarization of the opinions, an annex of the "Williamsburg Declaration on Economic Recovery" which was announced after the Summit, stated that the Summit countries agreed to start examinations of a multilateral surveillance system for the economic policy of the member countries by IMF.

The "London Economic Declaration", announced at the London Summit in June 1984, recognized that economic recovery had come to stay and stressed the need for temperate fiscal and monetary policies based on mid- and long-term perspectives. The main agenda of the summit was the start of a new GATT Round, so that the start of the preparation of a new Round was agreed.

The Problem of Debt Accumulation. While signs of a debt accumulation crisis had emerged in Eastern European countries from around 1981, the external debt crisis of Mexico in 1982 significantly affected the world economy. On August 23, 1982, Mexico had difficulty in paying its external debt and made a request for an emergency loan to the IMF and for an extension of the due date for the official debt to its creditor banks.

The debt crisis of Mexico immediately affected Argentina and Brazil.

The default risk of developing countries in the 1980s increased as they depended on the short-term loans of foreign financial institutions.

Against the debt accumulation crisis, the United States, as the largest creditor country to countries with debt accumulation, started to take measures under the lead of government. The organizational emergency support program led by the United States had the IMF play the role of promoting rescheduling and providing new loans from private financial institutions, as well as its facilities. Since then, the IMF started to take on the character of a rescue organization.

Japanese commercial banks furnished loans to the so-called “problem countries” (about 30 countries) for about $30 billion as of June 1983. The total amount of loans to Mexico, Brazil and Argentina was $21.5 billion. Japanese government provided the emergency supports of IMF or BIS and stated that debtor countries should make strong efforts in terms of economic adjustment first.

2 Trade Friction and the Yen-Dollar Committee

The Trend of the Balance of Payments. The current account deficit which resulted from the second Oil Crisis continued even after 1980, but turned into a surplus of $4.7 billion in 1981 (Table 1-3-1). Then, the surplus range rapidly increased to $35 billion in 1984. One of the main reasons for the current account surplus was the expansion of the trade surplus.

The trade surplus to the United States was particularly large. Exports to the United States were 24.2% of the total amount of exports in 1980, but increased to 35.2% in 1984. This increase in exports is attributed to the increase in exports such as motor vehicles, motorcycles, semi-conductor electronics products, audio tape recorder, AV apparatus and office machines. The rapid increase of Japan’s trade surplus with the United States led to severe trade frictions between Japan and the United States.

In terms of the capital account, the long-term capital account became an over inflow in 1980 for the first time in 16 years, which was a temporary phenomenon. In and after 1981, it shifted to become a capital over outflow and excess outflow of $49.6 billion in 1984. Securities investment led to an increase in external investment in this period. The amount of securities investments increased by 8 times in 1980 to 1984. This was because institutional investors actively invested in bonds in the United States, as the Japan-U.S interest spread was large. In contrast to this, the increase in direct investment was only about 2.5 times in the same period.

Exchange reserves fluctuated along with the dollar appreciation, but the fluctuation was gradual as a whole from 1980 to 1986 (Figure 1-3-1).

Increase in External Assets. External assets decreased in 1980 from the previous year after being affected by the Oil Crisis, but rapidly increased after that. The balance of external assets increased by 2.5 times from $135.3 billion in late 1979, to $341.2 billion in late 1984. Meanwhile, external liabilities increased by 2.5 times during the same period. Net external assets exceeded the 1978 level which was the best on record and reached $74.3 billion in 1984 (Figure 1-3-2).

The main increase in external assets was caused by the securities investments of the private sector. For external liabilities, in particular, the increase in stock transactions of non-residents of Japan and the increase in securities investment due to the dynamic issuance of corporate bonds by Japanese enterprises were noticeable.

The Trend of the Foreign Exchange Rate. Yen depreciation recorded a low of ¥251/$ in the NY market in late February 1980, after yen depreciation started due to the U.S. dollar defense package and the second Oil Crisis. As a result of cooperative countermeasures against yen depreciation by the major countries, yen appreciation resumed in and after June and reached ¥203 by the end of the year (Figure 1-3-3).

However, yen depreciation occurred again, reaching ¥247 in August 1981. The yen started to increase from November to ¥217 in early January 1982. However, there was in trend of yen depreciation after that, reaching ¥278 in early November of the year.

Yen was ¥230.40 in early 1983 and reached ¥232.00 to close by the end of the year. The fluctuation for the year was relatively small at ¥20.60. In March 1984, yen appreciation went to ¥222, but reached ¥251 at the end of the year, because of dollar appreciation thanks to the economic recovery in the United States.

Measures for Opening up the Market. The Japan and U.S. trade friction was rekindled in the middle of the 1980s. In particular, regarding motor vehicles, there was a move in the U.S. Congress toward legislation for introducing import restrictions on motor vehicles, and voluntary export restrictions to the U.S. was decided upon in May 1981. The U.S. Secretary of Commerce Baldridge, visited Japan in October 1981 and requested the expansion of import products. The third Jones Report, issued in December of that year, insisted that Japan should open its markets for agricultural products (beef and citrus fruits), fertilizer, leather, tobacco and services.

Criticism of Japan by the EC also increased. In February 1981, the EC executive council meeting of foreign ministers announced an eight-point statement on commerce and trading issues with Japan. The representative of the EC Committee visited Japan in September of the year to request import expansion of fourteen items.

The Japanese government decided upon its policy, "Japan's Current Economy and Basic Policy of Economic Operation" in the Ministerial Conference for Economic Measures on September 5, 1980, to gradually progress the improvement of the balance of payments. However, Japan was requested to present more specific policies in 1981, and the Suzuki Cabinet, established in 1981, proposed measures to solve the external economic friction as one of its important policies. The Ministerial Conference for Economic Measures decided upon its "Measures for Further Opening the Market" on December 16, 1981 (primary measures to open up the market). They included: 1) a foreign currency lending facility up to $500 million; 2) an interest subsidy to promote saving of rare metals, such as nickel and chrome; and 3) early implementation of improvements to the import testing procedures and reduction of tariff rates. In January 1982, the Office of Trade and Investment Ombudsman (OTO) was established, with the Deputy Chief Cabinet Secretary as the chief.

Pressure to open up the Japanese market grew fierce in 1982.

On May 28, 1982, the Ministerial Conference for Economic Measures announced its "Additional Measures to Open up the Market" (the second set of measures to open up the market). They included: 1) improvement of import testing procedures; 2) reduction of tariff rates; 3) relaxation of import restrictions; 4) an increase in imports; and 5) improvement of the distribution system and business practices.

The Ministerial Conference for Economic Measures decided upon its "On the Promotion of External Economic Measures" for further opening up the market on January 13, 1983 (the third set of measures to open up the market). They included 1) the reduction of the tariff rates of 86 items; 2) import expansion of six agricultural products, such as tomato juice; and 3) holding an OTO advisory council, improvement of standard and certification systems, and improvement of import testing procedures.

Although the Japanese government proposed measures to open up the market one after another, talks to ease frictions were proceeding with difficulty. Therefore, the government started to consider new external economic measures from July 1983. It was decided to organize the new external economic measures as comprehensive economic measures, which led to the "Comprehensive Economic Measures" being decided upon on October 21. The "Comprehensive Economic Measures" included: 1) economic stimulation by expansion of domestic demand; 2) market opening; 3) import promotion; 4) encouragement of capital inflow; 5) promotion of international transactions in yen and improvements in the conditions of the financial and capital markets; and 6) promotion of international cooperation. It was a remarkable feature that financial and capital market issues (4 and 5) were newly included in the measures.

Furthermore, the "External Economic Measures" were also announced on April 27, 1984. They included six points as follows: 1) market opening and import promotions (reduction or abolition of tariff rates, relaxation of the import restrictions on beef and oranges, import liberalization and distribution improvements for manufactured tobacco products); 2) market opening in the high technology sector (purchasing communication satellites and allowing open access to telecommunication businesses); 3) promotion of the liberalization of financial and capital markets and the internationalization of the yen; and 4) the promotion of international investment.

The Official Visit of President Reagan in Autumn 1983 and the Establishment of the Yen-Dollar Committee. After the Yen-Dollar Committee was established in autumn 1983, the liberalization and internationalization of financial and capital markets were rapidly progressed.

American industries were irritated by the expansion of the imbalance of trade between Japan and the U.S. and sought a solution. The so-called "*Morgan Paper*" pointed out that the cause of yen depreciation/dollar appreciation was that Japan's financial and capital markets were closed. As U.S. government officials paid attention on this report, the U.S. government decided to request the liberalization of Japan's financial and capital market in early October 1983.

The Secretary of the Treasury Regan requested the Japanese government in a letter to the Minister of Finance, Noboru Takeshita, dated October 13, 1983, to make a statement referring to the immediate promotion of the liberalization of the capital market and specific measures to achieve it, when President Reagan visited Japan in November. The "Comprehensive Economic Measures", decided upon on October 21 by the Ministerial Conference for Economic Measures, included the "promotion of international transaction in yen and the improvement of the conditions of financial and capital markets, etc." as well as a review of real demand rule, a study toward the establishment of a market for trade related banker's acceptance denominated in yen and the elimination of the designated companies system.

The Prime Minister's statement after Nakasone-Reagan talks revealed that Japan and the United States had agreed on creating opportunities to talk about the problems of exchange rates and investments. On the same day, Takeshita-Regan Joint Press Announcement was issued.

The Working Group of Joint Japan-U.S. Ad Hoc Group on the Yen-Dollar Exchange Rate, Financial and Capital Market Issues. The Ministry of Finance finalized its basic policy on the “active”, “voluntary” and “progressive” liberalization of the financial and capital market and the internationalization of the yen in the newly established Yen-Dollar Committee.

The working group was comprised of the Ministry of Finance of Japan and the Department of the Treasury of the United States. Vice Minister of Finance for International Affairs Oba and Under Secretary Sprinkel became the co-chairmen. There were six working group sessions held from February to May 1984, to discuss a wide range of issues including items other than those listed in the joint press announcement in November 1983. Additional requests from the United States were: 1) the establishment of a Euroyen market; 2) access for American financial institutions to the Japanese market; 3) capital market liberalization; and 4) direct investment to Japan.

As regards the expansion of the Euroyen market, early in the meeting, Japan insisted that the first priority would be the internationalization of the Tokyo Market, to expand that market, so that development of a Euroyen market should be considered as a supplemental issue. The United States, however, did not agree, and Japan complied by showing their intention to start expanding the Euroyen market in April 1984. In terms of the liberalization of financial and capital markets, Secretary of the Treasury Regan expressed his frustration by tapping the meeting table as Japan was being too cautious but the Prime Minister Yasuhiro Nakasone committed to progress the liberalization immediately. Consequently, Japan agreed to considerable liberalization.

The report was prepared in the fourth to sixth working group sessions in May and submitted to the Japanese Minister of Finance and the U.S. Secretary of the Treasury on May 29.

The “Yen-Dollar Meeting Report”. The “Yen-Dollar Meeting Report” was published on May 30, 1984. The MOF also issued a document entitled the “Current Status and Future Prospects for the Liberalization of Financial and Capital Markets and the Internationalization of the Yen” concurrently. On May 28, the Minister of Finance Takeshita made a consultation with the Committee on Foreign Exchange and Other Transactions about the internationalization of the yen.

The “Yen-Dollar Meeting Report” summarized as follows:

“Both sides expressed their expectation that the agreed measures and follow-up steps to liberalize the Japanese capital market, to internationalize the yen, and to improve access for foreign financial firms to the Japanese capital market, will help enable the yen to more fully utilize its underlying strength and Japan's importance as a great trading and financial world power, and will significantly improve the efficiency of the Japanese and the world's capital markets."

The United States was interested in (A) Capital Market Liberalization; (B) Access for Foreign Institutions to Japanese Money and Capital markets; (C) Development of Euroyen Investment and Banking Markets; and (D) Direct investment.

(A) Capital Market Liberalization

The United States requested the removal of the withholding tax on earnings, the removal of interest rate ceilings on time deposits, the establishment of a short-term financial market similar to TB market, the deregulation of CD issuance conditions, the establishment of a yen-dominated Banker's Acceptance (BA) market, the removal of swap limits, the liberalization of overseas yen lending, the removal of real demand rules in forward exchange transactions and the liberalization of holding bank accounts overseas and direct trading by Japanese residents in Japan. The Japanese government accepted most of the requests of the U.S. government.

(B) Access of Foreign Institutions to Japanese Money and Capital markets

The United States requested the acquisition of membership for foreign securities firms in Tokyo Stock Exchange, participation in trust banking activities and secure transparency of the regulations and policies governing the activities of Non-Japanese financial institutions. Japan explained that Tokyo Stock Exchange was an autonomous membership organization, and that the government was not in a position to determine the terms and price of membership. Meanwhile, Japanese side agreed on the entry of foreign banks into the trust banking business in Japan.

(C) The Development of Euroyen Investment and the Banking Market

The United States requested the expansion of Euroyen bond market, free access to Euroyen bond market for foreign underwriting contracts, the removal of withholding tax on earnings by non-residents on investments in Euroyen bonds issued by Japanese residents, the establishment of a Euroyen CD market and permission for Syndicated Euroyen lending based on the perspective that the "Establishment of a completely free Euroyen market is the cornerstone of progress toward the internationalization of the yen," and therefore that Japan should approach the yen's internationalization from the establishment of a Euroyen market. Japan accepted both requests for implementation.

(D) Direct Investment

The United States proposed the elimination of the designated company rule and the provision of basically an equal, national treatment of foreign investors, in order to "eliminate barriers, impediments and policies that interfered with the free international flow of direct investment," and Japan accepted to do so.

The Follow-up Meetings. The Yen-Dollar Committee was terminated with the announcement of the report and the items agreed went on to be implemented in order. For implementation, the Report of the Committee on Foreign Exchange and Other Transactions (the "Internationalization of the Yen") was released in March 1985, which was followed by the "Outline of the Action Program for Improved Market Access" on July 30.

Furthermore, Japan-U.S. Follow-up Meetings were held six times until April 1987, for the schedule management of items in the Yen-Dollar Meeting Report, and opinion management between the Japanese and U.S. governments. In 1989, in succession to the Follow-up Meetings, the "Joint Japan - U.S. Working Group on Financial Markets" was newly established, to discuss issues on financial deregulation between the two countries.

In addition, financial talks with other countries such as the U.K., West Germany, France, Italy, Canada and EC Committee were held from 1984 to 1986.

3 The Liberalization of External Financial Transaction and External Financial Services

Elimination of the Yen Conversion Regulations and the Real Demand Rule. Foreign exchange banks were severely restricted from obtaining short-term funds (Euro dollars, etc.) from overseas, to supplement the shortage of domestic funds under the yen conversion regulations (introduced in February 1968; revised to be stricter in February 1970). This regulation was toward deregulation, after the yen conversion regulations were revised, with the different title of "Swap Limitations" in June 1977. The swap limitations were then eliminated on June 1, 1984. The elimination of swap limitations meant the complete end of the ban on arbitrage transactions of short term funds, so that Japanese banks were able to obtain a strong means of overseas short-term funding.

In April 1984, the real demand rule was eliminated. The real demand rule in forward exchange transactions required the forward exchange transactions between foreign exchange banks and customers (residents) to be based on the demand according to the actual transaction, such as trading. The MOF proposed a review of the real demand rules in its "Comprehensive Economic Measures" in October 1983. In the November Joint Press Announcement, Takeshita and Regan announced their intention to eliminate the real demand rule.

Liberalization of Euroyen Transactions. The MOF was reluctant to intentionally expand the Euroyen market and assumed a restrained attitude regarding the issue of Euroyen bonds. However, Euroyen transactions were rapidly liberalized after the Yen-Dollar Committee.

Euroyen lending preceded the liberalization of Euroyen transactions. The MOF only admitted Euroyen lending (lending of deposits of yen accepted by an overseas branch of a Japanese foreign exchange bank for short-term trade banking) from February 1981, and the restriction of use was eliminated in June 1983, to allow non-residents to lend Euroyen from overseas branches of Japanese foreign exchange banks for stock investment in Japan (this rule was applied to Japanese residents from June 1984).

Euroyen bond issuance was only permitted to non-residents, such as persons concerned with international organizations, but the guidelines on Euroyen bonds for Japanese residents were eased in April 1984, so that Japanese enterprises were allowed to issue the bonds.

Euroyen CD permitted foreign and Japanese banks to issue only for short-term bonds (within six months) from December 1984.

Problems relating to the Market Access of Foreign Banks and Securities Companies. Foreign financial institutions have been allowed to access the market of banking, securities and the insurance business for years in Japan, except for the trust business. As the Yen-Dollar Committee also raised the problem of market access to the trust business, the Japanese government indicated its policy to permit their entry to the trust business in 1984.

Another significant problem was the acquisition of membership of the Tokyo Stock Exchange for foreign securities companies, which had gained considerable attention since 1981. When the United States requested opening the market in the Yen-Dollar Committee in April 1984, the Tokyo Stock Exchange increased the number of membership, to allow six foreign securities companies to enroll in November 1985.

The External Lending of Foreign Exchange Banks. The external lending of foreign exchange banks rapidly increased, mainly for foreign currency denominated external lending (lending of Japanese Exchange Bank for non-residents, or overseas loans) in the early 1980s (See Table 2-3-1).

Foreign currency denominated mid- to long-term overseas loans, which were temporarily banned at the time of the second Oil Crisis, resumed in April 1980. The yen-dominated syndicate loans also resumed in October of the same year. The MOF had been restricting the total amount of external loans, but abolished the restrictions in September 1983. In terms of Euroyen lending, short-term lending was liberalized in June, and mid- and long-term lending were also liberalized in April 1985.

The number of increase of overseas stations such as overseas branches or local corporations in the early 1980s overwhelmed that of the late 1970s. The ratio of services by overseas branches of the overall services of Japanese banks jumped, reaching 19.6% for deposits and 10.3% for lending in March 1982, compared to only 7.4% for deposits and 3.7% for lending in September 1967.

Table 2-3-1 Balance of External Lending and Euroyen Lending

Year end	External lending		Euro yen lending			
	Foreign exchange-dominated	Yen-dominated			For non-residents	For Japanese residents
	$100 million	$100 million	$100 million	¥1 billion	¥1 billion	¥1 billion
1972	72	0	−	−	−	−
1973	133	0	−	−	−	−
1974	166	1	−	−	−	−
1975	178	2	−	−	−	−
1976	174	3	−	−	−	−
1977	183	8	−	−	−	−
1978	300	47	−	−	−	−
1979	436	79	−	−	−	−
1980	549	91	−	−	−	−
1981	743	136	7	162	162	0
1982	925	155	7	174	174	0
1983	1,026	198	8	192	192	0
1984	1,230	290	22	552	468	84
1985	1,344	352	76	1,532	1,399	133
1986	1,691	572	216	3,457	2,385	1,072
1987	2,182	804	686	8,433	3,253	5,180
1988	2,755	997	859	10,809	3,321	7,488
1989	3,373	1,083	1,198	17,184	3,946	13,238
1990	3,928	938	1,933	25,985	3,121	22,864

Source : Ministry of Finance,
Zaisei Kinyu Tokei Geppo (Ministry of Finance Statistics Monthly) No. 398,
Okurasho Kokusai Kinyu Kyoku Nenpo (Annual Report of International *Finance Bureau, Ministry of Finance)*

(Note) Yen-dominated foreign currency lending for 1972-1979 and Euroyen lending in US dollars
are converted to the Yen-Dollar market price at the end of the year.

