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Domestic sources of international payments adjustment: Japan's policy choices in the postwar period

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DOMESTIC SOURCES OF INTERNATIONAL PAYMENTS ADJUSTMENT: JAPAN'S POLICY CHOICES IN THE POSTWAR PERIOD

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ABSTRACT

In an increasingly interdependent global economy, the state must deal with two difficult adjustment problems: achieving domestic economic objectives and adjusting international payments imbalances. Policy instruments for adjustment of international payments imbalances vary from changes in exchange rates and trade/capital controls to macroeconomic policy. It is assumed that compared with other policy instruments, macroeconomic policy is difficult to apply for adjustment of international payments imbalances. This dissertation asks under what circumstances a state chooses macroeconomic policies in order to adjust external payment imbalances, despite the difficulty of altering domestic policies. To answer this question, this dissertation examines Japan's payments adjustment policy in the post-World War II period in relation to international monetary system and in comparison with other industrial nations.

Three cases of Japan's payments adjustment policy are chosen for the analysis: (1) 1968-73, (2) 1977-78, (3) 1985-87. In each case, the United States was pressuring Japan to take actions that would cause a substantial appreciation of the yen and, thereby, eliminate the trade imbalance and payments surplus. In each case, Japan chose macroeconomic policy, especially fiscal policy, with regard to payments adjustment. This dissertation focuses on what role domestic factors play in choosing a policy instrument for payments adjustment and finds that two domestic factors explain the Japanese response to its external payment surplus. The first factor was the important role of export-oriented, small-scale businesses, which were opposed to an appreciation of the yen. The second factor were political parties, all of which were sensitive to policy preferences of export-oriented, small-scale business and pressed the government to pursue an expansionary fiscal policy, which was also asked internationally. Through the examination of three cases, this dissertation explores how domestic and international factors interact to produce state policy outcome and international arrangement among nations.

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Chapter One

Introduction:
Payments Adjustment and Policy Instruments

1. The Problem

In an increasingly interdependent global economy, imbalances among industrial states in trade and capital flow have become sometimes too large to be adjusted by the mechanism of either a fixed exchange rate system or a floating exchange rate system. Balance of payments imbalances (hereafter, payments imbalances) among nations have caused not only volatile international economic relations, but also pressures for protectionism across borders, provoking political disputes among nations. Stable economic and political relations among nations therefore depend on how international payments imbalances are adjusted.

Many economists have claimed since the late 1960s that industrial countries, especially the United States, the Federal Republic of Germany (hereafter, Germany), and Japan, should coordinate their domestic policies in order to reduce international imbalances and related tensions. By doing so, they could adjust payments imbalances among nations. Only through such coordinated behavior by each state, according to the arguments of international coordination of domestic policies, could every country achieve economic growth and full employment at last.[1] Although there are various versions of such arguments, the basic assumption is that coordination of domestic policies among nations would lead to mutually beneficial economic consequences.[2]

In reality, however, international coordination of domestic policies is difficult to achieve, mainly because few states are willing to alter their domestic policies solely for the purpose of adjusting payments imbalances. Both economic and political considerations dictate that this be so.[3] Macroeconomic policy such as monetary and fiscal policies are traditionally formulated to achieve domestic economic objectives, such as adequate growth, price stability, and full employment. If existing macroeconomic policy is required to change for the sake of balance of payments adjustment (hereafter, payments adjustment) at the

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1 For one of the earlier proponents of international coordination of domestic economic policies, see Richard Cooper, *The Economics of Interdependence: Economic Policy in the Atlantic Community* (New York: McGraw-Hill, 1968).

2 The definition of policy coordination varies among scholars from *ad hoc* agreements among nations to formal technical arrangement. This thesis adopts Milner's definition of policy coordination, which is that "the policies of each state have been adjusted to reduce their negative consequences for the other states." Helen Milner, "International Theories of Cooperation among Nations: Strength and Weaknesses," *World Politics*, vol. 44, no. 3, (April, 1992), p. 467.

3 For example, see Robert Gilpin, *The Political Economy of International Relations* (Princeton: Princeton University Press, 1987), pp. 378-79.

expense of domestic objectives, it would be hard for a state to alter its macroeconomic policy.[4] Indeed, the state must deal with two difficult adjustment problems: achieving domestic objectives and adjusting international imbalances. Robert Gilpin summarizes this difficulty as the "the clash between economic interdependence and political autonomy."[5]

There are various policy instruments for payments adjustment. Policy instruments vary from changes in exchange rates and trade/capital controls to macroeconomic policy. Macroeconomic policy is domestic policy, whose primary concern is over the domestic economy. Fiscal policy in particular is assumed to be difficult to apply for external payments adjustment, because it needs to be authorized by legislature and thus there is room for politicization. It is therefore assumed that compared with other policy instruments, macroeconomic policy, fiscal policy in particular, is difficult to apply for payments adjustment, particularly when change in macroeconomic policy conflicts with domestic objectives.

Despite the difficulty of altering domestic policies, under what circumstances does a state nevertheless decide to apply its macroeconomic policy for adjustment of international payments imbalances? This is the main question posed in this thesis. To answer this question, this thesis

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[4] Payments adjustment means maintaining or restoring equilibrium in international balance of payments.
[5] Gilpin, *ibid.*, p. 167.

examines Japan's payments adjustment policy in the post-World War II period. The case of Japan has been chosen, because Japan, more than any other industrial country in the post-World War II period, has applied macroeconomic policy to payments adjustment whether it has been faced with either a payment deficit or surplus. Since Japan is often regarded as one of the more stubborn states in changing its domestic policy in some issue-areas such as market liberalization, even in the face of international pressure, one wonders why Japan decided to change its domestic policy with respect to external adjustment of payment imbalances. Japan's case is therefore appropriate to answer the question: under what circumstances does a state apply its macroeconomic policy for payments adjustment?