Impact Loans and Foreign Currency Deposits. The foreign currency lending of banks in Japan to Japanese residents was called impact loans. Impact loans were deregulated from 1978, and the regulations were abolished by March 1980. As a result, securities companies, trading companies, and manufacturers could easily obtain large funds by interest arbitrage transactions. Since 1981, the increase in impact loans was striking, mainly for short-term impact loans. The amount of loans reached $221 billion by the end of December 1988. The balance of long-term impact loans increased to $41.8 billion. Japanese banks also handled more than 80% of impact loans by 1989.

Regulations on foreign currency deposits for Japanese residents were lifted in May 1972, and it was largely liberalized under the amended Foreign Exchange Control Law in 1980, and then further expanded.

Issuance of Foreign Bonds and the Adjustment of the Fields of Banks and Securities Companies. The issuance of foreign bonds by private enterprises was temporarily reduced in 1980, and growth was restored (see Figure 1-3-4). The rate of foreign bonds among the funds of Japanese enterprises obtained from the capital market rapidly increased, to reach 46.2% in 1983, from 26.8% in the previous year. From 1983 to 1985, bond raising overseas exceeded that in Japan. With the amendment of the Commercial Code, the issuance of corporate bonds with stock rights (warrant bonds) was permitted, so that the issuance of warrant bonds also started for foreign bonds.

The overseas business of securities companies boomed, as major securities companies expanded their business in the Euro bond market, and semi-large securities companies opened their businesses in overseas markets. On the other hand, banks felt that the domestic policy of the “Separation of Banking and Securities Activities” was an obstacle for them in developing their security business in the Euro Market, which had no such regulations. Therefore, the Banking Bureau, the Securities Bureau and the International Finance Bureau of the MOF held a consultation, for the adjustment of the fields of finance and securities.

4 Development of Economic Cooperation

The actual amount of ODA in 1980 exceeded $3 billion for the first time. The three-year ODA doubling plan, decided upon in 1978 (the primary interim target) exceeded the target by 16%. On January 23, 1981, the government confirmed the cabinet decision on the second target (the “Second Medium-Term Target for Official Development Assistance”) and newly set the goal of the actual ODA amount for the five years of the early 1980s (1981-1985) as more than doubling the total amount of the five years of the late 1970s ($10.68 billion). However, the amount of ODA did not increase as scheduled, due to various reasons including the progression of yen depreciation and fiscal difficulties. Therefore, the actual amount of the second target was $18.1 billion: an 84.7% achievement ratio.

5 The Tokyo Round Negotiations and Further Opening of the Market

The Tokyo Round Negotiations. In December 1979, the Tokyo Round Negotiations were finally concluded, so that the tariff was uniformly reduced for the items categorized under Japan's tariff reduction concessions for 8 years, from April 1, 1980.

However, Japan has already conducted a 20% uniform reduction in FY1972 and an "advanced implementation of reduction of tariff rates" in 1978, so the current effective tariff rate of quite a number of items was already lower than the standard tariff rate. Therefore, even though a gradual reduction in the tariff rates would be implemented according to the Tokyo Round Agreements, no actual effect of the reductions was expected for the first few years. Thus, the United States and the EC requested that Japan reduce the effective tax rate from the initial year. In order to cope with this requirement, Japanese government announced that the tariff reduction of Tokyo Round Negotiations would be voluntarily implemented in May 1979, earlier than planned. The Ushiba-Strauss talks in June confirmed this announcement. The number of items for advanced implementation was about 1900, which accounted for about 72% of the entire offered items.

Trade Frictions and Market Opening. As Japan was able to overcome the damage caused by the second Oil Crisis easily compared to other countries, its trade surplus became a substantial surplus in FY1981, and the trade imbalance between Japan and other industrialized countries was expanded, and the industrialized countries started criticizing Japan and demanding the implementation of reduction or elimination of tariff and non-tariff barriers and the improvement of the market access. The focus was on foods with the EC and on motor vehicles, tobacco and semi-conductors with the United States.

On December 16, 1981, the "External Economic Measures", decided upon in the Ministerial Conference for Economic Measures, proposed the improvement of import testing procedures, the easing of import restrictions and the reduction of tariff rates as measures for opening of the Market. In order to improve the import testing procedures, the Office of Trade and Investment Ombudsman (OTO) was established with the Deputy Chief Cabinet Secretary as the chief. As for the reduction of tariff rates, the government announced that they would implement it two years earlier than agreed in the Tokyo Round Agreement. Then, they implemented it uniformly in FY1982. The number of items covered by this measure was 1653 (114 agricultural products and mining and 1539 manufacturing products).

The Ministerial Conference for External Economics announced its “Additional Measures to Open up the Market” on May 28, 1982, before the Versailles Summit. According to this, the government implemented tariff reductions on 215 items requested by the United States and the EC in FY1983. In January 1983, “On the Promotion of External Economic Measures” was announced with tariff reductions on 83 items, such as chocolates and biscuits.

The current account surplus in 1983 reached $20.8 billion, so that it was requested that Japan further reduce its surplus and expand imports to avoid external economic frictions. The “Comprehensive Economic Measures” of October 1983 included the advanced implementation of the tariff reductions for mining and manufacturing products agreed in the Tokyo Round Negotiations, and tariff reductions were implemented for 1280 items.

Chapter 3: Fiscal and Monetary Policies after the Plaza Accord

Section 1 Fiscal Policy

1. Measures to Expand Domestic Demand and Fiscal Policy

The Budget for Fiscal Reconstruction. Efforts to reduce expenditure in the budget compilation for each fiscal year continued, past the original target year for the government's finances to escape from its dependence on special deficit-financing bonds, which was extended to "FY1990" in the long-term government economic plan, "Outlook and Guidelines for the Economy and Society in the 1980s" (August 1983).

The guideline for budget requests (or "ceiling") was set severely, to about the level of FY1984, with a current expenditures decrease of 10%, and an investment expenditures decrease of 5% respectively, in the FY1985 budget compilation. Moreover, greater focus was placed on the consolidation and rationalization of subsidies compared to other fiscal years, and the government also decided to review the measures for local finance. In the process of budget compilation, the policy of the privatization of the Nippon Telegraph and Telephone Public Corporation and the Japan Tobacco & Salt Public Corporation (April 1985) was decided. Two thirds of the Nippon Telegraph and Telephone Co. (NTT) stocks and half of the Japan Tobacco Inc. (JT) stocks were placed into the National Debt Consolidation Fund as fiscal resources to redeem government bonds, and the remainder was allotted to the Industrial Investment Special Account, to use the dividends as revenue to promote social overhead capital. While the overall review of the budget system and the administrative and fiscal reforms were underway, a fiscal reconstruction-type budget draft for FY1985 was finalized, and the General Account expenditure showed ¥52.4996 trillion, an increase of 3.7% compared to the initial budget of the previous year. In terms of expenditure, the national debt service accounted for ¥10.2242 trillion, as the biggest part among the major expenditure, which exceeded the social security-related expenditure of ¥9.5736 trillion. As local allocation tax grants were also enormous at ¥9.6901 trillion, the trend of the fiscal rigidity became more obvious. Moreover, the reductions were focused on foodstuff control expenditures and public works-related expenditures, etc. for the current expenditure, which had been reduced continuously for 3 years since 1983.

On the other hand, the bond revenue in FY1985 declined by ¥1 trillion (special deficit-financing bonds were reduced by ¥725 billion) to ¥11.68 trillion, because the tax revenue estimate increased by 11.4%, thanks to economic expansion. However, at the implementation stage of the budget, the increase in tax revenue was less than had been expected, so the supplementary budget was revised significantly downward (approved

February 15, 1986) mainly for the corporation tax, and the government bond issuance was revised upward.

The government showed the stance of a severe expenditure reduction, even for the FY1986 budget compilation. The guideline for budget requests showed a 10% and 5% decrease on the current expenditures and investment expenditures respectively, compared to the initial budget of the previous year. Then, as the yen appreciated rapidly by coordinated intervention to correct dollar depreciation, based on the “Plaza Accord” in September 1985, the Japanese government decided upon and implemented its “Measures for the Increase of Domestic Demand”. However, this was a measure regarding the demand of fiscal reconstruction, so that the increase in domestic demand here mainly depended on the Fiscal Investment and Loan Program, utilization of the private sector’s vitality to the public sector and tax reduction for investment. In the end, in the FY1986 budget draft, General Account expenditure was ¥54.0886 trillion which was an increase of 3% from the initial budget of the previous year. The bond revenue was reduced by ¥734 billion to ¥10.9460 trillion. While the policy to control expenditures contributed to saving of the general expenditure for four consecutive years, as it had in the previous year, the increase rate of defense-related expenditure, which was considered to be a “sanctuary” from the stage of budget requests, was higher than that of other main expenditures. This was because the “Medium-Term Defense Program” for FY1986-1990 had been decided upon by the Cabinet (September 18), and FY1986 was the initial year of a new defense program. The Medium-Term Defense Program was expected to be ¥18.4 trillion in total, which was 1.038% annually compared to GNP. Under these circumstances, the opposition parties demanded the firm maintenance of the 1% frame for national defense expenditure compared to GNP. Then, in the discussion in the Diet in the autumn, Prime Minister Yasuhiro Nakasone finally confirmed that the ratio should maintain within the 1% frame in the FY1986 budget compilation, and the ruling party reached agreement with the opposition parties.

Although the government was able to keep the general expenditure of the FY1986 budget to the equivalent or below the amount of the initial budget of the previous year, there was little hope for additional tax revenues. Therefore, the reduction of special deficit-financing bonds was only ¥484 billion and fiscal consolidation did not make much progress. In the FY1985 supplementary budget (approved February 15, 1986), which was submitted to the Diet at the same time as the FY1986 budget, since tax revenues would not cover the expenses of disaster reconstruction and the hike in civil servant’s wages, the shortage was covered by the additional issuance of special deficit-financing bonds of ¥405 billion, in addition to the construction bonds.

Meanwhile, although the idea of the "Reconstruction of Public Finance Without Dependence on Tax Increases" and the technique of "Zero Ceiling or Minus Ceiling" budget compilation were effective in controlling the natural increase of obligatory expenditures and increasing the opportunity to reduce government bond issuance, some specific budget techniques were taken to achieve the fiscal reconstruction in each fiscal year. For instance, the issuance of the refunding of government bonds conversion greatly contributed to reducing government bonds by ¥1 trillion in the FY1985 budget, as mentioned above. Another significant reason for the reduction of the government bond issue was the suspension of fixed rate transfer from the General Account to the National debt Consolidation Fund since FY1982. Since obligatory expenditures, such as national debt service and local allocation tax grants increased rapidly, social security-related expenditures and public works-related expenditures were controlled severely. In addition, measures that meant that the financial burden was carried over to the following fiscal year were taken, such as postponing the transfer from the general account fund to welfare pensions under the "Special Case Law concerning Administrative Reform" for another one year (see Chapter 2.1.1). Accordingly, the reduction of the special deficit-financing bond issue from FY1984 was not that easy, but in some regards it showed the limits of the "Reconstruction of Public Finance Without Dependence on Tax Increases". A tax increase would also be necessary, concurrent with a severe cut in government expenditures, to accomplish fiscal reconstruction. Therefore, it was further acknowledged that a drastic tax reform, including a review of the ratio of direct-indirect taxes and an expansion of the tax base, were necessary.

Measures for the Recession Caused by Yen Appreciation after the Supplementary Budget of FY1986. The government faced opposite requests —both for measures for domestic demand expansion and measures for fiscal reconstruction— due to the economic slump after the "Plaza Accord" in September 1985. Moreover, fiscal authorities had the important task of completing a drastic review of the tax system.

Based on the process of budget compilation at that time, the guideline for FY1987 budget requests showed a 10% and 5% decrease in current expenditure and investment expenditure respectively. The government showed its determination to significantly reduce government expenditures. This was because it was seen that it was not the time to ease the ceiling, by taking into consideration the increase in national debt service and local allocation tax grants, and requests to decrease the issue of government bonds, even though there would be a natural increase in tax revenue. Before the deadline of budget requests, on the other hand, there was concern that the rapid yen appreciation in July

1986 may affect the earnings of export-related companies and tax revenues. Therefore, the government decided upon its “Comprehensive Economic Measures” (measures for recession caused by yen appreciation) mainly regarding public investment, in September. Moreover, in the FY1986 supplementary budget (approved on November 11) it prepared to execute measures intended to deal with a decrease in tax revenue of ¥1.12 trillion. It also maintained the amount of transfer from the General Account to the National Debt Consolidation Fund at ¥410 billion, and the issuance of construction bonds of ¥549 billion as a fiscal resource for public works was also scheduled, besides the carried-over surplus which was assumed to be a fiscal resource. The FY1986 budget was, in the meantime, executed with 77% of the contract ratio for public works in the first half of the year, which was the biggest advanced implementation ever. Moreover, public works-related expenditures were significantly added to the supplementary budget. Consequently, the Comprehensive Economic Measures were not effective in achieving sufficient effect for the sluggish economy.

The General Account expenditure of the FY1987 restraining-type budget draft was ¥54.1010 trillion, representing a rate of 0.0% increase compared to the initial budget of the previous year. The general expenditure had been decreasing for five years in a row, while social security-related expenditures, which exceeded ¥10 trillion yen for the first time, were controlled at an increase rate of 2.6% compared to the initial budget, and the pace of increase rate was restrained constantly from FY1985. However, the Fiscal Investment and Loan Program plan showed the highest growth (22.2%) for the first time since FY1973, in contrast to the control policies of the General Account budget. This then contributed to domestic demand expansion, with subscription to government bonds of ¥2.4 trillion. The bond revenues reached ¥10.5010 trillion. Although the issue amount of special deficit-financing bonds decreased to ¥4.9810 trillion, the reduction of the issue amount compared to the previous year was only ¥445 billion for overall government bonds, and ¥265 billion for special-deficit financing bonds. In such a process of budget compilation, it was decided that the Japanese National Railways would be privatized (April 1987), following the privatization of the Nippon Telegraph and Telephone Public Corporation and the Japan Tobacco & Salt Public Corporation.

The biggest issue in the discussion on the FY1987 budget was sales tax. The opposition parties demanded an additional speech and refused to make their questions to the Diet, causing the Diet to go into turmoil, because Prime Minister Yasuhiro Nakasone had not addressed the issue of a sales tax in his administrative policy speech (January 26, 1988). Arguments about the FY1987 budget were suspended, as the opposition parties refused to discuss it until the ruling Liberal Democratic Party attended the Diet and first made an explanation of the budget draft by the Minister of Finance Kiichi Miyazawa in the budget committee of the House of Representatives without the opposition parties. This resulted in the suspension of discussion even for other issues, such as the government and ministerial ordinance related to sales tax, and its discussion scheduling. Therefore, a provisional budget needed to be compiled for FY1987 due to the delay in such discussion. While a provisional budget should not include policy-related expenditure in principle, it is necessary to include the expenditures for public works, with due consideration for business activity, if the period covered by a provisional budget is more than a month. In this case, a provisional budget for fifty days until May 20 was compiled, since the budget approval was anticipated as being delayed until May, due to the nationwide gubernatorial elections scheduled on April 12, and the House of Representatives' vote for the budget was expected to be made after that.

Emergency Economic Measures and the Large-scale FY1987 Supplementary budget. As the Comprehensive Economic Measures in September 1986 were not effective, as mentioned above, the government proposed a large-scale economic measure on May 29 after the FY1987 budget was approved, and finalized the Emergency Economic Measures with a fiscal measure of more than ¥6 trillion. This was not only an economic measure but also one to execute the External Economic Measures that were agreed in the Finance Ministers meeting and the Japan-U.S. Summit talks. Therefore, it was a comprehensive measure for the expansion of domestic demand, such as public investment, tax reduction, revitalizing local economies and measures for small- and medium-sized enterprises, as well as fiscal measures, monetary policy and activation measures for the mobilization of private sector vitality. A large-scale supplementary budget (the first) of ¥2 trillion was approved, to secure fiscal resources for the Emergency Economic Measures on July 24, 1987. With this supplementary budget, the General Account expenditure in FY1987 increased to ¥56.1803 trillion, and an additional issuance of construction bonds of ¥1.36 trillion was made for public works. Moreover, the revenue from government-held shares of Nippon Telegraph and Telephone Co., after its privatization from the Nippon Telegraph and Telephone Public Corporation, was used to provide social overhead capital at this time. The revenue from the sales of NTT shares should have been allotted to the fiscal resources for government bonds redemption in principle, but it was decided to give permission to use the revenue, as long as it did not interfere with the management of the National Debt Consolidation Fund. In addition, it could be transferred to the Social Capital Adjustment Account, newly categorized in the Industrial Investment Special Account, through the General

Account, which would be available for lending without interest. In addition, the special measure expenses for government procurement were included as a temporary exceptional measure of the supplementary budget to contribute to the expansion of imports. With this measure, government planes and a super-computer were procured.

The “Yen appreciation recession”, representing the economy of 1986, turned out to rapidly shift to economic recovery in FY1987. A sense of economic boom was widespread by around summer. In terms of the settlement tax revenue in FY1987, the tax revenue increase was remarkable, mainly because of plentiful corporation tax revenue. A secondary supplementary budget (February 20, 1988) was compiled under these conditions. The feature of this ¥2.3390 trillion supplementary budget was in its revenue. The government bonds issue was back to the level of the initial budget draft by including the reduction of the special deficit-financing bonds for ¥1.322 trillion. The “Medium-term Estimates of the National Budget (FY1986-1990)” submitted by the MOF to the Committees on Budget in both the Houses of Representatives and Councilors in February 1987, showed a ¥1.66 trillion reduction of special deficit-financing bonds was necessary every year, in order that the special deficit-financing bond issuance would be zero by FY1990. This meant that the reduction of ¥1.5870 in the FY1987 revised budget, based upon the two supplementary budgets, would be big step towards the fiscal reconstruction.

The Privatization of Japanese National Railways. The Japanese National Railways (JNR) reform including its financial matters was considered to be one of the biggest issues for the Second Ad Hoc Commission on Administrative Reform (Chairman Toshio Doko), launched in March 1981, because of the difficulty of the privatization initiative of JNR, and its social and economic impact.

There were once three public corporations - the JNR, the Nippon Telephone and Telegram Public Corporation and the Japan Tobacco & Salt Public Corporation - at one time. However, the limits of public enterprise management started to be exposed in the business substance, management system and financial management of these companies in the first half of the 1970s, so that the necessity for drastic reform was pointed out from various fields. Especially, the financial problems of the JNR were serious, and it was recognized as being one of the “3K” national debt accumulation problems (3K: JNR, rice price, and health insurance). Railway traffic had started declining due to motorization and qualitative changes in transportation needs after the early 1960s. Furthermore, with the delay in the rationalization of management caused by cost rises and labor problem, the annual financial balance turned to a deficit in FY1964. After this change, the JNR accumulated an enormous amount of financial deficit, since the JNR's business management did not fit with economic and social trends, and it had various conflicts with other fields. After discussion in the Fiscal System Council, the "Measures for the Financial Reconstruction of the Japanese National Railways" were approved by the Cabinet in February 1973, and the target of turning the financial balance after depreciation to a surplus, by FY1982, was set. In addition, revisions and improvements to the reform plans were made, such as by Cabinet decision (the "Outline of the Measures for Financial Reconstruction of Japanese National Railways") in December 1975, and enactment of the "Law Concerning the Special Measures for the Acceleration of the Reconstruction of the Management of the Japanese National Railways", including rationalization of local lines which created deficit, on December 27, 1980.

The Second Ad Hoc Commission on Administrative Reform declared in its third report (Base Report), on July 30, 1982, that "Not only is the Japanese National Railways going bankrupt, but also the other two public corporations are not able to perform as public entities, and even spoils their public image. It is even doubtful nowadays if a public corporation system can keep the advantage of both its public character and role as an enterprise in harmony", although once public corporations had had an important role for the national economy, in the postwar reconstruction and high growth eras. With this basic recognition, a basic policy for JNR reform, by area segmentation and by privatization, was proposed. More specifically, the achievement of the JNR reform within five years, and the establishment of executive committee for the reconstruction of the JNR, were decided based on a Cabinet decision ("The Special Programs of Administrative Reform for the Future") in September of the same year. This committee also reported its "Opinions on the Reform of the Japanese National Railways –For the Future of Railway Services", in June 1983. The policy clearly stated how the management should be reconstructed as a sound business unit, by cutting its enormous liabilities and rationalization of its excessive workers, aiming for the privatization of the JNR. This proposal was effective for enabling the government to proceed with the reform, and the "Law concerning Railway Company and Freight Railway Company" was enacted, for the execution of the JNR reform, including seven area segmentation and privatization of the JNR, in April 1987.

The "Japanese National Railways Settlement Corporation Law", one of the seven laws related to the JNR reform, specified the shift of the JNR to the Japanese National Railways Settlement Corporation, for settlement of its assets and liabilities, as well as promotion of staff's reemployment. Finally, the long-term liabilities which belonged to the Japanese National Railways Settlement Corporation were about ¥25.5 trillion, at the beginning of FY1987. Therefore, a settlement plan, including selling the estate of the old Japanese National Railways and its JR stocks, was made.

2 Fiscal Policy in the "Bubble Economy"

Continuance of Measures for Domestic Demand Expansion. The stance of taking large-scale aggressive economic measures, by making a supplementary budget after the initial budget approval, was still continued in the FY1988 budget compilation. The guideline for FY1988 budget requests showed a 10% decrease in current expenditures, but investment expenditures remained unchanged from the initial budget of the previous year, for the first time since the Minus Ceiling was adopted. This guideline implied that investment was maintained to the level of public works in the investment expenditures of the FY1987 revised budget, for domestic demand expansion. However, for fiscal reconstruction, the report by the Temporary Administrative Reform Council in July 1987 was submitted to the government, stating that the postponement of fiscal reform was not permitted, and the government also reconfirmed its policy to reduce special deficit-financing bonds as much as possible. Furthermore, the opinion was that the issuance of construction bonds should be controlled as much as possible, as mentioned by the Fiscal System Council chairman. And the revenues from the sales of NTT share purchases, as a result of the administrative reform, should be used as fiscal resources for investment. In the FY1988 budget draft, decided by the Takeshita Cabinet that was launched in November, the General Account expenditures were ¥56.6997 trillion, a 4.8% increase from the initial budget of the previous year, and bond revenues were ¥8.841 trillion. The increase rate of General Account expenditures was the largest since the FY1982 budget (6.2%) but the reduction of special deficit-financing bonds, which did not progress till then, turned out to be ¥1.8300 trillion, all at once the prospects of success in fiscal reform looked good. That success was brought about by the revenue from sales of NTT stock of ¥1.3000 trillion, in addition to the expectation of a great increase in tax revenue.

As for the FY1987 second supplementary budget, which was submitted to the Diet at the same time as the FY1988 budget, the amount of the supplement was ¥ 2.3390 trillion, the financial resources were a ¥1.893 trillion tax revenue increase, as well as ¥1.934 trillion in carried-over surplus from FY1986. However, as mentioned earlier, this was a completely opposite direction of progress compared to the FY1986 supplementary budget, as the special deficit-financing bonds were reduced by ¥1.322

trillion. The pace of economic recovery was fast, and a large sum in tax revenue increases was expected, which was more than the tax revenue reduction upon withdrawal of the sales tax bill.

Economic Recovery and the Prospects for Fiscal Reform. As mentioned above, the fiscal outlook and budget compilation faced favorable conditions, because the tax revenue increased, thanks to the rapid economic recovery. The “Medium-term Trial Estimates of the National Budget (FY1987 to 1991)” stated that even though the increase rate of tax revenue was estimated to be at a low level of 5.5%, on the premise that the special deficit-financing bond of ¥3.151 trillion in FY1988 should be zero by FY1990, the shortage of revenue would be ¥5.51 trillion in FY1990. However, the final results of the FY1987 tax revenue exceeded the upward revised budget, which had been corrected upward for ¥3.71 trillion, so that it seemed that the target of delivering the government’s finance from its dependence on deficit-financing bonds could be achieved before FY1990. This encouraged the government to introduce an indirect tax with a broad tax base, to take the place of the sales tax bill, which had already been abolished. The achievement of this goal, with the tax reduction on a net basis, was motivated by such favorable financial conditions.

The guideline for FY1989 budget requests showed a 10% decrease in current account expenditures and the same amount for investment. Moreover, it was expected to use the revenue from sales of NTT stock of ¥1.3 trillion, the same as the previous fiscal year. However, it was assumed that the consolidation and rationalization of government finance remained an issue, because the government debt outstanding was still high, at ¥158 trillion at the end of FY1988, even if the fiscal condition had recovered. On the other hand, the movement for tax reform also accelerated. “The Outline of Tax Reform” of June 1988, stated that, income tax, corporation tax, inheritance tax, and gift tax should be reduced, and a consumption tax newly applied, in place of the commodity tax and other excises. It also included the reform of local taxes and local allocation tax grants. This large-scale tax reform draft showed a net tax reduction of ¥3.78 trillion (annual). The related bills were submitted to the Diet on July 29, and approved on December 24, upon correction.

The new era of “Heisei” started with demise of Emperor Hirohito (January 7, 1989), and the FY1989 budget draft, decided upon by the Cabinet on January 24, was ¥60.4142 trillion for General Account expenditures, a 6.6% increase from the previous year. Special deficit-financing bonds were expected to be ¥1.331 trillion, with a significant decrease of ¥1.82 trillion, as the tax revenue increase was expected to be ¥5.92 trillion.

While two thirds of the increase in expenditures resulted from the increase in local allocation tax grants, this was because of the increase of tax revenue and the additional ratio of 24% for consumption tax and 25% for the tobacco tax, which were newly allocated to local allocation tax grants. Thus, the FY1989 budget was designed to aim for fiscal reform, such as by the consolidation and rationalization of expenditures, to achieve the “Target of Delivering the Government’s Finances from its Dependence on Deficit-bonds in FY1990”, while considering the continued expansion of the domestic demand.

The FY1988 supplementary budget, approved on March 7, 1989, should have been compiled earlier, as the tax reform had been implemented since 1988, but discussions in the Diet were delayed because of the “Recruit” scandal. An increase in tax revenue of ¥3.16 trillion was included in the supplementary revenue, in addition to the carried-over surplus of ¥2.9745 trillion for FY1987. Therefore, a large amount of tax revenue increase was expected, mainly because of the increase in corporation tax, in spite of tax the reduction, of about ¥2 trillion, and special deficit-financing bonds were also reduced by ¥1.38 trillion. On the other hand, for supplementary expenditures, the transfer to the Welfare Insurance Special Account ¥1.5078 trillion was appropriated, which has been put back as the termination of the special measures of the “Special Case Law Concerning Administrative Reform” after FY1982. Due to this supplementary budget for ¥5.152 trillion, the issue amount of the special deficit-financing bonds in FY1988 was ¥1.7710 trillion, which was reduced to a level even close to the initial budget of FY1989. Furthermore, as the tax revenue exceeded the supplementary budget for ¥2.7200 trillion, it could easily be anticipated that the FY1989 tax revenue would also exceed the budget draft.

Achievement of the Fiscal Reform Target. As domestic demand kept increasing, the business upturn continued in FY1989. On the other hand, the current account surplus tended to decrease due to an increase in imports.

The guideline for FY1990 budget requests showed a 10% decrease in current expenditures, and the investment expenditures were assumed to be the equivalent to the initial budget of the previous year. Moreover, the use of the revenue from the sales of NTT stock purchases was expected to be ¥1.3 trillion, the same amount as in FY1989. The FY1990 budget compilation aimed at emerging from the bond dependent finance and achieving the “Target of Delivering the Government’s Finances from its Dependence on Deficit-bonds by Fiscal Year 1990” as the first stage of the fiscal reform. A thorough consolidation and rationalization of government expenditures was made for this purpose, which made the FY1990 national budget reach ¥66.2736 trillion for the General Account expenditures, a 9.7% increase compared to the initial budget of the previous year. The tax revenue was still expected to increase by ¥6.994 trillion, while the issue amount of government bonds was reduced by ¥1.481 trillion compared to FY1989, with only ¥5.63 trillion in construction bonds. However, the House of Representatives was dissolved on January 24, 1990, and the 39th general election of the House of Representatives was held on February 18. Therefore, expenditures related to the general election were suspended according to the termination of House of Representatives members, so that the FY1990 budget needed to be revised for reduced adjustment. Eventually, the FY1990 budget was approved on June 17, 1990 with ¥66.2368 trillion for the General Account expenditures, a 9.6% increase compared to the initial budget of the previous year. The issue amount of government bonds included construction bonds of ¥5.5932 trillion and there were no special deficit-financing bonds issued. This contributed to achieve the fiscal reconstruction that the government had been aiming for a long time. Although the bond dependency ratio dropped to 8.4% (11.8% for the FY1989), the government debt outstanding remained high at over ¥166 trillion. Therefore, the fiscal reconstruction needed to be further promoted strongly, in order to cope with various issues, such as the rapid accumulation of the national debt service, the rapid progress of the aging society and the increased responsibility of Japan in the international community, in a flexible manner.

The “Heisei Boom” supported by the “Bubble Economy” ended with its peak in February 1991, and the economy turned downward (the so-called “Heisei recession”). Then, the government started to make efforts to reduce the official discount rate and take economic measures to expand domestic demand against the depression of domestic demand, as symbolized by the significant decrease in private equipment investment.

The Gulf Crisis, the Gulf War and Japan’s Contribution to the Middle East. The “Gulf Crisis” broke out concurrently with the end of the “Bubble Economy”. Iraq invaded Kuwait on August 2, 1990, which affected the world economy, such as with soaring crude oil prices. The following describes the financial support of Japan to the allied forces in the Gulf War, which was organized immediately after “Gulf Crisis.”

When the “Gulf Crisis” occurred, Japanese government announced economic sanctions on Iraq on August 5, assuming a ban on the import of crude oil and the suspension of economic cooperation. As the U.S. and the U.K. dispatched their military forces to Saudi Arabia on August 7, the Japanese government started to consider measures for its contribution to Middle East. Consequentially, Prime Minister Toshiki

Kaifu decided on sending financial support of $1 billion to the allied forces on August 30, and notified President George Bush of this program. In addition, the Japanese Government made additional financial support of $1 billion and contributed $2 billion in financial support to the three countries (Egypt, Turkey and Jordan). Finally, the government decided on $4 billion in all, for its Middle East contribution plans.

Under the circumstances, Japan was required to provide support appropriate to its status in the international community, to the peacekeeping operations in the Gulf region. The fund scheme was made upon request of the "Gulf Peace Fund" for donation to the allied forces, as part of the Middle East support program. As for the financial resources, firstly, $1 billion was financed from the reserve funds of the FY1990 budget and another $1 billion was financed from the supplementary budget. The emergency commodity credit was applied as a contribution to the three countries (Egypt, Turkey and Jordan). The FY1990 supplementary budget was approved on December 17 (it was automatically enacted after rejection by the House of Councilors) and the amount was ¥2.281 trillion, including ¥130 billion in contribution to the Gulf Peace Fund.

Around the end of 1990, the negotiations for a peaceful resolution were unsuccessful and the withdrawal limit from Kuwait in Iraq by the U.N. Resolutions expired on January 15, 1991. The military action to Iraq by the allied forces therefore could not be avoided. Thus, the attack by the allied forces began (the "Gulf War"). Then the government decided to make a contribution of $9 billion (¥1.17 trillion) to the new Middle East support program on January 24. The FY1990 supplementary budget (secondary) was organized as its financial resources. The expenditures included ¥1.17 trillion for contribution to the Gulf Peace Fund. The ad-hoc special deficit-financing bonds for ¥968.9 billion were appropriated on the revenue side. The supplementary budget (secondary) was eventually approved on March 6, which was after the end of the "Gulf War" (February 27).

The New Target of the Mid-term Fiscal Management. The fiscal authorities expedited to make the framework for the new target of mid-term fiscal management, by the end of FY1990, when the government's finance could be delivered from its dependence on the special deficit-financing bond. The Fiscal System Council submitted a report for the mid-term fiscal management to the Minster of Finance, Ryutaro Hashimoto, on March 1, 1990, which was followed by the MOF's preparation of a basic concept for the promotion of fiscal reform. This was submitted to the Diet on March 7.

The Fiscal System Council report pointed out that the fiscal structure still showed potential for the government becoming dependent on special deficit-financing bonds again, if the tax revenue was short, due to recession or other reasons. Therefore, it was concluded that it was necessary to create fiscal conditions which would prevent the accumulation of outstanding government bonds, by reducing the bond dependency ratio and making efforts for the early redemption of special deficit-financing bonds. In practical terms, the “Medium-term Trial Estimates of the National Budget (FY1991 to 1993)” of the MOF assumed a reduction of government bonds of ¥400 billion every fiscal year, on condition that the standard of bond dependency ratio would be “below 5%”, as the Fiscal System Council proposed. However, the government bonds reduction in FY1991 remained at only ¥250.2 billion, which revealed that it was still difficult to strengthen fiscal structure. As mentioned above, due to the economic slump called the “Heisei Recession” after the peak of boom in February 1991, government bonds tended to significantly increase, as the government implemented a series of economic measures to stimulate domestic demand. In addition, special deficit-financing bonds were issued again after FY1994, in order to stimulate economic recovery, so that the government kept issuing government bonds (special deficit-financing bonds) at a high level, even surpassing the level of the 1970s or the 1980s.

3 Prospects for Fiscal Soundness and Government Debt Management Policy

Flexible Issuance of Refunding Bonds. The refunding of government bonds after FY1985 was executed according to the method that had been shown in the “Basic approach to Immediate Problems of Conversion of Government Bonds”, issued by the Conference on the Problems of Government Bonds (May 25, 1984). It confirmed that in order to securely eliminate the large amount of refunding bonds, the relation of maturity between the maturing bonds and the refunding bonds should be maintained, from the viewpoint of avoiding a concentration of maturity distribution. However, particular care should be taken to consider the arrangement for maturity that might be most easily accepted by the market under the various situations, such as the new issue amount and the market conditions. Thus, refunding bonds were to be issued in the most advantageous and appropriate way, according to the financial conditions, with occasional issues of bonds, if necessary. Moreover, the maturity bonds and the refunding bonds were to be issued according to the term and the maturity date at the end of fiscal year. Therefore, the refunding funds were issued in a flexible manner, according to the current financial conditions, regardless of the maturity of each maturing bond.

In addition, the National Debt Consolidation Fund Special Account Law was amended on June 28, 1985, in order to allow the front-loaded issuance of refunding bonds for redemption and refinancing of the large amount of government bonds. Such front-loaded issuance of refunding bonds was executed when the financial conditions were good, and it was advantageous to move up the front-loaded issuance of refunding bonds in the following year, or the equalization of bond issuance would be needed, as compared to the underwriting capability of the market in order to deal with the large-scale redemption of government bonds in the following year. The front-loaded issuance of refunding bonds up to FY1990 accounted for ¥6.5923 trillion, after the system was introduced in FY1985.

The Promotion Policy of the Government Bonds Market. The issue amount of government bonds in the FY1987 budget was ¥10.5010 trillion, which showed a reduction of ¥445 billion from the initial budget of the previous year. It was assumed that the current state of allowing a large scale government bond issuance should remain unchanged, even though the issue amount of special deficit-financing bonds was being downsized and there was a trend for the reduction of government bonds. The MOF, therefore, enhanced the promotion policy of the government bond market, increasing banks bonds and enhancing the handling of the public offering of government bonds. Thus, the complete competitive auction of 20-year bonds, underwriting amount auctions for 10-year bond, and the introduction of the handling of life insurance commodities by banks were implemented from October.

In addition, the government bond issuance in FY1987 was especially to be noted in view of the substantial issuance of public offering bonds. While the super long-term bonds of 20 years were underwritten by public subscription or by the Trust Fund Bureau at the beginning of FY1986, a significant amount of these were changed to that of public subscription in FY1987, though some continued to belong to the Trust Fund Bureau. In terms of the 10-year bonds, the underwriting amount auction was applied for 20% of public subscription from November. In the meantime, dealing of outstanding issues, which began in 1986, increased by as much as 2.5 times compared to the previous year by the end of 1987. Thus, the government debt outstanding at the end of FY1987 reached ¥151.8093 trillion, as it increased cumulatively because refunding bonds increased, although new issue amount were suppressed. It only took four years for government debt outstanding, which was ¥10 billion at the end of 1983, to reach ¥150 trillion. Furthermore, low interest bonds were promoted by refunding, so that the change of the government bond market in FY1987 was further promoted in the following fiscal year, 1988.

The Problem of Market Access for Foreign Financial Institutions. The U.S. government had been insisting on the maintenance of the impartiality of 10-year bonds, within the framework of the syndicate underwriting system, in relation to market access for foreign financial institutions to the Japanese government bond market, since the "Yen-Dollar Committee Follow-up Meeting" in April 1988. The expansion of the underwriting share of syndicate underwriting for foreign financial institutions was requested to a great extent, as well as the introduction of a competitive auction system, even partially. As the scale of the financial and capital market, including the secondary government bond market, started to expand with the progress of liberalization and internationalization, the Japanese government also acknowledged the necessity to encourage competition in the bond market. Therefore, the MOF announced in the document entitled "On the Maintenance of the Government Bond Market" on September 6, 1988, that they would introduce a partial competitive auction to improve the competitiveness and transparency of the Japanese bond market, within the framework of the syndicate underwriting system of 10-year bonds, and to contribute to the improvement of market access for foreign financial institutions to the government bond market. Thus, 40% of the monthly amount of 10-year bond issuance was allocated to price competitive auction by syndicate underwriting, and the remainder was subscripted by a fixed rate share, and a so-called partial competitive auction system was adopted from April 1989. Then, the ratio of price competitive auction by underwriting syndicate increased to 60% from October 1990.