Understanding Japan's policy choices regarding payments adjustment can help one better understand the adjustment problem that international economic structural change puts on industrial countries and the implications of the policies which states choose for international cooperation. Considering Japan's rising position in the international economy, Japan's case is thus instructive not only to students of comparative politics interested in different state responses to payments adjustment problems, but also to analysts of international relations, for whom international cooperation has been a major concern.

Among explanations of international policy coordination, the international systemic-level approach has been a major approach. According to this approach, state choice of applying macroeconomic policy, which contributes to international policy coordination, is explained in terms of international systemic-level factors such as power-relations among nations and the relative positions of states in the international system, not in terms of domestic factors of states. In contrast to systemic-level approaches, which cast the nation-state as a unitary actor, this thesis argues that domestic-level factors are critical to explaining why states apply domestic policy for external payments adjustment in an increasing interdependent world economy. This thesis focuses upon two domestic-level factors as important variables to understanding state choice of payments adjustment policy. The first factor is domestic preferences regarding the exchange rate. Whether or not, and the extent to which there is representation of domestic preferences towards the exchange rate is an important element to understanding incentives for and constraints on state policy choice with respect to payments adjustment. The second domestic-level factor is state political structure regarding payments adjustment policy. Knowing how state officials and political parties respond to such domestic preferences is essential to understanding state policy choice.

Before elaborating on my argument of explaining Japan's payments adjustment policy, the next section will outline first the types of policy instruments for payments adjustment in an effort to clarify the main question: under what circumstances does a state apply its macroeconomic policy with respect to payments adjustment? For adjusting international payment imbalances, states choose a policy instrument or a combination of policy instruments. In order to understand state choice of adjustment policy, it is essential to know what kinds of policy alternatives to payments adjustment are available, and why states choose particular policy instruments. This typology helps to understand the characteristics of industrial state policy choices as well as the reasons for Japan's choice.

2. Typology of Policy Instruments for Payments Adjustment

In an increasingly interdependent global economy, international imbalances in trade and capital flows are constantly taking place. Since international payment imbalances among nations caused not only instability to the world economy, but also political disputes, states must simultaneously pursue their own domestic economic objectives, as well as help maintain stable international relations through coordinated and compatible economic policies.[6]

Payments adjustment policy is defined here as "a policy which is applied by a state to eliminate its external balance of payment imbalances or to restore equilibrium in its external payment." States have chosen various types of policy instruments for payments adjustment. These instruments can be divided into four categories.[7] The first category of policy instrument is use of reserves and borrowing from international organizations such as the International Monetary Fund (IMF), World Bank, and foreign central banks. The IMF is equipped with financial facilities, which a member country can borrow to adjust payment deficit. The second category is direct control of international trade and capital transactions at national borders. In trade control such as special taxes, tariffs and quotas, deficit countries tend to restrict imports and promote exports, while surplus countries are likely to do the opposite. In capital control such as exchange control and

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[6] There is not always a consensus that payments imbalances are incompatible with the economic objectives of the countries which have external imbalances. I will return to this point later.

[7] Cooper defines three categories of policy instruments under fixed exchange rates: external, internal, and financing measures. Cooper, *op. cit.*, pp. 13-23. Webb shows three categories: external policy, symptom management policy and internal policies. Michael C. Webb, "International Economic Structures, Government Interests, and International Coordination of Macroeconomic Adjustment Policies," *International Organization*, vol. 45, no. 3 (Summer 1991), p. 314.

special tax, deficit countries are apt to restrict capital outflows, while surplus countries tend to restrict capital inflows. The third category is changes in exchange rates. Under a fixed exchange rate system, deficit countries might favor devaluation to encourage exports; surplus countries might prefer revaluation in order to reduce imports. Under a floating exchange rate system, exchange rate policy means direct and indirect intervention in the foreign exchange markets to influence exchange rate movements.[8] Under a floating exchange rate system, exchange rates are supposed to be higher for surplus countries and lower for deficit countries to adjust international payments imbalances. The fourth category is macroeconomic policy, which is usually used to achieve stable domestic economic conditions. Monetary and fiscal policies are formulated primarily to achieve domestic economic objectives such as an adequate growth rate, price stability, and full employment, but can also be considered useful in adjusting external imbalances. For example, a payment deficit may be corrected by a more deflationary policy, while payment surplus may be corrected by a somewhat more inflationary policy.

Of these categories of policy instruments, the first two categories are applied and useful only for temporary payments imbalances. Capital and trade controls for the purpose of

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[8] In a floating exchange rate system, along with the rapid transactions of capital, it has become much more difficult to alter exchange rates by a single country's intervention.

adjusting payments imbalances are considered as undesirable for a free and liberal international economic system by the IMF. The latter two categories, that is, changes in exchange rates and macroeconomic policy, are considered as main policy instruments for correcting external imbalances.[9]

Policy instruments for adjustment of payment imbalances according to the latter two categories are summarized in Figure 1.1. Facing external imbalances, a state can choose either change in exchange rate or macroeconomic policy or both. In the case of deficit, states apply either devaluation (depreciation of its currency) or deflationary (tight) macroeconomic policy. In the case of surplus, states apply either revaluation (appreciation of its currency) or inflationary (expansionary) macroeconomic policy. However, choosing one policy instrument does not necessarily imply that one policy instrument is applied exclusively; rather than that particular policy instrument may receive more emphasis than any other policy instrument.[10]

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[9] There is no theoretical consensus about the effectiveness of each policy instrument on payments adjustment. This categorization is based on a conventional theory about policy instruments for payments adjustment. For example, see Paul R. Krugman, "Has the Adjustment Process Worked?," in C. Fred Bergsten, ed., *International Adjustment and Financing: The Lessons of 1985-1991* (Washington, D. C.: Institute for International Economics, 1991), pp. 279-285, Peter H. Lindert and Charles P. Kindleberger, *International Economics*, Seventh Edition (Illinois: Richard D. Irwin, Inc., 1982), Part III and IV.

[10] As for macroeconomic policy, fiscal and monetary policies are not considered as one policy. Fiscal policy might be directed to internal stability and monetary policy to external stability, because monetary and fiscal policies have opposite effects on the capital account in the balance of

[Figure 1.1 ABOUT HERE]

Economic literature on international coordination of macroeconomic policies focuses mainly on how states assign macroeconomic policies to adjust external imbalances or how they combine macroeconomic policies to achieve optimal social welfare of individual states.[11] According to conventional economic theories regarding policy instruments, if the domestic economy is inflationary and a payment surplus is accumulating, revaluation (appreciation) might be applied to achieve both domestic goals and international payments adjustment. In the case of a deficit country with a deflationary domestic economy, devaluation (depreciation) would be regarded as an appropriate policy instrument for both domestic economic goals and payments adjustment.[12]

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payments. However, they have similar effects on domestic economies and on the current account in the balance of payments. See, Robert A. Mundell, "The Appropriate Use of Monetary and Fiscal Policy for Internal and External Stability," *IMF Staff Papers*, vol. 9, no. 1 (March 1962), pp. 70-78.

[11] For example, see Jan Tinbergen, *On the Theory of Economic Policy,* Revised Edition (Amsterdam: North-Holland Pub. Co., 1956), Mundell, *op. cit.*, Koichi Hamada, "A Strategic Analysis of Monetary Interdependence," *Journal of Political Economy,* vol. 84, no. 4 (August 1976), pp. 677-700, Warwick J. Mckibbin, and Jeffrey Sachs, "Coordination of Monetary and Fiscal Policies in the OECD," *National Bureau of Economic Research Working Paper Series,* no. 1800, 1986.

[12] As for an example of typology of a desirable policy instrument, see, C. Fred Bergsten, *The Dilemmas of the*

3. State Choice of Policy Instruments in A Changing International Monetary System

Do states choose similar policy instruments of payments adjustment policy in parallel economic conditions? If so, what kinds of factors regulate state choices of policy instruments for payments adjustment? If not, how can the differences in state choices be explained? In order to answer these questions, this section will examine which policy instruments industrial countries chose for adjustment of payments imbalances in the post-World War II period.

(1) Policy Instruments in the Bretton Woods System

(i) The Norm of the Fixed Exchange Rate System

The IMF originally put emphasis on the need to eliminate balance of payments imbalances as well as other purposes: to promote international monetary cooperation; to facilitate the expansion and balanced growth of world trade; to maintain stable exchange rates; and to assist in the establishment of a multilateral system of payments. The main purpose of the IMF was therefore to establish the framework of reconciling international payments adjustment with domestic objectives.[13]

In the Bretton Woods system, payments adjustment was to be achieved by countries who had substantial unsustainable external imbalances, either deficits or surpluses. Such countries had to take responsibility for adjusting their own external imbalances by applying their own policy instruments. These policy instruments were mainly external policy instruments such as the use of reserves, controls on capital transfers, restrictions on exchange transaction and changes in exchange rates.[14]

Temporary imbalances were expected to be adjusted by using reserves, supplemented by the resources of the Fund. Using restrictions on exchange rate transactions and on current account transactions were to be subject to approval by the Fund, depending on economic condition of each country.[15] While most countries, especially industrial

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Dollar: The Economics and Politics of United States International Monetary Policy (New York: New York University Press, 1975), pp. 520-527.

[13] The Bretton Woods system consisted of several rules for a stable international monetary system. The IMF was expected to play two main roles in establishing a stable international economic system: one was regulating the exchange rate regime, while the other was financing funds for member countries who were faced with payment deficits.

[14] External policy instrument refers to policy instruments which differentiate domestic transactions from transactions with foreigners. See Cooper, *op. cit.*, p. 13.

[15] Article VIII of the IMF requires that a member country obtain the Fund's explicit approval for any restrictions it maintains or imposes on the making of payments and transfers for current international transactions. Article XIV admits member countries who are in the post-war transitional period to maintain and adapt to changing circumstances restrictions

countries, were in deficits and maintained the status of Article XIV, policy instruments applied by these countries were mainly restrictions on imports and on payments for imports. Under Article XIV, countries were allowed to use restrictions on import and capital outflows to eliminate external imbalances which had resulted from uneven economic capabilities between the United States and the rest of the world during the immediate post-World War II period. As countries rebuilt their devastated economies and world trade expanded, however, restrictions on imports and on capital flows were relaxed. By the early 1960s, trade and capital restrictions were no longer popular as policy instruments for payments adjustment.[16]

Meanwhile, changes in par value were allowed by the IMF only to adjust a "fundamental disequilibrium."[17] A "fundamental disequilibrium" was regarded as persistent balance of payment surplus and deficit that could not be adjusted by domestic policies within a reasonable time

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on payments and transfers for current international transactions.

[16] Article VIII status country, without approval of the Fund, may not impose restrictions on the making of payments or transfers for current international transactions, or engage in discriminatory currency arrangements or multiple currency practices. By 1961, twenty-one countries accepted the obligations of Article VIII. Most major European countries and the United State were included in this group. Japan accepted the status of Article VIII in 1964.