Issuance of Ad-hoc Special–deficit Financing Bonds. After the outbreak of the "Gulf War" on January 17, 1991, the Japanese government decided to contribute $9 billion to the new Middle East support plan (refer to 2 in this section). The FY1990 supplementary budget of the General Account (secondary) included revenues arising from the special measures of transfer from the Foreign Exchange Fund Special Account to the General Account, and from the General Account to the National Debt Consolidation Fund Special Account, as well as the foundation of a special provisional corporation surtax and a special provisional petroleum surtax. Concurrently, "Ad-hoc Special Deficit-financing Bonds" of ¥968.9 billion were issued as government bonds, which should be redeemed by the revenue transferred from the General Account and the above-mentioned special provisional tax. For the redemption of the ad-hoc special deficit-financing bonds, ¥201.7 billion was transferred from the General Account to the National Debt Consolidation Fund Special Account, which continued until FY1994.

4 The History of Tax Reform: The Introduction of the Consumption Tax

Background to the Drastic Tax Reform. The fiscal conditions of the Japanese government worsened from the late 1970s to the early 1980s. It was difficult to implement tax cuts, including to income tax. Measures to the increase tax burden within the existing tax system, such as by corporation tax and indirect tax, were conducted repeatedly, from the viewpoint of correcting the imbalance between fiscal revenue and expenditure. As mentioned in Chapter 2.1, although an income tax cut was made in FY1984 for the first time in seven years, the tax reform demanded financial resources from the increase of corporation tax and indirect tax, in order to prevent the fiscal conditions from being worsened. As time passed, various “imbalances” and “distortions” between the changing economy and society and the existing tax system were revealed, and the government started to recognize the importance of solving these critical issues. The report on the FY1985 tax reform argued for the necessity of a drastic review of overall tax system, as partial changes could cause confusion. The Tax Commission received consultation regarding a drastic review of the overall tax system from Prime Minister Yasuhiro Nakasone in September 1985, and began discussing this issue immediately. In this consultation, the Commission was required to propose a desirable tax system, based on principles such as impartiality, fairness, simplicity, choice, and vitality of taxation, in line with the changing economy and society, such as the restructuring of industry and employment, and the improvement and equalization of the income level. The main aims of the review were to eliminate the “distortion” or “imbalance” of the tax system, so that the government could establish a stable revenue system. The following is the history of the drastic tax reform.

Examination for a Drastic Tax Reform. As a result of the examination, the second sub-committee (income tax and inhabitant tax) and the third sub-committee (corporation taxation, property taxation and indirect tax) of the Tax Commission submitted an interim report to the plenary meeting in April 1986, for the drastic reform of taxes. Firstly, the report made proposals on income tax and inhabitant tax, including the rationalization of the tax burden, the easing of progressive structure, special exemptions for spouses, and the clarification of the characteristics of deduction for employment income. With regards to corporation taxation, property taxation and indirect tax, it was considered to review the tax reform, by assuming a 50% reduction of the effective tax rate, in considering the trend of tax cuts in foreign countries. Then the Tax commission proposal summarized the above, and submitted its “Report on a Drastic Review of the

Tax System" ("Drastic Reform Report") to Prime Minister Yasuhiro Nakasone on October 28.

The basic philosophy of this Report was to assume neutrality and internationalism in addition to equity, fairness, simplicity, choice, and vitality of tax, as discussed in the consultation. It aimed to extend the tax base of the overall tax system. It showed that the tax burden should be borne broadly and thinly by the public, in order to prevent tax revenue from decreasing. It represents a stance of neutrality, as no burden should remain for future generations. More specifically, it involved the reduction of the tax rate and progressive flattening of the tax rate structure for income tax and inhabitant tax (as for income tax, there were six brackets, and its maximum tax rate was 50% for incomes of more than ¥15 million), etc. Special exemptions for spouses were also requested. As for the taxation on capital gains, the gain from the transfer of securities was expected to be taxed in principle, to extend its tax base and also the gain from land transfer. In addition, the standard tax rate was to be reduced towards the direction of the effective tax rate cut, and the tax rate of the small and medium business enterprises brought close to the standard tax rate. In addition, the reduced tax rate on dividends-paid at the corporation stage was also abolished, aiming to adjust the taxation at the individual stage. In addition, a review of deductive reserve and special taxation measures was requested, in order to extend the tax base.

On the other hand, the indirect tax further required drastic tax reform. The report was based on the idea that it was appropriate to introduce a new type of consumption tax, which required that the burden would be spread broadly over consumption, in order to cope with the changing economy and society. The report also proposed three types and four systems as a general consumption tax, which included manufacturer sales tax (Plan A), a duty-free sales tax between companies (Plan B) and a Japanese-type added-value tax (Plan C). Although the report suggested that Plan C was the most effective, it concluded that the tax reform should be considered from a wider range of views, by watching the trend of public opinion to identify which type should be introduced.

Tax Reform Before and After the "Drastic Reform Report". The 1985 tax reform included: the reduction of the statutory ratio of deductive reserve for bad debts of corporation tax, the abolishment of the "Green Card system" for preferable measures for taxes on gain from interest and dividends, and the improvement of the tax exemption system, such as organizing the paperwork for the tax-free small-sum saving system. As for the consolidation and rationalization of special taxation measures, the development of a tax haven system and a reassessment of the special treatment of taxation on land and housing were conducted. The tax reform of FY1986 was for a newly created tax regime to encourage residential acquisitions, a measure for the mobilization of the vitality of the private sector, a one-year extension of the special measures of the corporation tax system, and a tobacco excise tax hike. Of these, the tobacco excise tax was newly established in 1985, as a measure related to the privatization of the Japan Tobacco & Salt Public Corporation. Extra revenue generated from the tax hike was applied to special local distributions.

As for the tax reform of FY1987, a tax bill was prepared according to the principles of the above-mentioned “Drastic Reform Report”. An income tax cut was conducted, mainly to reduce the burden of salaried workers for the two years of 1987 and 1988. The tax rate structure was simplified to 12 brackets, from 15 brackets, and the maximum tax rate was changed from 70% for income more than ¥80 million, to 60% for income more than ¥50 million. In addition, the special exemption for spouses was newly established and interest and dividend incomes were taxed in principle, so that separate withholding taxation at source on interests and dividends was introduced. Thus, the tax-exempt system for small-lot savings was restructured into those for the savings of the elderly, etc. On the other hand, the sales tax was expected to be introduced in January 1988, as it needed to be adjusted with the existing indirect tax. Consequentially, the government removed the sales tax and corporation tax from the tax reform bill, after the abolishment of the sales tax bill in May 1987, in order to avoid any confusion in the Diet session on the introduction of sales tax, but submitted the bill for the reduction and rationalization of individual income taxation, and a review of taxation on interest and dividends in July. These bills were approved in September.

The Drastic Review of Interest Taxation. With the income tax reform of FY1987, the taxation on interest and dividend incomes began to be taxed as above, and separate withholding taxation at source was introduced. The FY1987 report on the tax reform of the Tax Commission pointed out that the equity of the tax burden among various kinds of income had been spoiled, as the majority of individual savings received the benefits of the tax-exempt system for interest of small-lot savings, so that a large sum of interest was not being taxed. From the viewpoint that the higher a person’s income, the greater its benefit, it is less necessary to protect them uniformly under the policy to encourage savings. Therefore, it was requested that the tax-exempt savings system be reassessed. The report proposed that it would be appropriate to reform the system to be beneficial to those who are not capable of receiving a sufficient income for living, including the elderly, fatherless families, and the handicapped. The MOF, therefore, decided to apply a series of review plans such as: 1) a tax-exempt system for interest on small-lot savings (the “Maruyu” system) and small-lot postal savings to be restructured into those for the savings of the elderly, fatherless families, and the handicapped (up to ¥3.5 million for the original principal); 2) the abolishment of the tax-exempt system for interest on small-sum government bonds (the special non-taxable system remained unchanged); and 3) the introduction of separate withholding taxation at source, with a 20% tax rate (15% for national tax and 5% for local tax). Then, during the Diet sessions, additionally, 4) the tax exemption system of interest income from employee’s assets formation savings was abolished, but a tax exemption system of interest income from employee’s assets formation savings earmarked for house acquisition was established. The new, reorganized interest taxation system was executed, and became effective on April 1, 1988, after the amendment of the Income Tax Law. In addition, the special treatment of tax exemptions for employment income earners’ specified expenditures (a tax exemption for the expenses of salaried workers) and a deduction for public pensions etc., were newly established.

The History of the Introduction of the Consumption Tax. In the Diet session over the tax reform bill in FY1987, the biggest issue was the introduction of the sales tax. The Liberal Democratic Party consequentially won a great victory in the election, on its manifesto regarding the implementation of the sales tax, in the election of both the House of Representatives and the House of Councilors, on the same day in July 1986. The government submitted a bill for the sales tax and amendment bills, such as the Income Tax Law (a tax cut for income tax and corporation tax; the abolishment of the “Maruyu” system), to the Diet in February 1987. However, the bill met with intense opposition from the opposition parties, and demands for the withdrawal of the sales tax were heard even from some members of the ruling Liberal Democratic Party. The budgetary discussions for the FY1987 budget became complicated owing to the proposed introduction of the sales tax. Eventually, Speaker of the House of Representatives Hara suggested a mediation proposal, to practically abolish the sales tax bill. Then, the four opposition parties agreed to this proposal, and the budget plan was approved. The sales tax bill was finally abolished on May 27 upon consultation between the ruling and opposition parties.

Therefore, direct tax reform was not reviewed concretely until FY1988. At that time, the Takeshita Cabinet was established, on November 6, 1987, and the Tax Commission received the consultation concerning the basic idea of the “Report of a Drastic Review of the Tax System" and the desirable form of the tax system based on various conditions. It was intended to make a bill to establish a stable tax structure among income, consumption and assets, in order to maintain a society of long-life and welfare. The Tax Commission then resumed its reform of indirect tax again. However, there was no time to submit the FY1988 tax reform bill, based on discussions in the Tax Commission, therefore it was only raised as an issue to be implemented in a prompt manner in conjunction with the drastic tax reform plan. However, in terms of land taxation, as one of the measures of the "Emergency Land Measures" based on the Report of the Administrative Reform Council, the special treatment of capital gains from the transfer of properties was reformed.

Next, the Tax Commission submitted its interim report in April 1988, as an immediate plan for the tax system review, including the reform of indirect tax. In addition, the "Report of the Tax Reform" was submitted in June. The government then decided upon its "Outline of Tax Reform" on June 28, based on these reports, to take a step forward towards achieving these objectives. In terms of the indirect tax, the most controversial issue was assumed to be the establishment of a "Consumption tax", an accumulative deduction-type tax, and the bill was submitted to the Diet on July 29. This consumption tax was to have consumers bear the burden broadly and thinly. For small-sized companies which had gained sales of ¥30 million or less in the previous year (the previous accounting period before), they would be exempted from the consumption tax, by tax credit for consumption tax on purchases based on the company's account (book keeping). In addition, the taxation system would be simplified to calculate the amount of tax from the sales of companies' annual sales of ¥500 million or less in the previous year (the previous accounting period before). At that time, moreover, there was confusion in the Diet on issues for discussion due to the "Recruit" scandal in July, which was just before the bill was submitted.

In September, the Special Committee for Research on Taxation was launched, to discuss tax issues including the rectification of unfair taxation, such as strengthening the taxation on gains from the transfer of securities. Then, the three parities of the Liberal Democratic Party, the Komeito and the Japan Democratic Socialist Party reached a basic agreement on the establishment of a special committee regarding the "Recruit" scandal and six bills related to the tax reform, so that the six bills were amended and approved in the House of Representatives' plenary session (opposed by the Komeito and the Japan Democratic Socialist Party, and in the absence of the Japan Socialist Party and Japan Communist Party). Thus, the six bills related to tax reform, focusing on the introduction of consumption tax, were amended and adopted (the Komeito and

Democratic Socialist Party were opposed, and Japan Socialist Party and Japan Communist Party were absent) in the House of Councilors plenary session, through parliamentary deliberations confused due to the “Recruit” scandal and the submarine “Nadashio” collision accident, etc. on December 24. The enforcement of the Consumption Tax Law occurred April 1, 1989.

Tax Reform after the Introduction of Consumption Tax. The tax system was greatly simplified from 12 brackets, of up to 60% for income over ¥50 million, to 6 brackets, in the FY1988 tax reform, based on the “Report of the Tax Reform”. Regarding corporation tax, the tax rate on dividends-paid was reduced and a reduction of the tax rate was implemented. In addition, the maximum tax rate for inheritance tax and gift tax were reduced and the taxation brackets were extended, as well as the tax threshold being increased. As a result of these measures, the amount of net tax reduction exceeded ¥2 trillion annually.

The tax reform in FY1989 focused on land taxation, regional revitalization, and social policy considerations. The reform of the special exemption for capital gains from land transfer from January 1, 1989 to December 31, 1989, was enforced regarding land taxation. In terms of measures for regional revitalization, the special depreciation system was extended and the license tax was exempted, under certain conditions using the system of interest-free loans, based on the Law concerning the Special Measures for the Progress of Social Overhead Capital, from the sales of government-held shares in NTT. Income tax was also reformed to increase the tax threshold from ¥2.619 million to ¥3.198 million for employment income earners in married couples with two children after 1989, by the FY1988 reform, and the tax rate was simplified. The tax rate structure was simplified from 6 brackets to 5 brackets, and the maximum tax rate changed from up to 60% for income of ¥50 million, to up to 50% for income of ¥20 million. In 1991, the consumption tax was revised to extend the scope of exemptions and increase the opportunity for tax filing and payment, in order to establish the consumption tax firmly. The reform of land taxation was also recognized as an immediate issue to be implemented, as in FY1989. The FY1990 tax reform included a review of the special treatment of the taxation on capital gains from land transfer.

Section 2 Monetary and Financial Policy

1 Financial Liberalization and Internationalization, and the “Bubble Economy”

The Easy Money Policy after the Plaza Accord In September 1985, the G5 countries confirmed the agreement on a concerted intervention to correct the dollar depreciation against the Japanese yen and German mark, the implementation of the domestic demand expansion measures in these countries, and the correction of the balance of payments imbalance through these measures (The “Plaza Accord”). The Japanese government also acknowledged that domestic demand should be improved to reduce the surplus, in order to avoid an anxiety that the yen appreciation would advance given the background of current account surplus, and that it would cause severe damage to export related industries. The domestic demand expansion measures were then decided upon by the Ministerial Conference for Economic Measures.

If the fiscal policy was not executed to expand domestic demand because it was in the process of fiscal reconstruction, the easy money policy would entirely play the role. A policy mixture of strained public finance and monetary easing would be effective to cut the interest rate, promote the capital outflow (yen selling/dollar buying) and lead to dollar appreciation and yen depreciation. It would even be a reason to increase imports and decrease the exports of Japan, and increase the current surplus. Immediately after the Plaza Accord, the Bank of Japan was concerned about such matters as the decline of interest rate, the expansion of the interest spread between Japan and the U.S., and action for yen depreciation. The yen-dollar exchange rate was stabilized at ¥215 per U.S. dollar in and after October, but the yield curve of interest rates at that time showed a negative yield, and the short term interest rate was higher than the long-term interest rate. That is, the BOJ made the short-term interest rate higher, to try to change their prediction that the expectation of decrease for the future interest rate in the market had been cause that had hindered the correction of yen depreciation.

However, as the end of the year was approaching, the U.S. interest rate decreased, leading to less anxiety about the expansion of international interest-spread, and the yen appreciation rapidly advanced; therefore people started to talk of a “Yen appreciation recession”. Under these circumstances, the BOJ took clear easy money measures to cut the official discount rate continuously, in and after January 1986, as shown in Table 3-2-1. Finally, the official discount rate recorded 2.5%, which was the lowest level in history (as of) February 1987. This low interest rate was maintained until May 1989, and the bubble economy occurred and expanded in the meantime. (See Figure 5-8 of the

Introduction).

Table 3-2-1 Change in the Official Discount Rate (FY1983-1991)

Year/Month/Date	%	Year/Month/Date	%
1983.10.22	5.00	1989. 5.31	3.25
1986. 1.30	4.50	10.11	3.75
3.10	4.00	12.25	4.25
4.21	3.50	1990. 3.20	5.25
11. 1	3.00	8.30	6.00
1987. 2.23	2.50	1991. 7. 1	5.50

Source: Bank of Japan, *Keizai Tokei Nenpo*, [Economic Statistics Annual] for each year.

The Start of the Bubble Economy. The sharp rise in land prices had already started in around 1983 in the commercial area in central Tokyo. This was because foreign financial institutions began to launch their businesses in Tokyo, one of the international financial centers and it was said that this had a background of real demand based on economic power. There were strong prospects for the Japanese economy because of the competitiveness and incomparable system, even if the trade surplus was criticized by foreign countries.

As shown in the Introduction, the "Yen Appreciation Recession" occurred in 1986, due to the surge of yen appreciation after the Plaza Accord, but a significant decrease in the prices of imported raw materials made a tremendous surplus of investment capital for Japanese companies to use. Then, fund management was booming, even creating the word "*Zaitech*". In conjunction with the progressing rise of land and stock prices and the strong prospects of the economy, the aspects of a boom of speculation (Bubble Economy) became strong from around 1987. In particular, bank loans by real estate securities increased to excessively create money for transactions in assets, which was supported by the continuous easy money policy of the BOJ (affluent base money supplies).

The BOJ, though, had concerns about the increasing momentum of money supply, as in the saying "dry firewood piled up goes up in flames": meaning that the "firewood" could soon be burnt up if it was ignited (by a blast of inflation). However, it was difficult to make monetary tightening policy since general prices were quite stable and the most important mission of the central bank was to stabilize prices. Therefore, the BOJ was under strong pressure to take responsibility for situation if they jeopardized the opportunity for epoch-making economic growth by a taking monetary tightening policy. Looking back, it was obvious that forward-looking (preemptive) tightening measures was necessary but it was quite difficult to apply such measure to the ongoing economy. The BOJ would have needed to oppose to the enthusiasm of the majority if they did so. It was even more difficult to make monetary tightening policy since prices were stable. There was a proposal for an "inflation targeting" scheme; that is, the risk of the bubble economy is high especially when prices are stable. Therefore, it might be argued that the price (inflation rate) should be made a uniform indicator, and made the stringent rule of the monetary policy, but it would also be important to consider the experience that coped with the above difficult problems.