[17] Changes in exchange rates were admitted only within the range of one percent of parity. Here, change in exchange rate is used interchangeably with change in par value to mean change in par value.

without aggravating inflation and unemployment.[18] However, a "fundamental equilibrium" had never been formally defined by the IMF.[19] This loose definition of "fundamental equilibrium" was the product of a compromise between the U.S. plan, which supported rigid international regulation of changes in exchange rates, and the British plan, which claimed that there should be flexibility and ease of changes in exchange rates.[20]

Although the criteria of using changes in exchange rates was substantive, the underlying norm of the fixed

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[18] Margaret G. de Vries and J. Keith Horsefield, *The International Monetary Fund 1945-1965, vol. II* (Washington, D. C.: International Monetary Fund, 1969), pp. 91-92, Dam says that the most illuminating definition of "fundamental disequilibrium" was offered probably by the Bank for International Settlements (BIS) in 1945; "a disequilibrium which cannot be eliminated by any other method than an alteration of exchange rates must be regarded as fundamental." Kenneth W. Dam, *The Rule of the Game: Reform and Evolution in the International Monetary System* (Chicago, University of Chicago Press, 1982), p. 92.

[19] The principle Article regarding change in exchange rate was Article IV and particularly Section 5;

(a) A member shall not propose a change in the par value of its currency except to correct <u>a fundamental disequilibrium</u>.

(b) A change in the par value of a member's currency may be made only on the proposal of the member and only after consultation with the Fund.

(c) ---

(d) ---

(e) ---

(f) The Fund shall concur in a proposed change ---- if it is satisfied that the change is necessary to correct <u>a fundamental disequilibrium</u>. In particular, provided it is so satisfied, it shall not object to a proposed change because of the domestic social or political policies of the member proposing the change.

(underlined by author)

[20] The adoption of substantive criterion; "fundamental disequilibrium," was added to the U.S. plan in November 1942. Dam, *op. cit.*, p. 89.

exchange rate Bretton Woods system was that member countries should avoid changing their fixed exchange rates frequently. Despite the fear of IMF officials that countries might resort to competitive devaluation, which happened in the 1930s, most countries were reluctant to change their fixed exchange rates, especially to devalue their currencies after they had set their initial exchange rates in 1946.[21] Because most industrial countries other than the United States needed to import necessary goods from the United States for reconstructing their economies devastated by the World War II, they wanted to maintain their overvalued exchange rates against the U.S. dollar.[22]

However, one exceptional case was a series of revaluations in 1949. Britain devalued the sterling in 1949, because it was faced with the massive outflows of reserves due to its attempt of convertibility in 1947. Following Britain's 30.5 percent revaluation, about thirty countries devalued their currencies to correct overvalued par values.[23] However, after 1949, exchange rate policy was generally little used during the period from 1949 until the breakdown

[21] During most of the early Bretton Woods period, external payments imbalances most countries were faced with were payment deficits, not surpluses.
[22] Besides economic explanations, devaluation was often regarded as a result of government's mismanagement of domestic economy in domestic politics.
[23] They were not only the countries in the sterling area (Australia, Canada, Iceland, India, Iraq, and the Union of South Africa), but also states in other currency areas such as Belgium, Denmark, Finland, France, and Netherlands.

of the Bretton Woods System in 1971.[24] In particular, from 1962 to 1967, major industrial countries such as France, Germany, Italy, Britain, the United States, and Japan did not change their exchange rates at all.[25]

(ii) Macroeconomic Policy as a Policy Instrument

Regarding macroeconomic policy such as monetary and fiscal policies, the Fund presupposed that states were to be free to apply their monetary and fiscal policies to pursue purely domestic objectives. The Bretton Woods system did not impose any specific obligations on countries to restrain inflationary domestic policies, that might necessitate undue resort to exchange devaluations and/or import restrictions.[26] Indeed, the Article of Agreement of the Fund did not explicitly refer to the domestic policies of member countries.

However, the original ideology of payments adjustment under the Bretton Woods system recognized that the prevention by each member country of domestic inflation would help avoid generating unnecessary external payments imbalances. The IMF

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[24] See history of the IMF; de Vries and Horsefield, *op. cit.*; Margaret de Vries, *The International Monetary Fund 1966-1971*, vol. I (Washington, D. C.: International Monetary Fund, 1976).
[25] John Williamson, *The Failure of World Monetary Reform, 1971-74* (New York: New York University Press, 1977), p. 6. During this period, the balance of payments disequilibrium among the industrial countries was lessening.
[26] J. Mancus Fleming, "Developments in the International Payments System, " *IMF Staff Papers*, vol. 10, no. 3 (November 1963), p. 462.

could deny the use of its resources to countries whose policies were considered incompatible with the purpose of the IMF, that is, adjustment of payments imbalances. In order to strengthen the positions of balance of payments of member countries, the IMF could urge them to intensify domestic policy instruments to reduce domestic inflationary pressures. Such instruction could be made bilaterally, often during consultations with member countries which had requested Fund resources.[27] In the 1950s, countries experiencing temporary payments imbalances began to use monetary policy to adjust their external imbalances as well as to achieve their domestic objectives.[28]

(iii) Differences of State Choices

Although the IMF's Articles of the Bretton Woods system set forth a framework of payments adjustment in which countries experiencing unsustainable external imbalances were expected to eliminate their own imbalances through their policies, they did not explicitly state which policy instruments should be used for payments adjustment by which countries when adjustment was desired. There was also no

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[27] The IMF has developed a body of policies and procedures to govern the use of its resources. This is called "conditionality."

[28] Margaret Garritsen de Vries, *Balance of Payments Adjustment, 1945 to 1986* (Washington, D. C.: International Monetary Fund, 1987), pp. 27-30.

explicit criteria of how to share the responsibility between surplus and deficit countries.[29]

When states were faced with external imbalances, they were expected to correct imbalances. Furthermore, despite the norm of the fixed exchange rate system, in reality, states were relatively free to choose policy instruments, changes in exchange rates or domestic macroeconomic policy, or a combination of the two. Even changes in par value, which should have been precluded by the norm of the fixed exchange rate system, were allowed. Indeed, the IMF generally concurred with the proposals by countries to change their par values, since there was no ultimate criteria to distinguish "temporary disequilibrium" from "fundamental disequilibrium." Still, these changes in exchange rates were proposed not by the Fund, but initiated by the member country.

Although there was a general pattern of avoiding changes in exchange rates under the Bretton Woods system, there were differences in state choices of policy instruments for payments adjustment. Some states showed more rigid attitudes toward changes in exchange rates, while other

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[29] OECD Report of 1966 suggested to use several indicators to forecast the emergence of internal and external disequilibrium and to promote an understanding of cooperation among nations in adjusting payments imbalances. Organization for Economic Cooperation and Development, "The Balance of Payments Adjustment Process," A Report by Working Party No. 3 of the Economic Policy Committee of the OECD (Paris: Organization for Economic Cooperation and Development, August 1966).

states preferred not applying macroeconomic policies for eliminating external imbalances.

Britain, for almost thirty years after the World War II, consistently refused to devalue when it was faced with external deficits. Instead, Britain applied deflationary domestic policies, although it was forced to devalue in 1948 and 1967.[30] Japan also maintained its exchange rate when it experienced external deficits and deflated the domestic economy so as to reduce imports even in the midst of high economic growth plan.[31] Similarly, the United States also never altered its exchange rate under the Bretton Woods system. In contrast, some states resorted to changes in their exchange rates when they were faced with external payments imbalances. For example, France chose to devalue rather than to pursue less inflationary policies when faced with payments deficit, leading France to devalue five times under the Bretton Woods system.[32]

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[30] Peter Hall, *Governing the Economy: The Politics of State Intervention in Britain and France* (New York: Oxford University press, 1986), pp. 50-51, p. 250, Stephen Blank, "Britain: The Politics of Foreign Economic Policy, the Domestic Economy, and the Problem of Pluralistic Stagnation," in Peter J. Katzenstein, ed., *Between Power and Plenty: Foreign Economic Policies of Advanced Industrial States* (Madison: University of Wisconsin Press, 1978), pp. 106-113, Susan Strange, *Sterling and British Policy* (London: Oxford University Press, 1971).

[31] Japan set its initial exchange rate in February 1949. The details will be reviewed in Chapter 3.

[32] Devaluation was taken place in 1948, 49, 57, 58 and 69. Hall, *op. cit.*, p. 245, Michael Loriaux, *France After Hegemony: International Change and Financial Reform* (Ithaca: Cornell University Press, 1991), pp. 20-22.

Differences in states choices of policy instruments can be also found in cases of payment surplus. Whereas Germany chose to revalue in 1961 and 1969 when confronted with a payment surplus, Japan resisted revaluation in the late 1960s until the breakdown of the Bretton Woods system in August 1971, even though it experienced a similar external surplus. For both states, growing payment surpluses increased foreign exchange reserves, which translated into rapid monetary expansion and higher prices. Confronted with external surpluses and internal inflational economies, both states faced a similar choice between revaluation or expansionary macroeconomic policy, yet each chose different policy instruments.

As for macroeconomic policy, there were various degrees of responsiveness among nations to payments adjustment. Monetary and fiscal policies were expected to be responsive to payment imbalances under the Bretton Woods system. According to the study of fiscal and monetary policies applied by major industrial countries from 1950 to 1966, however, there were different patterns of applying macroeconomic policies for payments adjustment among nations.[33] In fiscal policy, among industrial states, budgetary policy was generally not responsive to the

[33] Michael Michaely, *The Responsiveness of Demand Policies to Balance of Payments: Postwar Patterns* (New York: National Bureau of Economic Research, 1971). This study examines nine countries: Belgium, Britain, France, Germany, Italy, Japan, Netherlands, Sweden, and the United States.

requirement of the balance of payments. The degree of responsiveness of monetary policy varied by state. Britain and Japan used monetary policy consistently in accordance with their external positions; that is, more restrictive in deficit and more expansionary in surplus. France was less responsive to the balance of payments during the 1960s when it was in surplus than the 1950s, when it suffered from a chronical deficit. Both Germany and the United States proved less responsive to the balance of payments in their monetary policies throughout the 1950s and 1960s.[34]

By examining the policy choices of industrial countries when faced with external payments imbalances, certain patterns emerge. Using two criteria which had been proposed in the preceding section; -- whether state chose to change in exchange rate or not; and whether state applied macroeconomic policy to payments adjustment or not --, I offer the following categorization, which has been based on which policy instrument states put greater emphasis on changes in exchange rates or on macroeconomic policy. This categorization is summarized in Figure 1.2.

[FIGURE 1.2 ABOUT HERE]

[34] *Ibid.*, pp. 44-45, pp. 62-65.

Facing a payment deficit, France in the late 1940s and the early 1950s chose to apply change in exchange rate for payments adjustment. Unlike France, Japan in the 1950s and in the early 1960s and Britain in the 1950s and 1960s resisted changing their fixed exchange rates and chose to apply deflationary policies to adjust payment deficits. In the case of payment surplus, Germany in the 1960s chose to apply revaluation instead of applying expansionary macroeconomic policy for payments adjustment, while Japan after the late 1960s chose to apply expansionary policy for payments adjustment to avoid change in exchange rate. Japan, Britain and the United States all resisted regarding their exchange rates as policy instruments that could be manipulated. In Japan and Britain, devaluation was more rigidly perceived as politically sacrosanct than in other industrial countries. Japan and the United States never altered their exchange rates until 1971. In macroeconomic policy, however, while Japan and Britain were unusually responsive to the balance of payments adjustment until the late 1960s, Germany and the United States were less responsive to payments adjustment than other industrial countries.[35]

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[35] While IMF officials praised Japan's responsiveness of monetary policy measure in January 1969, they also recommended that Japan consider liberalizing the remaining impediments to imports and capital transactions. See de Vries, *The International Monetary Fund 1966-1971, vol. I, op. cit.*, pp. 494-495.