The worldwide collapse in stock prices ("Black Monday") which occurred in October 1987 also made monetary tightening policy difficult to take. This was because of the logic that Japan was not able to raise the interest rate, which was an anchor to stabilize the interest rates in the global market. In spring 1988, when the stock price turmoil had settled and the United States and Germany raised their interest rates, it was also an opportunity for Japan to make monetary tightening policy. However, the timing was missed and the official discount rate was raised after a year, in May 1989. The bubble economy was expanding rapidly during the period.

Monetary Tightening Policy and the Collapse of the Bubble Economy. Land prices did not fall for a while even when the Nikkei Stock Average started to decline from early January, after the peak of stock prices in the final session of 1989 at ¥38,915. The bullish expectations of the public remained unchanged and in a good mood, and substantial economic expansion also continued. However, the BOJ had togo ahead with its monetary tightening, and finally cut the official discount rate and eased the monetary policy in July 1991. It was too late to start monetary tightening, therefore, the policy became too hard and also the policy change came too late. The downward reaction caused by the collapse of the bubble economy was large and lasted long, so that the Japanese economy suffered from the negative effects for more than 10 years to follow.

The MOF then made guidance to financial institutions regarding land related loans as follows.

Financing had expanded due to aggressive lending for the real estate securities of the banks, which was one of the factors that triggered the bubble economy. Most of the loans at that time were mainly for the three industries including real estate, construction, and non-bank financial institutions (the loans eventually went to real estate related assets by way of non-bank). The MOF then controlled this type of loans by issuing the notification, "On the Handling of Land-related Loans" in July 1985, which was followed by continuous guidance which gradually made the more contents stringent. They requested banks not to encourage speculative land transactions at inappropriately high prices, or only for reselling. Moreover, a special hearing was also held referring to specific loan details after July 1987 but its effect did not appear. Therefore, the MOF proposed its strongest measures in the notification of March 1990 called the "*Sōryō Kisei*" (Quantitative restrictions on extension of real estate related loans), which was to request banks to control the increase rate of loans for real-estate industries, under the increase rate of the total amount of loans, as well as to request them to prepare a report on the loans for the above three industries. Although it was not legally compulsory, and even uncommon, because it intervened in the fund allocation of financial institutions, the last notification (*Sōryō Kisei*), contributed to stopping the bubble economy expansion, at that time, in conjunction with the monetary tightening policy of the BOJ that had already been executed.

2 Liberalization and the Increased Flexibility of Financial Regulations

The BIS Accounting Capital-adequacy Ratio. The Agreement of the "International Convergence of Capital Measurement and Capital Standard" (Basel Agreement) which was made in the Committee on Banking Regulations and Supervisory Practices (Cooke Committee) was approved by the BIS governor's meeting in July 1988.

The MOF recognized the background that this issue was raised for measures to deal with the risk for banks under the internationalization of financial markets, and intended to create fair competing conditions (specifically, to control the excessive presence of Japanese banks).

In January 1987, the U.S. and the U.K. joint proposal for unifying the restrictions based on the risk asset ratio were announced. It became the basis for discussions in the Cooke Committee. Japan then acknowledged that they should cooperate in the international agreement in general, so they decided to take the issue to G10 by making an agreement with the United States (and the U.K.), first of all. The process of coordination was to make each country compromise on their conditions for the final agreement of the standard ratio of 8% (the assumption of the United States was 10-12%). Another issue considered was the inclusion of appraisal profit to the equity capital (the U.S. and the U.K. insisted on non-inclusion, and Japan insisted on 70%). It was eventually settled at 45%. The agreement was made in the Cooke Committee in November 1987, and then agreed on the BIS, through consultations in each country in

July 1987.

It was recognized that the agreement included insufficient coverage of issues such as the risk assessment from the beginning and needed to be reconsidered. At this point, the MOF considered this was an opportunity for Japanese banks to shift their corporate management from “quantitative” to “qualitative” (expansion) but such intention had been swept away under the bubble economy.

The Shift to Financial Liberalization

The Liberalization of Interest Rates. In the field of interest rate liberalization, reduction of the minimum deposit (and eventually, the abolition of the limit) and expansion of the deposit term were progressed, based on the principle of “From a large lot deposit to a small one”. The easing of the NCD issue was also gradually advanced.

The year of 1985 was a time of big transition in terms of the interest rate liberalization, including the introduction of the “MMC (Money Market Certificate)” (March) and the interest rate liberalization of large-lot time deposits (October). Categories of deregulated interest rate products had been expanded gradually thereafter. From 1989, liberalization of small sum deposits began, while the interest rate liberalization ended due to the liberalization of the liquid deposit interests in 1994, which was followed by the abolition of the time limitation in the following year. It eventually took about ten years (15 years from the launch of NCD in 1979).

Entry, Exit and Merger of Banks. The number of financial institutions in this period changed, as shown in Table 3-2-2.

City banks decreased to 11 with the merger of the Mitsui Bank and Taiyo Kobe Bank on April 1, 1990 (the name of the bank was changed to the “Sakura Bank” from the Taiyo Kobe Mitsui Bank) while it had been 12 for a long time. This was the beginning of the movement toward integration of the major banks that happened after the collapse of the bubble economy.

The number of banks - 1 foreign exchange bank, 3 long-term credit banks, 7 trust banks and 64 regional banks - remained unchanged, but 5 cooperative banks decreased in this period, while the number of credit cooperatives started to decrease suddenly from 1988, by 41.

The biggest change occurred for mutual banks. With the reduction of 1 bank (merger of the Heiwa Sogo and Sumitomo Bank), the number became 68. Then most of the mutual banks were changed to ordinary banks as member banks of the Second Association of Regional Banks (Regional Banks II).

Table 3-2-2 Number of Financial Institutions

Year End	1985	1986	1987	1988	1989	1990
City bank	12	12	12	12	12	11
Foreign exchange bank	1	1	1	1	1	1
Long-term credit bank	3	3	3	3	3	3
Trust bank	7	7	7	7	7	7
Regional bank	64	64	64	64	64	64
Mutual bank (Sōgo Bank)	69	68	68	68	68	68
Cooperative bank (Shinkin Bank)	456	455	455	455	454	451
Credit cooperative	448	446	443	419	414	407

Source : Bank of Japan, *Keizai Tokei Nenpo* , [Economic Statistics Annual] 1992
Note : Since 1989, the number of mutual banks are that of the Regional Banks Ⅱ.

While the Banking Bureau was considering the conversion of banks, a formal request for conversion was submitted by the president of the National Association of Mutual Banks in May 1984. The Financial System Research Council established the Financial System Sub-Committee (see below) in September 1985 to study the issue, and compiled a report in December 1987. The report claimed that the separation of categories was less meaningful now, as the ratio of mutual installment that was once the original business of mutual banks became the lowest ever, and even ordinary banks increased loans for small and medium companies. By this report, a policy was made to allow financial institutions to convert based on the “Law concerning amalgamation and conversion of financial institutions” if they wished.

The Banking Bureau issued a notification concerning the operation of the “Law Concerning the Amalgamation and Conversion of Financial Institutions” in July 1988, and issued authorizations, one by one. Then, the number of banks that converted was 52 in February, 10 in April, 3 in August and 1 in October 1989. The two mutual banks remaining were also converted to become the “Regional Banks II”.

The management of financial institutions with problems that occurred in this period included the Heiwa Sogo Bank, Daiichi Sogo Bank, Tokuyo Sogo Bank, Saga Sogo Bank, Gifu Chuo Shinyo Kumiai and Sanyo Shinyo Kumiai: these banks were either reconstructed or merged. The worst case was the Heiwa Sogo Bank. This bank had a large bad loan, including that for the family business of the founder, and there were internal management troubles after the death of the founder. Aggressive corporate management was executed by the strong leadership of the owner but it turned out to be problematic for such a case, which was sometimes seen in mutual banks. The MOF made a severe inspection and considered a solution, while they sent advisors with the BOJ. Then, in 1986, the amalgamation with the Sumitomo Bank was authorized in 1986, as it had been prepared from an early stage, and the amalgamation was executed by October.

Regulations on Branching. Regulations on branching were eased in line with the procedure of the previous term. For instance, it included: deregulation of the location of branches in metropolitan areas (competition with branches of ordinary banks was allowed from FY1985), abolition of the regulation on the number of ATMs (FY1987) and authorization of a reverse-conversion (e.g. 3 small branches consolidated into one ordinary branch from FY 1987). Thus, although deregulation and liberalization advanced as there was a change from the regulations restraining expansion in the past, it can be said that administrative guidance remained unchanged, as new regulations were proposed in turn, because the provisions of deregulation were created every year in more detail.

As for the number of branches, only city banks had increased their branches under the deregulation policy, while the increase in the entire number was modest.

The number of branches started to decrease from 1993, after the collapse of the bubble economy. Therefore, regulations on branching lost their meaning, and restrictions on the number of branches in regions except for city banks were abolished in 1993 and for city banks in 1995. Furthermore, other regulations on the location of branches, limitations on personnel in small or automated branches and limitations on handling business for sub-branches were abolished, which led to the end of history of regulations on branching (only applications were required afterwards).

The Liberalization and Increased Flexibility of Financial Regulations. The fifth and sixth “Measures for the Liberalization and Increased Flexibility of Financial Regulations” were executed, following the previous term. The fifth (FY1985) program included authorization for establishing associate companies for investment advisory, money lending, venture capital and computer service undertakers, increase of partnership services with the securities and insurance business. The sixth (FY1986) program included: the abolition of regulations on the ceiling of dividend rates, deregulation of fund management for loan trusts, pension trusts, federation of credit co-operatives (Shinren) and agricultural co-operatives (Nōkyō) and easing of advertising regulations (abolition of voluntary rules of the Federation of Bankers Associations of Japan) etc.

The Review of the Managerial Indicators Regulations. The MOF announced its "Review of Managerial Indicators", and revised its basic notification in May 1986. The basic concept of this notification showed that regulations and administrative guidance should be minimized in the future but financial institutions should be required to check the soundness of their corporate management based on their own responsibility, by using managerial indicators as a check point because the risk increased along with liberalization.

Concrete review points were as follows: 1) the enhancement of equity capital aiming at 4% or more of the total assets (6% or more for international activities); 2) regulations on dividend payout ratio (within 40%) were to be continued from the viewpoint of increasing profit reserves, while the regulation on the ceiling of the dividend rate was to be abolished, 3) provision of two indicators including the solvency ratio (liquidity assets/liquidity debt) and the ratio of long-term management and procurement (long-term management [long term procurement + equity capital]), 4) enhancement of the regulation on large loans by including acceptances and guarantees, and loans of the associate subsidiaries of borrowers. 5) a requirement to submit a report including managed credits, off-balanced trade and managerial indicators of overseas subsidiary companies, to understand the management conditions.

Inspections of Financial Institutions. In order to prepare the inspection method, surveys were made in foreign countries every year from FY1985. The CAMEL method in the United States was then referred to in the revision of the inspection system in Japan in 1987. CAMEL stands for the following: C (Capital: enhancement of capital), A (Assets: soundness of assets), M (Management: system of management), E (Earnings: earnings performance), and L (Liquidity: liquidity). It was based on the recognition that a more multilateral risk assessment was now demanded, which paid attention to these items.

As a result of the inspections, land-related loans and loans for *zaitech* significantly increased. The defects of the management system, such as the incomplete examination of land-related loans, and organization form that examination section took into each business headquarters, were also pointed out. However, the corporate management of financial institutions was in a good state due to the background of the good conditions of the economy and the expansion of business activities and it was not necessary for the authority to issue a warning. Problems like the increase in bad loans emerged after the collapse of the bubble economy.

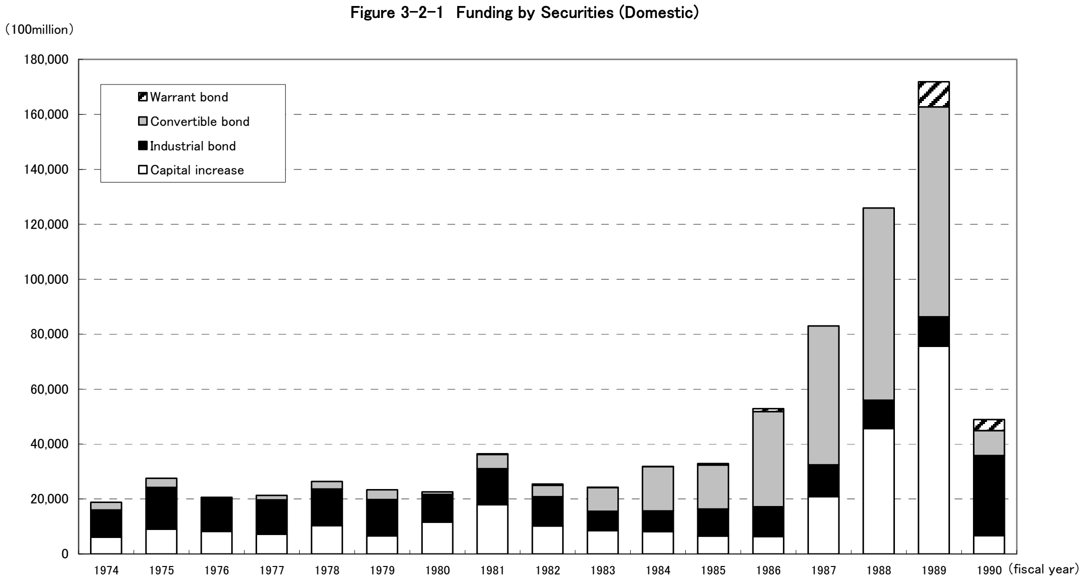
3 The Expanding Securities Market

The Bubble Economy and Black Monday. The stock market in this period, as mentioned earlier, showed an energetic expansion under the bubble economy. The Nikkei Stock Average recorded its highest price of ¥38,915 in the final session of the year on December 29, 1989. It rose suddenly and tripled in only four years, from ¥13,113 at the end of 1985. Even despite the sharp drop in the NY stock market on October 19, 1987, (Black Monday) and the worldwide depreciation of stock prices, the Japanese market recovered earlier than that of other countries.

In the boom of the stock market, the issue of securities, including warrant bonds and convertible bonds and stocks (the issue of these securities was called "equity finance") increased significantly as shown in Figure 3-2-1. The system of corporate bonds with warrants ("warrant bonds") was established in 1981, and the first warrant bond was issued in the same year. In the corporate finance of this period, securities issuance increased more rapidly than bank loans, therefore securities issuance exceeded as much as two-thirds of bank loans in 1988, although the bank loans also increased.

The bank loans increased mainly for real estate securities and real estate properties and funding by bond issues also increased. The internal capital of enterprises was also abundant, and those capitals were allotted to the properties investment, such as stocks and real estate, as well as for aggressive real investment. Both assets and liabilities increased at the same time, and in terms of assets, they were significantly increased in both real and financial investments. However, this turned into excess indebtedness once the assets decreased upon the collapse of the bubble economy. Therefore, balance sheet adjustment was inevitable, so that a serious and long economic stagnation was caused as a reaction from the boom (deep-rooted stagnation including financial sectors).

Figure 3-2-1 Funding by Securities (Domestic)



Source: Ministry of Finance, *Okurasho Shokenkyoku Nenpo* [Annual Report of the Securities Bureau, Ministry of Finance] 1989, 1990.

The Hollowing out of the Domestic Corporate Bond Market. Against the economic boom, the primary market of domestic corporate bonds started hollowing out. For funding by corporate bonds, offshore funding exceeded the funding in the domestic market in FY1983. The offshore funding exceeded domestic funding for overall securities including stocks in FY 1985. In the period of the bubble economy, the domestic funding increased suddenly and exceeded the foreign market, but the problems of domestic market had basically not yet been resolved.

The problems of a domestic bond market were obvious for the straight industrial bonds because their cost was higher than that of foreign market in terms of interests, commissions and swap etc., inflexible schedule and conditions of issuance and the severe standard required for unsecured bonds (the cost would be expensive for secured bonds). That is, the domestic market did not meet the needs of issuers and investors.

The Problem of the Increase in the Membership of the Tokyo Stock Exchange. With the Yen-Dollar Meeting report, the Tokyo Stock Exchange decided to increase its membership in its board of governors meeting in August 1985.

Upon selection of the candidates, ten companies were granted the membership (4 American, 2 British and 4 Japanese companies) as the primary program in December. In the secondary program, 22 companies (6 American, 4 British, 2 French, 2 German, 2 Swedish and 6 Japanese companies) were granted membership in December 1987.

Administrative Guidance. In terms of the supervision of securities companies, with the merger of the Yamaichi Securities Investment Trust Sales, Koyanagi Securities and Daifuku Securities in April 1985 (to become Taiheiyo Securities), securities investment trust sales company no longer existed. With the increasing merger of medium-sized securities companies, the number of semi-major general securities companies became noticeable.

Regulations on branching were eased by the notification in March 1986. In particular, the double procedures, once required for inner authorization before authorization was amended as the inner authorization process, were abolished. It was a big step for simplification of administrative guidance.

The performances of securities companies were sound as a whole, thanks to the vitality of the market in the bubble economy but problems hid behind the boom. Problems such as illegal transactions (scandals) and the financial difficulties of companies came to be noticed after the collapse of the bubble economy.

4 Liberalization, Internationalization, the Aging Society and Insurance

The Trend of the Insurance Market. As mentioned above, the insurance market in this period kept growing, thanks to the economic expansion in the bubble economy.

The trend of the life insurance business was as follows. There had been 20 life insurance companies for a while in the postwar era, but it became 21 after the entry of the Ryukyu Life Insurance Company in 1972. Then, American Life and American Family entered into the market in 1973 and 1974 respectively. Both companies only opened the branches to enter the market under the “Law Concerning Foreign Insurance Companies” of 1949. This was followed by Seibu All State in 1975, and Sony and Prudential in 1981 which entered into the market as joint venture. INA entered into the market as 100% foreign capital affiliated company in 1982. Then, following the precedent, foreign insurance companies began to enter into Japanese market, and therefore, the number of Japanese companies became 25 (16 mutual companies and 9 stock companies) based on the Insurance Business Law and the number of companies based on the Law Concerning Foreign Insurance Companies reached 5. Companies in total became 30 at the end of FY 1988.

There had been 22 non-life insurance companies in Japan for a long time in the postwar era, but Allstate Automobile and Fire Insurance Company (as an overseas subsidiary of Allstate Insurance Company (U.S.) by 100% foreign capital) obtained a business license based on the Insurance Business Law and entered the market and the total number of companies reached 23. There were also foreign non-life insurance companies based on the Law concerning foreign insurance companies so that the number was 37 at the end of FY 1988.

In addition, as there were also insurance services, such as mutual aid and postal life, and the insurance market tended to expand.

The Insurance Council Report's Recognition of the Era. There were two Insurance Council Reports in this period: "On the Desirable Form of the Life Insurance Business to Correspond to a New Era" in 1985, and "On the Desirable Form of the Non-life Insurance Business on entering a New Era" in 1987. Both reports summed up the trend of the financial market comprehensively that liberalization and internationalization were developing progressively, and considered its effects on insurance business, and the reports specified the measures required for insurance companies in detail.