After 1968, international payment imbalances were aggravated mainly by the huge increasing deficit of the United States and the accumulating surpluses of the other industrial countries. Industrial countries became increasingly reluctant to adjust their payments imbalances because such adjustments were regarded as detrimental to their domestic economies, increasing short-term capital movements across borders. In 1969, France devalued, and Germany revalued. In 1971, the United States experienced a $29.8 billion overall balance of payment deficit, most of which were huge capital outflows rather than current account deficit. In stark contrast, other major industrial countries enjoyed large surpluses. Japan's overall balance of payment surplus reached more than $7 billion, which was a record high surplus in its history. Britain had a $6.6 billion surplus, Germany had a $4.5 billion surplus and France reached a $3.5 billion surplus.

Between the U.S. suspension of convertibility of dollars into gold in August 1971 and the introduction of a floating exchange rate system in March 1973, the adjustment problem was discussed continuously among nations.[36] They debated how to share the responsibility of adjusting payment

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[36] For U.S. decision of suspending convertibility of dollars into gold, see Joanne Gowa, *Closing the Gold Window: Domestic Politics and the End of Bretton Woods* (Ithaca: Cornell University Press, 1983), John S. Odell, *U.S. International Monetary Policy: Markets, Power, and Ideas as Sources of Change* (Princeton: Princeton University Press, 1982), chapter 4.

imbalances between surplus and deficit states. However, a new framework for sharing responsibility for payments adjustment was not established, primarily because of divergent opinions between the United States and other industrial countries. The United States regarded the Bretton Woods system as asymmetrical, because it imposed the burden of payments adjustment mostly on deficit countries. The other countries claimed that the United States was not responsible for its external deficit, taking advantage of its status as a key currency country.[37] In this international economic climate, Japan was still faced with the problem of adjusting its payment imbalance, this time, a payment surplus. During the period from August 1971 to March 1973, Japan was faced with an increasing payment surplus and chose to apply inflationary macroeconomic policy, instead of revaluation, under the U.S. pressure which urged Japan to adjust its external imbalance.

In sum, from the comparison with other industrial countries, it can be concluded that Japan was more rigid in exchange rate policy. Regardless of whether it faced a payment surplus or deficit, Japan consistently subordinated its macroeconomic policy to international payments consideration within a framework of the Bretton Woods system (See Figure 1.2).

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[37] For the details of discussions including those of Committee of Twenty, see Williamson, *op. cit.*, Robert Solomon, *The International Monetary System, 1945-1981* (New York: Harper & Row, Publishers, 1982), pp. 216-234.

(2) State Choice of Policy Instruments in the Post Bretton Woods Period

(i) Impact of the Breakdown of the Bretton Woods system on State Choice

In March 1973, the fixed exchange rate system of the Bretton Woods system was abolished; a floating exchange rate system was introduced formally in 1976. In principle, a floating exchange rate system was assumed to solve the problem of how to share the responsibility for payments adjustment and which policy instrument should be applied. There were two main assumptions. First, in a floating exchange rate system, payments imbalances were expected to be adjusted automatically by the mechanism of foreign exchange markets. States did not have to be concerned about sharing the responsibility of payments adjustment with other states. Second, macroeconomic policies which had been expected to be responsive to the balance of payments under the Bretton Woods system were assumed to be free to apply solely for domestic economic objectives. Macroeconomic policy, according to this assumption, would no longer be policy instruments for payments adjustment.

However, these assumptions did not appear to work as the economic theories had projected. In the 1970s and 1980s, the international economy suffered from excessive exchange rate volatility, misalignment of the major currencies and continuing payments imbalances. Under a floating exchange rate system, the persistence of current account imbalances increased. According to a comparative study between the fixed exchange rate system period (1963-72) and floating exchange rate system period (1973-86), current account imbalances in the United States, Japan and Germany have been larger and more persistent under a floating exchange rate system.[38]

As for the autonomy of macroeconomic policies from payments imbalances, it appears that the macroeconomic policy of one country affected not only its own domestic economy, but also other countries' economies, transmitted through floating exchange rates. With increasing capital movements across borders, macroeconomic policies can no longer be independently determined, without considering the effect on external balances and other states' economies.[39]

Although the expectations regarding payments adjustment and autonomy of macroeconomic policies appeared to be unrealistic under the floating exchange rate system in the post-Bretton Woods period, a new international framework of payments adjustment including choice of policy instruments

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[38] Jocelyn Horne and Paul R. Masson, "Scope and Limits of International Economic Cooperation and Policy Coordination," *IMF Staff Papers*, vol. 35, no. 2 (June 1988), pp. 270-272.
[39] For the relationship between an interdependent international economy and macroeconomic policies, see, for example, Richard Cooper, *op. cit.*; "Economic Interdependencies and Coordination of Policies," in R. W. Jones and P. B. Kennen, eds., *Handbook of International Economics*, vol. 2 (Amsterdam: Elsevier, 1985), pp. 1195-1234.

had not yet emerged among nations. Although the floating exchange rate system did not solve the problem of payments adjustment, given the lack of regulations or agreements regarding policy instruments of states, this system did give states more flexibility in conducting macroeconomic policies.

(ii) Payments Adjustment As An International Agenda

In the post-Bretton Woods period, economists and international organizations such as the IMF and the Organization for Economic Cooperation and Development (OECD) have stressed the necessity to apply macroeconomic policy to payments adjustment. However, there is no consensus among nations on how much payments imbalances should be adjusted. External imbalances are sometimes not perceived as incompatible with national objectives by countries who have such payment imbalances. Despite the attempts by a number of economists to define optimal policy choice, there is also no single economic model spelling out how much payment imbalances should be adjusted and which countries should apply which policy instruments.[40]

Since there is less regulations regarding payments adjustment in the post-Bretton Woods period than under the Bretton Woods system, countries faced with payment imbalances

[40] For the existence of various models regarding international macroeconomic policy coordination, see Jeffrey A. Frankel, *Obstacles to International Macroeconomic Policy Coordination*, Princeton Studies in International Finance no. 64 (December 1988).

want other countries to take responsibility for changing their policies and eliminating payment imbalances. When deficit countries do not want to devalue their currencies and deflate incomes and employment, they press surplus countries will make adjustment policies. When surplus countries do not wish to increase the value of currencies and price level, they want deficit countries to assume deflationary domestic policies.

Incentives of states for international coordination of macroeconomic policies were, therefore, likely to arise only when an international economic system was perceived as not working for achieving a stable international economy by major industrial countries. In other words, under the floating exchange rate system, individual states did not pay serious heed to the choice of applying policy instruments for payments adjustment, unless payments imbalances seemed incompatible with their own economic objectives or undermined international economy as a whole, thereby becoming an issue for nations.

The periods, 1977-78 and 1985-87, are two such examples. In both cases, there were large international payments imbalances, especially between the United States on the one hand, and Germany and Japan on the other. Exchange rates did not move enough in the direction to eliminate payments imbalances, and instead the U.S. dollar was strengthened against both the yen and the Deutsche mark. In both cases, the surplus countries of Japan and Germany were reluctant to discuss which state should apply which policy instrument. In both cases, the United States played a major role in setting the agenda of international payments adjustment and advocating the use of particular policy instruments. By the autumn of 1976, although macroeconomic policy coordination had become a standard item on the international agenda of summit and OECD countries, alike,[41] setting a particular proposal regarding policy instruments as an international agenda still required initiative of the United States.

(iii) State Choices During 1977-78 and 1985-87

After the breakdown of the Bretton Woods fixed exchange rate system, adjustment of international payments imbalances appeared on the international agenda in 1977-78 and in 1985-87. During 1977-78, the United States urged Germany and Japan to expand their macroeconomic policies to stimulate their domestic economies, advocating a "locomotive theory," in which the expansion of economies of the United States, Germany and Japan would provide benefits of other countries. The United States also emphasized the relationship between exchange rate misalignment and its own payment deficit, and

[41] Robert D. Putnam and C. Randall Henning, "The Bonn Summit of 1978: How Does International Economic Policy Coordination Actually Work?" *Brooking Discussion Papers in International Economics*, no. 53 (Washington, D.C.: Brooking Institution, October 1986), p. 19.

pushed Germany and Japan to appreciate their currencies. During 1985-87, only after the United States acknowledged the links among budget deficits, a high dollar and current account deficit, did the exchange rates and macroeconomic policies come to the fore of the international agenda. In both cases, the United States, Germany and Japan were faced with the dilemma of which policy instruments to apply for international payments adjustment -- either exchange rate realignment or macroeconomic policy, or both. These states chose to apply exchange rate policy as an initial policy instrument.[42]

As for macroeconomic policy, Germany and Japan warded off international pressures and resisted applying expansionary macroeconomic policies because of their domestic concerns about inflation and budget deficits. Germany and Japan were in parallel economic circumstances in terms of current account surplus and budget deficit (see Table 1.1). However, in both cases, Japan chose to apply expansionary fiscal policy earlier than did Germany, although Germany's unemployment rate was higher, and budget deficit was smaller, than in Japan. In the 1977-78 case, despite its government policy of reducing a persistent budget deficit, Japan agreed to set a goal of seven percent annual growth and decided to increase fiscal expenditure as early as in December 1977.

[42] The choice of exchange rate realignment in 1985 was partly because exchange rate volatility in itself was perceived as disturbing international economy by most states.

Germany, meanwhile, postponed its decision on changing its fiscal policy until the Bonn Summit in May 1978. In the 1985-87 case, Japan finally decided on substantive fiscal expansionary policy (1.8 percent to GNP) in May 1987, which led to the highest budget increase rate since 1981, despite its austerity policy, while Germany decided to frontload of the 1990 tax cut to 1988 later than Japan and the size of tax cut was small.

[TABLE 1.1 ABOUT HERE]

Both these cases, 1977-78 and 1985-87, illustrated that although macroeconomic policy was generally avoided as a policy instrument of payments adjustment in the early stages, Japan proved more likely to choose expansionary macroeconomic policy, fiscal policy in particular, than Germany in parallel economic circumstances (See Figure 1.3).

[FIGURE 1.3 ABOUT HERE]

The above examination of policy choices of industrial countries demonstrated that both in the Bretton Woods fixed exchange rate system and in the floating exchange rate system, industrial countries put emphasis on different policy instruments with respect to payments adjustment in parallel balance of payment position. The puzzle is why Japan consistently applied macroeconomic policy in the Bretton Woods period and why Japan finally chose macroeconomic policy, fiscal policy in particular, in the post-Bretton Woods period with respect to payments adjustment.

4. The Argument in Brief

(1) The Argument: Organization of the Thesis

The main purpose of this thesis is to answer the question: under what circumstances does a state apply its macroeconomic policy for international payments adjustment? To answer this question, this thesis deals with Japan's payments adjustment policy as a case. The preceding section demonstrated that Japan applied macroeconomic policy -- fiscal policy in particular -- for payments adjustment more frequently than other industrial countries in parallel economic circumstances. This thesis argues that domestic-level factors mattered more in policy choice of adjustment policy than international systemic-level approaches assume, and that it is important to know how the international economy affected domestic factors in payments adjustment policy.[43] Two domestic-level factors are emphasized in this thesis as important variables in explaining state choice of policy instruments of payments adjustment: (i) domestic preferences regarding the exchange rate and (ii) political structure which responds to domestic preferences.