The 1985 report related to life insurance summarized the change in the market environment as follows: the liberalization of financial market was steadily advancing under the base of the change of the growth pattern and the economic structure, due to causes such as the advanced accumulation of financial assets, the increase of government debt outstanding, the expansion of bond market, the revolution of financial technologies due to electronics and the internationalization of financial market.

It showed the necessity for life insurance companies to enhance their capability and competitiveness, because the effects of competition with other business and foreign companies would be severe. As for expansion of business activities, they should take into consideration of the importance of the principles of specialization of the insurance business, in order to prevent potential loss from doing other business. On the other hand, it stated that the expansion of affiliated business and services with affiliate companies should be positively progressed.

Moreover, it was pointed out that the progress of the aging society would be an important factor for companies to take measures such as regarding income insurance (mainly for personal and corporate pensions) and medical benefit (mainly for medical insurance), and pursuing the possibility of a contribution to meet various needs of welfare services for the elderly, such as nursing.

The 1987 report related to non-life insurance summarized the changes in the market environment, and pointed out measures to be taken as follows: financial liberalization would affect the asset management of non-life insurance companies directly, in the same manner as other investors. In this situation, effective operations of business and requirements were necessary to provide services to customers. Regarding the products and services, there would be little direct impact on business (such as competition), but profitability as financial assets was also demanded for insurance products, which was seen as a savings-type products. Meeting the customer needs, as one of the factors of financial liberalization, was also seen as required for the non-life insurance business, and therefore, non-life insurance companies were required to enhance their products and services.

Increased Flexibility regarding in the Third Sector. The 1985 report stated that as for the third sector across the life insurance and non-life insurance businesses, "it would be necessary to study about the promotion of flexible management," in order to meet the increasing needs and to fulfill provision of insurance products, such as bodily injury insurance, and sickness-related insurance, with the progress of the aging society.

In 1980s, insurance companies were facing the final stage of the postwar era and the predawn of the new era, as shown in Chapter 1. The new era, in which the market faced real competition and companies were required to confirm their own corporate management policy, came in the 1990s.

5 Examination of a "New Financial System"

The Progress of Discussions. To examine the desirable form of the financial system from the basics, the Financial System Research Council decided to establish a Financial System sub-committee in September 1985. In the six years to come (all periods of the bubble economy were consequentially covered) issues were discussed, in the Financial System Sub-committee and in the first and second subcommittee, regarding a financial system. Finally, the Financial System Research Council submitted its report "On a New Financial System" in June 1991. The "Package Law for the Comprehensive Review of the Financial System" based on this report was promulgated in June 1992, and enforced on April 1, 1993. This was a step toward the drastic reform of the financial system, to be made through the mutual entry method, by establishing separated subsidiaries.

The Report of the Financial System Subcommittee. The Financial System sub-committee summarized its report "On the Desirable Form of a Specialized Financial Institutions System" in December 1987. This report was a summary of the major issues that needed to be considered, and stated the following:

○ It is necessary to examine the separation of financial systems from the viewpoint of efficiency, fairness, and the even quality of technology and globalization

○ The difference between “wholesale” and “retail” should be considered in the review of the financial system, because efficiency and self-responsibility are is important for the former, and safety is important for the latter.

○ While there are merits and demerits to universal banking, consideration would be necessary as to whether banks, which are required to be sound in management may enter the high risk securities market.

○ While “Economies of scope” are also effective for the financial market, it is necessary to consider issues, such as conflicts of interest and the soundness of business.

○ As for preventing conflicts of interest, there were such views as: 1) it will be prevented by competition; 2) it is necessary to use a fire wall (Chinese Wall); 3) it is necessary to separate into different companies; and 4) it is necessary to prohibit by-business. However, 1) and 4) would be difficult to adopt, and 2) would still be insufficient to solve all the problems.

Interim and Final Reports. With the above-mentioned report, the Council established the First Subcommittee (for small and medium-sized financial institutions) and the second Subcommittee (for others) to discuss financial system, and began discussions from February 1988.

The First Sub Committee reported that regional financial institutions played a role to provide services to meet the needs of regions, and financial institutions as a form of joint organization would be as necessary in the future as ever.

On the other hand, the Second Sub-Committee submitted its first interim report, “On a New Financial System”, in May 1989. The points of this report are as follows:

○ At present a separation system of activities has been made for the smooth allocation of chronically short funds to various industrial sectors through specialized institutions. However, the time has come to review the system, in line with the changing environment.

○ The main perspective of the review is the convenience or profit of users, internationalization, the maintenance of the order and fairness in financial systems.

○ There are five measures to review specifically (Figure 3-2-2):

A: The Mutual entry method

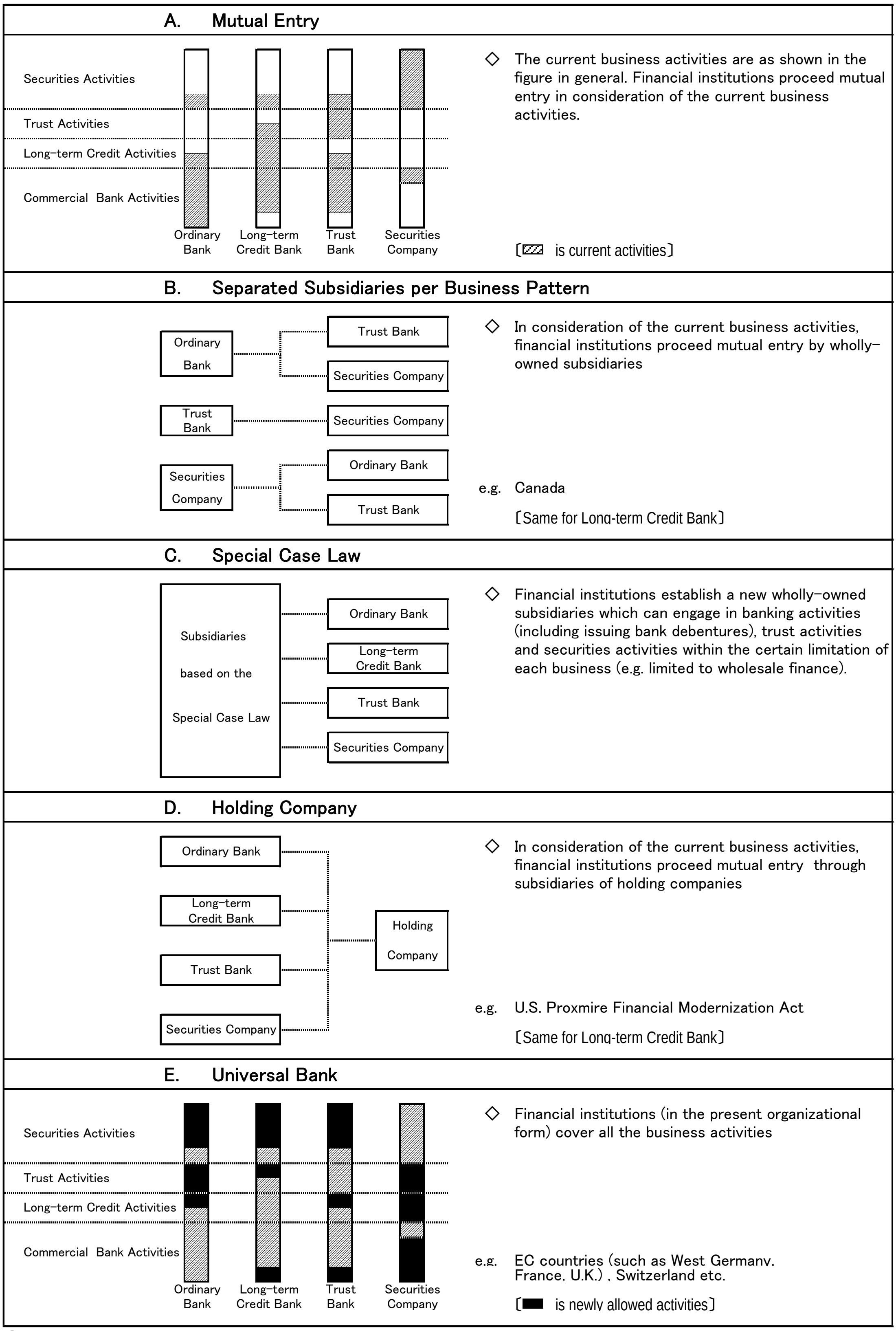
B: The Method of separated subsidiaries

C: The Special Case Law method (a special institution allowed to have by-functions of various financial services – called an “investment bank plan" – would be established by each financial institution as 100% subsidiary company)

D: The Holding company method

E: The Universal Bank method

Figure 3-2-2 The Five Systems Envisaged for the Review of the Financial System



Source : Institute for Financial System, *Atarashii Kinyu Seido Ni Tsuite – Kinyu Seido Chōsakai Toshin* [On A New Financial System – Report of the Financial System Research Council] p502(1991, Institute for Financial Affairs)

Note : Foreign Exchange Bank is included in Long-term credit bank in this figure as it is allowed to issue bank debentures.

The mutual entry method was too partial. The holding company method could be effective to prevent conflicts of interest, but there would be problem of dominant power like *zaibatsu* in the era before the World War II. The Universal Bank method was excellent in terms of efficiency but there were problems concerning the soundness of banks and conflicts of interest. In the end, it was decided that the method of separated subsidiaries per business pattern and the Special case Law method should be mainly considered.

The First Sub committee advanced the examination further, and prepared the second interim report “On a New Financial System” in July 1990. It concluded that the method of separated subsidiaries would be preferred in terms of credibility, prevention of conflicts of interest, fairness of competing conditions, and user benefit and convenience.

The final report “On a New Financial System” of the Financial System Research Council was submitted on June 25, 1991. In the same month, the report “How the Basic System for Capital Market ought to be reformed” was submitted by the Securities and Exchange Council. The Package Law for the comprehensive review of the Financial System was promulgated in June 1992, and enforced on April 1, 1993, to implement a drastic reform of the financial system through the mutual entry method.

The establishment of the separated subsidiaries was advanced, starting with the securities subsidiary established by long-term credit banks in July 1993. However, the management of financial institutions was weakened due to the collapse of the bubble economy, and there was a spreading sense of crisis that Japanese financial market would lose its competitiveness. In this circumstance, the “Japanese Big Bang” policy was applied to enact the Financial Holding Company Law (enforced in March 1998), the revised Foreign Exchange Control Law (April 1998) and the Financial System Reform Law (December 1998). Therefore, the large-scale reconstruction of financial industries significantly progressed, mainly using the holding company method.

Section 3 External Economic Policy

1 Economic Recovery of Industrialized Countries and the Prolonged Problem of Debt Accumulation

The Economic Recovery of Industrialized Countries. In the industrialized countries, the economies that had stagnated in early 1980s finally recovered in the late 1980s. The United States and Japan were the driving force for the economic recovery in the late 1980s. The United States' economy expanded for seven years from 1983 to 1989. In Japan, economic expansion by boosting of domestic demand occurred from 1987 to 1989 as well.

The United States became a debtor country in 1985, and the deficit of its trade balance and current account reached a record high in 1987. The trade imbalance towards Japan was not corrected much although the overall deficit was reduced, so that the economic friction between Japan and U.S. grew fierce. The USTR (United States Trade Representative) specified three articles to be prioritized for negotiation based on Section 301 of the U.S. Trade Act (space satellites, super computers, and wood) in May 1989. Negotiations on these three articles were settled in March and April 1990. From September 1989 to June 1990, the Japan-U.S. Structural Impediments Initiative Talk (SII) was held. The request from the United States to Japan was focused on six articles, including the expansion of public investment, the amendment of the Antimonopoly Law, and the abolition of the Large-Scale Retail Store Law. The talks intended to request that Japan proceed with reform because the trade imbalance had resulted from the systems and business practices of Japan, which was therefore different from a mere trade friction regarding certain articles.

The economic growth of Europe had remained slow since the first Oil Crisis, but the EC's economic integration became a driving force for economic recovery in late 1980s.

The Polarization of Newly Industrializing Countries (NIES). The NIES increased their trade towards the United States and developed their economies, in the rapid yen appreciation after the Plaza Accord. ASEAN countries received direct investment, positively aiming at industrialization for export. This eventually promoted the industrialization of the ASEAN countries, and in particular, export of heavy manufacturing products accounted for over 50% of their entire exports in 1989.

The inflow of short-term funds played an important role in the economic growth of NIES and ASEAN. However, such economic growth depended on the short-term fund, which deteriorated the soundness of financial institutions in ASEAN countries, resulting in the Asian monetary crisis in 1997.

In contrast, Latin America suffered from inflation, fiscal deficit, and the deterioration of the balance of payments after the monetary crisis in 1982.

Summits. The main agenda of the Bonn Summit in May 1985 was to decide the schedule to launch a New Round of negotiations. Most of the Summit countries agreed to start the New Round earlier, but no official consensus was reached at that time. The maintenance of the medium-term economic strategy since the Williamsburg Declaration on Economic Recovery (1983) was also confirmed as a target of the macro policy common to each country, which was contrasted with the economic stimulus measures in the Bonn Summit in 1978.

At the Tokyo Summit in 1986, the Summit countries decided to form a Group of seven Finance Ministers and Deputies of the Summit countries (G7) and to enhance the policy coordination of G7 countries.

In the Venice Summit in 1987, the main agenda was how to firmly execute the Louvre Accord, in February of the same year. The United States requested the creditor countries to expand their domestic demand and reduce their interest rates but Japan refused to reduce its interest rates, by stressing the priority of executing the Emergency Economic Measures. In terms of policy coordination, the United States, insisting on the introduction of elements for automatic operation which could have a strong compulsion power, stood against Japan and West Germany saying that compulsory measures were not preferable.

At the Toronto Summit in 1988, the Summit countries agreed to add commodity-price indicators to the existing indicators for multilateral surveillance activities. The United States requested that Japan and Germany maintain their easy money policy. The main agenda of this Summit was the economic and debt problems of the developing countries. Minister of Finance Kiichi Miyazawa proposed a debtor relief plan using the IMF, but the countries could not achieve the agreement on this proposal.

The Arch Summit in 1989 was held for three days from July 14 in Grand Arch (the new “Arc de Triomphe”) in a suburb of Paris, which coincided with the 200th anniversary of the French Revolution. Regarding the international monetary problem, concerted activities had been conducted after the Plaza and Louvre Accords. It was also confirmed that efforts should be made to solve the trade issues before the completion of the program by the Uruguay Round Negotiations in 1990. The debt and development problems of developing countries were one of the main agenda items of this Summit, so the Summit countries confirmed their intention to welcome the Toronto Scheme for the poorest countries and the "New Debt Strategy" for middle-income countries. Japan announced that it would enhance measures for recycling funds of over $30 billion for three years, as announced in the Venice Summit and execute the measures for recycling funds of over $65 billion in five years including the present three years.

The Houston Summit of July 1990 took place when liberalization and democratization of Eastern European countries was rapidly progressing, as represented by the collapse of Berlin Wall, which was opened up in October 1989, and was focused on political issues. The macro economic issues, which had initially been planned for discussion at the Summit, were raised little, as the economy of the Summit countries continued to expand for the eighth year, in contrast to the issues of Eastern Europe and Soviet Union.

Solutions to the Problem of Debt Accumulation. The United States took the lead in reviewing its debt accumulation policy in the late 1980s. In the IMF and the World Bank Annual Meeting, U.S. Secretary of the Treasury Baker proposed a new plan (the "Baker Plan") in October in 1985. This plan intended to implement a new lending system for 15 heavily indebted countries, including the unique feature of imposing a conditionality (structural adjustment) to receive the supply. However, this plan was eventually suspended, as the commercial banks of industrialized countries refrained from new lending to the debtor countries, and they even moved to retrieve the debt.

The economic situation of debtor countries remained difficult, as represented by the increase of the debt of Mexico in 1986, and emergency loans by the IMF, rescheduling of the loans of commercial banks and the moratorium on Brazil in February 1987.

At the IMF and the World Bank Annual Meeting in September 1987, Secretary of the Treasury Baker proposed the "Menu Approach" to supplement the "Baker Plan". This proposal was an idea for commercial bank lending to debtor countries to provide more choices (menu) of loans. This included loans for trade and projects, transfer of loans from central banks or governments to private sectors, and debt-equity swapping, etc., which was also aimed at improving incentives for commercial banks.

The IMF then took a step forward toward the diversification of facilities, in line with these proposals. In the IMF and the World Bank Annual Meeting of September 1987, Managing Director Camdessus appealed to members that it would be necessary for debtor and creditor countries to share responsibilities and cooperate to solve the problem of debt accumulation. The IMF should play a key role in cooperation with the

World Bank and diversify financing facilities, such as by the increase of the Structural Adjustment Facility (SAF), the use of the Extended Fund Facility (EFF) and the inspection of Compensatory Financing of export Fluctuations (CFF). The Enhanced Structural Adjustment Facility (ESAF) was newly established in December 1986 to provide long-term loans on concessional terms to low income countries (the name was changed to the Poverty Reduction and Growth Facility (PRGF) in November 1999). The compensatory financing of export fluctuation was reviewed and the Compensatory & Contingency Financing of export Fluctuations (CCFF) was established in July 1988.

The World Bank also started to address loans for supporting structural adjustment programs and getting financing from private sources by co-financing for the solution of debt problems, in addition to the conventional specific project loans.

However, as these additional measures did not have enough effect, further consultations were made on additional measures for debtor countries, and the “Brady Plan” was released in 1989.

The Miyazawa Plan proposed in the interim committee of the IMF in April 1988 and officially announced in the IMF and World Bank Annual Meeting in September 1988, was the base for “Brady Plan”. The plan proposed to reduce debts through the debt bond swap, etc., of creditor countries and commercial banks, with the warranty for the debt made by the IMF.

U.S. Secretary of the Treasury Brady proposed that commercial banks reduce debts and debt services and that the IMF and World Bank apply public funds to support commercial banks on March 10, 1989. This plan was agreed in G7 in April of that year as the “New Debt Strategy”.

The “Brady Plan” was a strategic change for debtor countries from debt rescheduling or new loans, to the reduction of the burden of debtor countries by lessening debt. The point of this strategy was to convert bad loans to quality loans warranted by the IMF and the World Bank for fluidizing. Actually, Brady Bonds (due after 30 years) were successful in achieving a high standard. In the 1990s, due to these bonds, private funds flowed into Latin American countries, which contributed to the increased capital inflow to developing countries, as supported by the development of derivatives with this. The developing countries’ financial and capital markets, known as “Emerging Markets”, increased their instability due to the rapid capital inflow, and this resulted in Mexican Currency Crisis in 1994 and the East Asian Currency Crisis in 1997.

2 From the Plaza Accord to the Louvre Accord

The Shift to Intervention Policy. The Plaza Accord of September 22, 1985 was the reason that the United States changed its conventional policy of dollar appreciation or nonintervention in foreign exchange markets, and started to correct the dollar appreciation by concerted intervention. The Plaza Accord was implemented at the initiative of the United States.

In the first term of the Reagan Administration, the nonintervention policy for the foreign exchange market was maintained, under supervision of Secretary of the Treasury Regan and Under Secretary for Monetary affairs Sprinkel. However, the dollar rapidly went up from April 1984 to the level of over ¥250/$. Furthermore, the United States' trade balance worsened and the trade deficit exceeded $100 billion in 1984 for the first time in history.

Thus the United States changed its policy to allow market intervention in the second term of the Reagan Administration, after the team changed to Secretary of the Treasury Baker and Deputy Secretary of the Treasury Darman, in February 1985.

Concurrently, the Japanese government started to think it necessity to correct the yen depreciation as the trade friction was worsening. Prime Minister Yasuhiro Nakasone had his private advisors study the conditions and finalized the policy in June, in order to conduct a meeting on currency adjustment between Japan and the United States.

In the G10 meeting held in Tokyo on June 21, the "Report Concerning the Reform of the International Monetary System" was adopted. In the communiqué which was announced after the meeting, there were many conclusions, including the rejection of ideas about target zones as being impractical, but even if the intervention in the exchange market would only be effective to play a limited role, the exchange market should be stabilized by policy coordination and conducting an aggressive concerted intervention when necessary.

Upon the request of the United States, informal talks were held between Vice Minister of Finance for International Affairs Oba and Assistant Secretary Mulford on June 19, just before the G10 meeting, and it was agreed to hold bilateral talks on the policy. This was followed by the talks between Minster of Finance Takeshita and Secretary of the Treasury Baker on June 22. The United States requested that the Japanese government change its fiscal policy, while Japan insisted on the need for concerted intervention in the exchange market. Then, the opinions of the two countries were adjusted in the Japan-U.S. talks in Paris on July 23, and in Hawaii on August 21, as the United States requested Japan to conduct a tax cut as an economic stimulus measure and increase its government expenditures, while Japan stressed the importance of concerted intervention. Upon consultation, the framework of the Plaza Accord was developed including the two principles of policy coordination and market intervention.

The Plaza Accord. The G5 deputies meeting (London) was held on September 15 to study the statement of the Plaza Accord and "Non-Paper" (the document shows a specific program for concerted intervention).

The G5 was then held at the Plaza Hotel in New York on September 22, and the agreement to appreciate the main non-dollar currencies against the dollar (the so-called "Plaza Accord") was made.

The Agreement stated that, "The Ministers and Governors agreed that the exchange rate should play a role in adjusting the external imbalance", in order to better reflect the fundamental economic conditions; that "some further orderly appreciation of the main non-dollar currencies against the dollar is desirable," and that the G5 countries "stand ready to cooperate more closely to encourage this" when it would be helpful to do so.

In the "Non-Paper" stating the specific measures of market intervention, it was agreed to correct the exchange rate by 10-12% for dollar depreciation, that the central banks would sell the dollar for $18 billion in six weeks, and to make a ratchet type intervention to prevent the reaction to dollar appreciation, as well as to limit the currencies for intervention to the U.S dollar, the Japanese yen and the German mark. The fund for intervention was comprised of 30% for the United States and Japan respectively, 25% for West Germany, 10% for France and 5% for the United Kingdom.

The concerted intervention was conducted from September 23 and 1 U.S. dollar fell from ¥238.5 before the statement, to the ¥200 level in November.

Therefore, the target for a 10-12% of downward correction of the dollar was achieved in two months. The total amount of funds required for intervention was $10.2 billion, including $3.2 billion from the United States, $3 billion from Japan, $2 billion from Germany, France and the United Kingdom and $2 billion from the other G10 countries.

Agreement for Macro Policy Coordination. The yen's appreciation rapidly advanced even after the concerted intervention was completed, and exceeded ¥200/$ in February 1986, and reached the ¥150/$ level in July. The Maekawa Commission Report (Report of The Advisory Group on Economic Structural Adjustment for International Harmony) from Prime Minister Nakasone's private advisory panel, was released. In contrast, the external trade deficit of the United States was not reduced even after the depreciation of dollar, which made the United States into a net debtor in autumn 1985, for the first time in 71 years.

From the G5 deputies meeting (in Paris) held on the November 13, 1985, policy coordination started, mainly on monetary policy. In the G5 meeting (in London) on January 18-19, 1986, monetary policy coordination was not agreed, but coordinated discount rate cuts by Japan, United States and Germany were achieved on March 6 and 7, following the cut of the official discount rate by the Bank of Japan alone on January 30. On April 21, Japan-U.S. coordinated discount rate cuts were made, upon the request of the United States (the third official discount rate cut of the Bank of Japan was from 4% to 3.5%).

The Bank of Japan started reverse-intervention (dollar buying intervention) from March 18, to suppress the rapid yen appreciation. However, the United States repeatedly said they would allow the yen appreciation, at G5 on April 8 and in the Nakasone-Reagan talks on April 12-13.

The United States presented a new plan for policy coordination in the Tokyo Summit in May 1986 (the Baker Proposal). It proposed 1) to form a group of Seven Finance Ministers and Deputies and hold a meeting (G7) at least once a year to conduct surveillance on policy coordination; and 2) to apply indicators (economic indicators) to conduct the surveillance of policies in an objective and severe manner for automatic correction, in the event that economic conditions deviated from the indicator. Although the Summit countries agreed to conduct such surveillance, the Baker Proposal for automatic correction measures was opposed by Japan and West Germany, as it was not desirable to apply the system in a rote and compulsory manner. This opinion became predominant at the Paris G5 on May 29. In the G7 meeting (the first G7) on September 27, the first session on the multilateral surveillance method was conducted. In the meeting, the G7 shared their intent for an agreement to correct the balance of payments disequilibrium and stabilize the exchange rate, by policy coordination on the reduction of the fiscal deficit of the United States and domestic demand expansion by Japan and West Germany.

Minister of Finance Miyazawa and Secretary of the Treasury Baker held talks on September 6 and 26, 1986, and the communiqué of the bilateral talks was released on October 31. In the communiqué, Japan announced that: 1) the Japanese government would submit a supplementary budget draft to the Diet for economic stimulus measures; 2) tax reform would be implemented, including a reduction in the marginal tax rates for both personal and corporate income; and 3) the Bank of Japan would reduce its official discount rate from 3.5% to 3%. The United States should make efforts to reduce the budget deficit, consistent with the Gramm-Rudman-Hollings Budget Law (G-R-H Budget Law, which requires a balanced budget by FY1993). In addition, they stated that they would cooperate to stabilize the foreign exchange rate in the future, as the instability of the foreign exchange rate could jeopardize stable economic growth. The key points were that Japan promised to expand its domestic demand and the United States promised to make efforts to stabilize the foreign exchange rate.

The Louvre Accord. The speculation on the yen and the mark became vigorous at in the beginning of 1987. The yen exceeded ¥150/$ on January 19. Minister of Finance Miyazawa immediately made a visit for talks with Baker. Then, a tacit agreement was made, aiming to stabilize the exchange rate at around the ¥150/$ level. Then Baker suggested holding a G7 meeting. G5 representative meetings were held three times in January and February 1987, for adjustment to set the reference range of the exchange market.

A G6 meeting was held in Paris on February 22, 1987, and an agreement to stabilize the dollar around current levels was announced. This agreement was the so-called Louvre Accord.

The G6 countries confirmed the objectives of the expansion of domestic demand in surplus countries and the reduction of budget deficits in debtor countries, and discussed the method of surveillance, monetary policy coordination and the stability of the exchange rate. As a result, they agreed to use six indicators (growth, inflation, current accounts/trade balances, budget performance, monetary conditions, and exchange rates) for surveillance, and would regularly examine these by using indicators. In terms of the exchange rate, it was clearly confirmed that no further depreciation of the dollar should be expected, but no clear agreement was made for the level and range for stability of the exchange rate. No statement was made regarding monetary policy coordination, either. In the statement of intent of each country, Japan promised 1) a comprehensive tax reform; 2) early implementation of the 1987 budget; 3) preparation of comprehensive economic measures; and 4) reduction of the official discount rate (which was conducted on February 23) from 3.0% to 2.5%.

In spite of the Louvre Accord and the large-scale market intervention, the dollar depreciation and yen appreciation further proceeded to ¥150/$ and ¥140/$, on March 23 and April 24, respectively.

Black Monday. The pace of the policy coordination in each country was not harmonious, even after the Louvre Accord was reconfirmed in the Nakasone-Reagan talks (April 30 to May 1, 1987) and the Venice Summit (June 8 to 10, 1987). The United States insisted on the responsibility of surplus countries, and demanded further reduction of interest rates and the expansion of domestic demand. Therefore, Japan and West Germany strengthened their caution about an excessive easy money policy.

On October 19, a sharp drop in stock prices, which was worse than the 1929 Great Depression, occurred in the New York Stock Market (Black Monday). The dollar kept declining and fell by up to ¥123/$ at the end of the year, although stock prices recovered at once.

Concerted intervention was found to be effective in 1988, so that the exchange rate regained its stability in the first half of 1988, and reached ¥125-130/$. At the Takeshita-Regan talks on January 23, it was agreed to make a new framework, using SDR to secure sufficient funds for concerted intervention. This resulted in the range of intervention based on the Japan-U.S. swap agreement being enhanced from $5 billion to $15 billion.

Interest Rate Rises and Structural Adjustment. In late 1988 and later, concern shifted to the interest rate rise, for inflation control. As West European countries started a coordinated official discount rate rise, following the rise in the official discount rate of West Germany on July 1, the FRB raised the official discount rate for the first time in 11 months. As the Louvre Accord aimed at a coordinated system, to include interest rate control, the raising of the official discount rates by each country meant the end of the Louvre Accord.

Governor of the Bank of Japan Satoshi Sumita declared that Japan had no intention to change its monetary policy, in the G5 and G7 meetings on September 24, so that Japan decided to maintain a low official discount rate. The BOJ finally raised its official discount rate for the first time in 2 years and 3 months on May 21, 1989.

At the G7 (in Washington) on April 2, 1989, the member countries confirmed that the meeting was mainly for the coordination of macro economic policy. Moreover, an agreement was made to consider the role of structural adjustment (= micro economic policy). Thus, the purpose of international policy coordination shifted from macro economic policy to consultation on structural adjustments.

3 Market Opening and the Internationalization of the Yen

The Trend of the Balance of Payments. For the trade balance, the surplus increased in 1985 and 1986, because of increase in exports and the decrease in the amount of imports due to yen appreciation. The trade balance in 1986 added up to a surplus of $92.8 billion, but the amount of surplus reduced afterwards. The current account surplus similarly shrunk, from $87 billion in 1987 as its peak. It turned out to be $35.7 billion in 1990 (Table 1-3-1). The trade surplus with the United States also reduced temporarily from 1988 to 1990.

A significant outflow of long-term capital continued. Long-term external investment exceeded the trade surplus, but it was because of short-term funding from overseas through the foreign exchange bank. The majority of the external investment was in securities, especially investment in bonds.

The Increase of External Assets. External assets increased by 5.4 times and external liabilities increased by 5.7 times from the year end of 1984, to that of 1990. The net assets increased consistently for the period concerned, by 4.4 times, from $74.3 billion to $328.1 billion (Figure 1-3-2). In terms of assets, the expansion of securities investments and financial accounts were remarkable, as capital management overseas by institutional investors boomed, starting transactions in the Tokyo Offshore Market by foreign exchange banks and much activity in terms of financial transactions with overseas branches.

A Sudden Increase in Exchange Reserves. In 1985, a large amount of dollar selling was conducted by concerted intervention, because the dollar depreciation measures were agreed by the G5. Exchange reserves were almost leveled off (Figure 1-3-1). The intervention operation of dollar buying started from when the yen surged in April 1986, and the exchange reserve increased by $15.7 billion by the end of 1986. A large-scale dollar buying intervention was conducted, based on the agreement for the stabilization of the exchange rate at the ¥140/$ level. Therefore, the exchange reserves increased suddenly, doubling in one year in 1987. They kept increasing until April 1989, and exceeded $100 billion for the first time. The dollar selling intervention continued, to stabilize the exchange rate against the dollar appreciation after May. It decreased to $73 billion in April 1990.

Trends in the Foreign Exchange Market. The U.S. dollar trading volume of the Tokyo Foreign Exchange Market (the total of spot, futures and swap trading) accomplished a rapid expansion from $1.4072 trillion in 1985, to $5.9625 trillion in 1990. This was because due to liberalization measures - including the elimination of the real demand rule in April 1984, the launch of direct dealing, and international broking

(U.S. dollar started from February 1985, others started from July or August 1984) - the market was expanded.

According to an investigation which compared the three large foreign exchange markets (Tokyo, London and New York) in April 1989, the daily average turnover (the total of spot and swap trading), in London was $187 billion, in New York was $128.9 billion and in Tokyo was $115.2 billion. The Tokyo market was comparable with that of New York.

The correction of dollar appreciation started gradually from March 1985. Since the Plaza Accord in September, the rapid yen appreciation had advanced. The yen was appreciated to ¥160/$ by the middle of May 1986, and hit ¥152.55/$ on August 20. In 1987, the dollar kept falling and hit ¥150/$ at the end of January, and then suddenly swung to yen appreciation due to Black Monday in October, and reached ¥120/$ at the end of the year. The G7 statement on December 23 declared its anxiety about the dollar depreciation. Then, the yen-dollar exchange rate started to stabilize at around ¥125/$, after starting from ¥120 in 1988.

U.S. Dollar again reversed in 1989: yen depreciation occurred and reached ¥151/$ by the middle of June. A G7 statement on September 23 decided on correction measure for the dollar appreciation, so that the dollar started to fall again and closed at ¥144 at the end of the year.

The Market Opening Policy and Action Program. Faced with criticism from foreign countries of its "External Economic Measures", the package method which had not been effective in reducing its trade surplus, Japanese government recognized the necessity for an action plan-type external economic policy.

The "Report of the Advisory Committee for External Economic Issues" of April 9, 1985, inquired into the reason why, although previous external economic measures had improved market access, they received a severe criticism from foreign countries. It also presented countermeasures. The report proposed that the government should make an action program for about three years and the program should be voluntary and positive in its contents.

The report, "Outline of the Action Program for Improved Market Access" was prepared in July 1985. The Action Program included tariff cuts of about 1800 items and the relaxation of the standards and certification system.

Japan-U.S. Economic Friction. The trade deficit of the United States with Japan reached $37 billion in 1984. The Reagan Administration was faced with public opinion that requested it to intervene in trade positively. In 1985, many protective bills were presented to the United States Congress, and U.S. government also started to apply Section 301 of the U.S. Trade Act of 1974.

In addition, the Market-Oriented Sector Selective talks (MOSS conference) between Japan and the United States started in January 1985, on four markets including electronics, telecommunication, medical products, medical appliances and forestry products. The talks between Minister of Foreign Affairs Abe and Secretary of State Schultz on January 10, 1986, settled matters on most articles, except semiconductors. In terms of semiconductors, which was the most serious area of trade friction, the "Agreement between the Government of Japan and the Government of the United States of America Concerning Trade in Semiconductor Products" was concluded on July 31, 1986, specifying the monitoring of the export price of Japanese semiconductors and the enhancement of imports of semiconductors to Japan from the United States.

The "Maekawa Commission Report" ("Report of the Advisory Group on Economic Structural Adjustment for International Harmony") was submitted to Prime Minister Nakasone on April 7, 1986. The report proposed the expansion of domestic demand, the change of the industrial structure, and the internationalization of the financial market, aiming at the conversion of the Japanese economic structure into one of international harmony. It stressed the promotion of the liberalization of the financial and capital market, so that Japan could establish a suitable financial and capital market for its economic magnitude in international finance, as well as strengthening the fund management market, in particular. For trading, the complete execution of the Action Program that had been compiled in the previous year and the promotion of imports of manufactured goods, etc., were proposed. Based on this report, the government decided on the "Outline for the Promotion of Economic Structural Adjustment" on May 1, and established the Government-Ruling Parties Joint headquarters for the promotion of Economic Structural adjustment. The "Maekawa Commission Report" materialized as "Policy Recommendation for Structural Adjustment" (the new Maekawa Commission Report) on April 23, 1987.

In May 1987, the government announced its "Emergency Economic Measures" aiming "to make efforts to correct the trade imbalance and to form external economic relations with foreign countries in harmony, as well as to positively promote the economy, by expansion of domestic demand." It included, specifically, the additional import of foreign manufactured goods totaling about $1 billion through government procurement, the enhancement of financing for the import of manufactured goods of the Export-Import Bank of Japan, the improvement of market access for foreign financial institutions to enter the Japanese market, the advanced implementation of the 7-year plan to double ODA in two years and the contribution of untied capital of $20 billion to developing countries (especially debtor countries) for three years, to bring dollars into developing countries.

During this period, the Japanese government promised and implemented domestic demand expansion and the reduction of the interest rate, but the trade surplus towards the United States kept increasing. The current account surplus to GDP started to decline from the peak of 1986 and the trade surplus to the United States finally shrunk, in and after 1988, but it was still not easy to settle the trade friction.

The United States' government proposed the launch of the Japan-U.S. Structural Impediments Initiative (SII) talks, while they recognized Japan as a priority country of Section 301 of the U.S. Trade Act on May 25, 1989. Japan and U.S. agreed to start SII at the Arch Summit on July 14, and the final report was presented on June 28, 1990. The Japanese government proposed: 1) the total amount of public investment for the decade from 1991 would be ¥430 trillion (¥455 trillion including the investment in the three old public corporations such as NTT); 2) the revision of large-sized merchandise shops to improve the distribution system; and 3) the revision of the Antimonopoly Law to exclude exclusionary business practices and transactions through business affiliations. The United States then announced the extension of the Gramm-Rudman-Hollings Budget Law for FY1993 and after, for fiscal deficit reduction.

The Internationalization of Financial and Capital Markets. The Yen-dominated BA (Banker's Acceptance) market was established on June 1, 1985. However, it could not be developed efficiently, as it was not advantageous compared to foreign markets and the procedures were complicated; therefore, there was less incentive for foreign exchange banks and companies to use it.

On December 1, 1986, the Japan Offshore Market (JOM) was launched. The offshore market allowed non-residents of Japan to make capital transactions freely in the market, through special financial and tax measures. In terms of the Tokyo Market, it was established on the model of IBF New York (International Banking Facilities were opened in December 1981) and was separated from the domestic market, which was one of its unique features.

The MOF believed that it would be desirable to promote the internationalization of the financial market in a form separated from the domestic financial market, until the domestic market was liberalized completely. However, after the start of the Yen-Dollar Committee, the idea became more concrete while there had previously been caution about it. The Report of the Committee on Foreign Exchange and Other Transactions (the "Internationalization of the Yen.") also suggested actively studying the offshore market system. Public opinion also encouraged developing the Tokyo Market to be an international financial market center, comparable to London or New York.

181 foreign exchange banks (including 69 foreign banks) joined the Japan Offshore Market, at the time it was established. The market scale rapidly expanded to the level of $607.6 billion by the end of 1989, and its scale became larger than New York, Singapore and Hong Kong, only within a few years after it was established. However, it fell into stagnation with the collapse of the bubble economy.

Participation in the Financial Futures Trading Market and the Foundation of the Tokyo Market. Future trading became very vigorous as a main aspect of risk hedging, with the shift to the floating exchange rate system, and the internationalization of financial transactions. The financial futures exchange was established in the United States in the early 1970s, which was followed in the 1980s by London (1982) and Singapore (1984).

Foreign financial futures transactions by Japanese financial institutions were authorized on May 22, 1987. Restrictions on the self-dealings of the spot option were lifted on March 22, 1988.

The Financial Futures Trading Law and revised Securities and Exchange Law were promulgated on May 31, 1988. The Tokyo International Financial Futures Exchange was established in April 1989 (its services started in June), as Japan's first financial futures exchange.

Report on the "Internationalization of the Yen". With the Yen-Dollar Committee, the move toward the internationalization of the yen progressed. At the Yen-Dollar Committee, the Committee on Foreign Exchange and Other Transactions discussed the matters regarding the internationalization of the yen and submitted its report on the "Internationalization of the Yen" in March 1985, which stated as follows:

"It is valuable and natural for the Japanese economy to promote the internationalization of the yen." Therefore, it is necessary to actively promote policy for improving the efficiency of financial and capital markets, developing the market as an international financial center, and allocating roles in the international market. Although Japan was conservative about using or retaining yen in Euro market, permission for this would be an important step toward internationalization of the yen. It is desirable for both the Euroyen market and the domestic market to develop in a complementary and competitive way, by using their unique features. It is necessary to implement the liberalization of trading by non-Japanese residents or Japanese residents, in line with the liberalization of the domestic market and the internationalization of Tokyo Market, at an early stage. Specifically, the liberalization should be promoted for the Euroyen bond market and medium-term and long-term Euroyen lending.

The Internationalization of the Yen. The Internationalization of the yen was to increase opportunities to use yen in international trading and to raise the yen-dominated ratio in asset holdings. More concretely, it could be understood as being three aspects of internationalization: merchandise trading (yen to be used for dealings in imports and exports), capital transactions (financial assets to be retained in foreign countries as yen), and public exchange reserves (foreign countries to retain yen as a reserve).

The yen-dominated ratio for export advanced particularly since the amendment of the Foreign Exchange Control Law in 1980, and rose up to 35.9% in 1985, from 0.9% in 1945. However, as the majority of exports for the United States were dollar-denominated, yen-denominated trading leveled-off. The yen-dominated ratio for imports was far lower than for exports, and it was only 14.5% in 1990. This is because of the trend that trading for raw materials, such as crude oil or the intermediate commodities, had dollar-denominated prices decided based on the international commodity market.

It is difficult to estimate the amount of yen-denominated capital transactions by using a single indicator, but the yen-dominated ratio for bonds in the Euro market may be shown here, as the major element of funding in the international financial and capital market was corporate bonds. The yen-denominated ratio in all Euro bonds increased up to 13% in 1990, from 5% in 1985 (it turned down again after a peak of 18% in 1994).

For public reserves, the ratio of yen used by foreign currency authorities increased from 2.7 % in 1975, to 8.0% in 1990, but the U.S. dollar was still overwhelming.

Expansion of Euroyen Dealings. As stated above, liberalization advanced rapidly in Euroyen dealings since the launch of the Yen-Dollar Committee.

Euroyen lending was only approved for short-term loans from February 1981, while long-term lending was approved for non-residents from April 1985 and for Japanese residents from May 1989. The balance of Euroyen lending was only ¥550 billion at the end of 1984, but increased to ¥17.18 trillion by the end of 1989 (¥13.24 trillion for Japanese residents and ¥3.95 trillion for non-residents).

The liberalization of Euroyen bond issuance for non-residents progressed from 1984 but the expansion of marketability and the relaxation of issuance guidelines were implemented in June 1985. In April 1986, the unification of qualification standards with rating standards, and the easing of the restrictions on reflow (the period that bonds could not be sold to Japanese investors after issuance was shortened from 180 days to 90 days) was allowed in April 1986. The issue of Euroyen bonds was permitted for foreign banks in June (Table 3-3-1).

The restrictions on Euroyen bond issuance by Japanese residents were lifted in April 1984, and the tax reform in April 1985 also made the conditions for issuing bonds easier. This was also followed by the easing of measures such as qualification standards or redemption standards (qualification standards were abolished in January 1996). However, as the Euroyen bonds for Japanese residents were more disadvantageous than Eurodollar bonds in terms of cost, the amount issued remained low.

The issue of Euroyen CD and Euroyen CP was also begun. It started in December 1984 in Japan. It was only limited to 6-month bonds, but it was extended to 1-year bonds in April 1986 and 2-year bonds in April 1988. Most of the Euroyen CD were issued in London market and the balance reached ¥347.8 billion at the end of 1989, but declined afterwards.

Euroyen CP was approved in October 1987 concurrently with the start of domestic CP issues.

Table3-3-1 Euroyen Bonds and Yen-Dominated Bond Issuance (1972 - 1990)

(100million yen)

Fiscal year	Euroyen bonds for non-residents	Euroyen bonds for residents	Yen-Dominated Bonds
1972	0	0	957
1973	0	0	801
1974	0	0	0
1975	0	0	200
1976	0	0	650
1977	300	0	3,260
1978	150	0	8,270
1979	250	0	4,002
1980	550	100	2,610
1981	800	400	6,125
1982	950	0	8,560
1983	700	0	8,990
1984	2,270	0	11,145
1985	14,457	1,400	12,725
1986	25,515	4,170	7,850
1987	29,939	5,200	4,975
1988	22,130	0	7,972
1989	35,579	120	9,990
1990	49,811	7,470	5,750

Source: Ministry of Finance [Finance and Monetary Monthly Statistics] 476,
[Ministry of Finance International Monetary Bureau Annual Statistics] 1991

Okurasho Zaisei Kinyu Tokei Geppo 476, Okurasho Kokusai Kinyu Kyoku Nenpo 1991
Note: 1980 and 1981 are on calendar year [Euroyen bonds for residents]

The Depression of Samurai Bonds. The issue amount of Samurai Bonds once exceeded ¥1 trillion, and played a key role for funding in yen for non-residents, but it was declined in the late 1980s, as the shift to the Euroyen bond occurred, because there were so many restrictions for Samurai Bonds.

However, the issue amount of Samurai Bonds temporarily recovered to $9990 in 1989, because Samurai Bonds with transfer settlement functions in the Euro market (Daimyo Bonds) were started in 1987, and the improvement of the disclosure system was attempted based, on the amendment of the Securities and Exchange Law in 1988.

The Entry to the Japanese Market of Foreign Banks and Securities Companies. Entries of foreign banks continued its gradual expansion until the latter half of the 1980s, when it seemed to be completed. The business environment for the existing branched of foreign banks in Japan showed a tendency to deteriorate due to the advancement of Japanese banks in entering the foreign currency finance market.

The number of foreign securities companies increased rapidly. However, in most cases, foreign securities companies only had a representative office, so that only 30% of those had shops (branches or overseas subsidiaries).

4 The Increase of the Japanese Presence in Overseas Markets

The Overseas Presence of Japanese Banks and Securities Companies. With the change of policy in 1984, Japanese banks were allowed to establish overseas branches at their discretion, and many regional banks, and member banks of the Second Association of Regional Banks, started establishing their overseas branch offices or representative offices. 23 out of 64 regional banks had overseas branches and 8 regional banks had overseas subsidiaries, at the end of 1990.

The establishment of Japanese securities companies rapidly increased, due to the internationalization of the securities business. The number of their branches increased at a rapid pace of 20 to 40 bases a year, after 1985. In the late 1980s, semi-large and middle-size securities companies started to establish their branches in Hong Kong and Singapore, which were new financial and capital markets. Major securities companies expanded their underwriter services, mainly for the Euro market.

The Increase of the Japanese Presence in Overseas Bond Markets. Funding by Japanese enterprises in the overseas market increased remarkably in the late 1980s. The pace of expansion was remarkable. Japan became the biggest borrower of capital in the overseas bond market at the time. After 1987, the amount of funding exceeded that of the United States, and reached $97.8 billion in 1989 at its peak. Especially, bond issuance in the Eurobond market expanded from $80 billion at the end of 1984, to $210 billion at the end of 1989.

The bond issuance in the overseas market exceeded that in the domestic market in 1984, in terms of the funding of Japanese enterprises. The deregulation of various corporate bonds, such as the introduction of warrant bonds, etc., promoted funding overseas. The real demand rule of the exchange reserve was abolished in April 1984, in particular. As capital could be brought from the foreign markets at low-cost, using the swap, foreign bond issuance increased rapidly.

In terms of foreign bonds, warrant bonds accounted for over 50% in 1987, and 79% in 1989 (Figure 1-3-4). In contrast, the regular corporate bonds showed a sharp decline, in terms of issue and share. In terms of market, 60 to 80% of all foreign bonds were issued in the Euro market.

The Rapid Increase of Outward Investments. Outward securities investments showed a remarkable increase, reaching a peak of about $1.37 trillion in 1986, and then leveling-off.

The reasons for this increase were that Japanese institutional investors conducted short-term trading in U.S. treasury bonds, and general investors such as business corporations, etc., actively invested in U.S. treasury bonds and the stocks of American enterprises. However, securities acquisitions in the U.S. market decreased after Black Monday in October 1987.

Outward direct investment kept increasing at a rapid pace every year from $12.2 billion in FY1985, and reached $67.5 billion in FY1989 (Table 1-3-2). In terms of regions, the amount for North American accounted for 45 to 50%, which was followed by that for Europe.

5 Becoming the World's Largest Donor Country

The Remarkable Expansion of Japan's ODA. The Japanese government decided upon its third medium term target for ODA on September 18, 1985, as follows: 1) to make total amount of ODA more than $40 billion for the seven years from 1986 to 1992; and 2) to make ODA in 1992 double that of 1985.

As ODA significantly increased in 1986, the Emergency Economic Measures (decided upon by the Ministerial Conference on Economic Measures) on May 29, 1987 included 1), that is, moving forward the third medium term target by two years, to make the achievement over $7.6 billion in 1990.

Japan's ODA recorded a remarkable increase of $5.6 billion in 1986 (a 48.4% increase on the previous year) and $7.5 billion in 1987 (a 32.3% increase on previous years). The third medium-term target (to be doubled in seven years and aiming for $7.6 billion) was achieved as soon as within two years (Figure 1-3-5).

In June 1988, the Japanese government announced the fourth medium-term target of ODA, before the Toronto Summit. It aimed at making ODA in the past five years (1983-1987) $25 billion in total, with the actual amount of increase doubled, to more than $50 billion in the upcoming five years (1988-1992). Eventually the target of ODA was almost achieved, at $49.7 billion within the term specified.

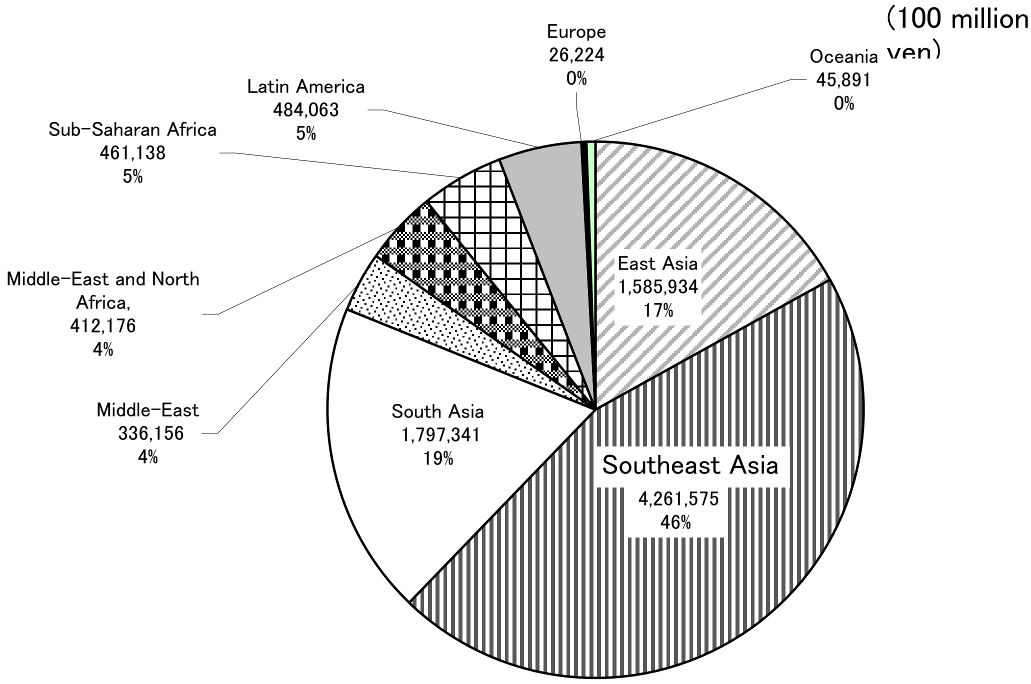
The amount of ODA granted by Japan became the largest in the world in 1989, surpassing the United States. However, in terms of the economic cooperation standard (ratio to the economic scale), it was only 0.33-0.36% of GNP, which was half of the U.S. ratio of 0.7%

Transition of Yen Credit. The accumulative amount of yen credit in FY1985 to 1990 was ¥4.6411 trillion. This accounted for 49.3% of the accumulative amount from 1972 to 1990 in these five years alone.

The largest beneficiary country was Indonesia, which was followed by China, India, the Philippines and Thailand. In the meantime, yen credit to South Korea shrunk, as their economic development was already remarkable, so that it was less necessary to provide economic assistance.

From FY1972 to FY1990, the total amount of yen credits was ¥9.4105 trillion, including ¥4.2615 trillion for South East Asia (46% of total), ¥1.7973 for South Asia (19%) , ¥1.5859 trillion for East Asia (17%) and ¥461.1 billion for sub-Saharan Africa (5%), and ¥484 billion for Latin America (5%) (Figure 3-3-1).

Figure 3-3-1 Regional Amount of Yen Credit (Approval) (FY1972-1990)



(Source) Japan Bank for International Cooperation Kaigai keizai Kyoryokukikinshi [History of Overseas Economic Cooperation Fund] 2003

6 Trade Friction and the Beginning of the Uruguay Round

The Advance Implementation of Tariff Reductions in the Tokyo Round Agreements. In the External Economic Measures in April 1984, the advanced implementation of tariff reductions from the Tokyo Round agreements was announced. Regarding these tariff reduction measures, ASEAN countries complained that the measures were specifically for products that the industrialized countries were interested in. The reform of the tariff system in FY1985 was made based upon the consideration of both the industrialized and developing countries.

It was announced in the External Economic Measures that the implementation of tariff reductions on industrial products would to be advanced by 2 years, and those on agricultural products by 1 year, in FY1985. The Japanese government also decided to move forward tariff cuts by two years on the products of developing countries relating to agriculture, forestry, and fishery products, in its External Economic Measure in December.

The target articles for the advanced implementation of tariff reductions were 1205 articles in FY1985, including 33 agricultural and marine products of developing countries, and 40 other agricultural and marine products, and 1132 mining and manufacturing products.

The Action Program. The report of the Advisory Committee for External Economic Issues (the Ōkita Report) was submitted on April 9, 1985, while economic friction between Japan and the United States was still fierce because of the trade imbalance.

The key point of this report was the “Action Program for Improved Market Access”, in order to show Japan’s intention to proceed with the internationalization of Japan.

The most important field of the Action Program was the further improvement of the standards and certification system. The United States was insisting in the Tokyo Round Negotiations that it was effective to improve the standards and certification system, as a measure to abolish non-tariff barriers. In the Action Program, it was aimed to make a comprehensive inspection of the standards and certification system, based on Japanese laws, as well as to make the system comparable to that of other countries, in terms of the openness of the market.

The Government-Ruling Parties Joint Headquarters for the Promotion of External Economic Measures decided upon the “Outline of Access Program for Improved Market Access” on July 30.

Based on the Action Program, the elimination and reduction of tariff rates on 1849 items was implemented from January 1, 1986.

The Liberalization of Agricultural Products and Tariff Reform of Industrial Products. The United States brought its case to GATT for the import liberalization of 12 agricultural products in 1986. As a result of the assessment, the panel report that the import of 10 items other than miscellaneous beans and ground-nuts was unfair, was submitted to the GATT Session in December 1987, and it was adopted by a unanimous approval in February, 1988.

Therefore, Japan and U.S. held bilateral talks on July 21, 1988, to liberalize 8 of the 10 items by FY1990, consecutively, and the Japanese government raised its tariff rates and introduced the tariff allocation system.

Concurrently, although a GATT panel was established in May for beef and citrus fruit, since the agreement between Japan and U.S. expired with the import batch in March 1988, the bilateral talks sought an early solution to this problem. On June 20, Japan and the United States agreed on: 1) the liberalization of imports of beef in

FY1991; 2) the liberalization of imports of fresh orange in FY1991, and orange juice by FY1992; and 3) the liberalization of imports of beef products from October 1988 to FY1990.

To improve market access, because the current account surplus of Japan was still substantial, and to correct the external disequilibrium, a large-scale abolition of tariffs and reduction of tariff rates of industrial products - as many as 1008 items in FY1990 - was implemented. This was equivalent to the scale of the tariff reduction by the Action Program that had been executed in January 1986.

The Beginning of the Uruguay Round. After the end of the Tokyo Round, while protectionism was growing, the Williamsburg Declaration on Economic Recovery in 1983 proposed the start of a new round. Then in the Bon Summit, the agreement for a new round was adopted. In the GATT ministerial meeting held in Punta del Este, in Uruguay, in September 1986, the ministerial declaration for beginning of the new round (Punta del Este Declaration) was adopted. There were 14 articles for negotiation, which included services, trade-related investment measures, and the newly proposed intellectual property rights.

The Uruguay Round was initially planned to end in four years, but actually it took seven years or more. Therefore the agreement was concluded in Marrakesh, in Morocco, on April 15, 1994. At the same time, the “Marrakesh Agreement Establishing the World Trade Organization” was concluded, and the GATT was reestablished as the WTO, on January 1, 1995.

Legend

１． Contributors

Yoshio Asai	Professor, Faculty of Economics, Seijo University, Tokyo.
Osamu Ito	Professor, Faculty of Economics, Saitama University, Saitama.
Jun-ichi Terai	Principal Economist, Policy Research Institute, The Ministry of Finance.

２． Descriptions

Introduction　Quantitative Overview of Economic Trends　Osamu Ito

Chapter 1 – Chapter 3 (in each Chapter)

Section 1	Fiscal Policy	Jun-ichi Terai
Section 2	Monetary and Financial Policy	Osamu Ito
Section 3	External Economic Policy	Yoshio Asai

3. Symbols in Statistics:「…」: unknown,「－」: no figure,「０」: 0 or less, △: negative

4. Note that formal nomenclatures may not be used for proper names.