In Japan, there has been overrepresentation of domestic preferences against revaluation or rapid appreciation of the yen (a high yen). Moreover, Japan's political structure translated such domestic preferences into the choice of macroeconomic policy. This thesis also argues that Japan's policy orientations regarding payments adjustment originated in the Bretton Woods period and lasted in the post-Bretton Woods period.

To elaborate on these arguments, this thesis is organized as follows. First, the thesis will review existing approaches to foreign economic policy and examine whether these approaches are appropriate to explaining Japan's policy choices regarding payments adjustment policy. By reviewing these approaches, the thesis claims that systemic-level approaches do not fully explain state policy choices for payments adjustment policy. This examination shows that in order to understand policy choice of payments adjustment

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[43] For the effect of international factors on domestic factors, see, Peter Gourevitch, "The Second Image Reversed: the International Sources of Domestic Politics," *International Organization*, vol. 32, no. 4 (Autumn 1978), pp. 881-912.

policy, it is necessary to look at the relations between the international factors and domestic factors. The first section of Chapter Two deals with these arguments.

Second, after examining existing approaches, the latter half of Chapter Two explains why it is important to put emphasis on two domestic-level factors for better understanding state choice of payments adjustment policy. To address this point, the case of Germany, whose position in the international economy was similar to Japan's after the 1960s, will be examined. Germany's case provides a critical comparative perspective on Japan's policy choice.

Third, the hypothesis regarding domestic-level factors to explain payments adjustment policy proposed in Chapter Two will be tested through Japan's cases in Chapter Three, Four, and Five. The hypothesis is that two domestic-level factors are important variables in explaining state choice of payments adjustment: (i) domestic preferences regarding the exchange rate, (ii) political structure which responds to domestic preferences. Chapter Three deals with Japan's payments adjustment policy under the Bretton Woods system. Under the Bretton Woods system, Japan was faced with both a deficit and surplus in balance of payments. The period of 1968-73 is important, because during this period, Japan was confronted with payment surplus for the first time in the postwar period, and its experience during this period affected subsequent policy formulation of payments adjustment. Chapter Four examines payments adjustment policy during 1977-78. Chapter Five explores payments adjustment policy during the 1985-87.

Finally, by discussing the findings drawn from the empirical case studies in Chapter Three, Four, and Five, Chapter Six places the arguments in the context of theories of international political economy and Japan's foreign economic policy.

(2) Contribution of the Argument

This thesis seeks to contribute to the study of both international political economy and Japanese foreign economic policy. First, although the focus of this study is on domestic-level factors, it will also explore the reciprocal effect of an interdependent international economy on domestic factors and the other way around. How an interdependent international economy affect state behavior or state policy outcomes is one of the main questions in the study of international political economy. How state policy outcomes relate to international arrangement among nations is also worth exploring. Examining the relationship between the international economy and Japan's payments adjustment policy contributes to an understanding of these issues. This study therefore fills a gap in the existing literature on international political economy by bridging systemic-level and domestic-level approaches.

Second, this thesis provides a case featuring a state other than the United States. Most studies of international economic policies of states have focused on the United States as a case, because the United States plays a central role in the international economic system. However, in order to understand the nature of the international economic system, examining other countries' policies is essential.[44] The case of Japan, whose foreign economic policy choices are essential to the international economic and political relations considering the size of its economy, will be helpful to understanding international coordinated behaviors by states more precisely. Comparison with Germany's policy choice is also useful to provide comparative perspective on foreign economic policy.

Third, analyzing three cases drawn from different time periods but in the same issue-area, can highlight how policy formulation has changed over time. There are very few studies on Japanese politics which analyze foreign economic policy formulation in the same issue-area at two or more points in time. However, this study deals with Japan's payments adjustment policy formulation in three cases over time.

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[44] For example, as for international trade, Stein states that "liberal international trade regimes did not, and indeed will not, emerge from the policies of one state." Arthur A. Stein, "The Hegemon's Dilemma: Great Britain, the United States, and the International Economic Order," *International Organization*, vol. 38, no. 2 (Spring 1984), pp. 355-386.

Since Japan's economic position in the international economic system has also changed over time, this type of examination helps illuminate whether changing positions in the international system affect state choice of payments adjustment policy. Further comparison of cases in the same issue-area may shed light on the similarities and differences in the factors which influence policy formulation over time and contribute to understand the effect of an changing international economy on state policy.

Figure 1.1

Typology of Policy Instruments for Payments Adjustment

Policy Instruments	Payments Imbalances	
	Deficit	Surplus
Change in Exchange Rate	Devaluation (currency depreciation)	Revaluation (currency appreciation)
Macroeconomic Policy	Deflationary Policy (tight policy)	Inflationary Policy (expansionary policy)

Figure 1.2

State Choice of Policy Instruments for Payments Adjustment under the Bretton Woods System

Policy Instruments	Payments Imbalances	
	Deficit	Surplus
Change in Exchange Rate	<u>Devaluation</u> (France in the late 1940s and in the 1950s)*	<u>Revaluation</u> (Germany in the 1960s)
Macroeconomic Policy	<u>Deflationary Policy</u> (Japan in the 1950s and in the early 1960s) (Britain in the 1950s and in the 1960s)	<u>Inflationry Policy</u> (Japan in the late 1960s and 1971-73) *the United States in <u>deficit</u> cases in the 1960s

* In France's case, deflationary monetary policy was also applied.

Figure 1.3

Choice of Policy Instruments for Payments Adjustment

in the Post-Bretton Woods Period:

the United States, Germany, and Japan

Policy Instruments	Payments Imbalances	
	Deficit	Surplus
Change in Exchange Rate	Currency Depreciation (the United States) Gramm-Rudman-Hollings Act	Currency Appreciation (Japan and Germany)
Macroeconomic (Fiscal Policy)	Tight Policy	Dec. 1977 May 1987 (Japan) May 1978 1988 (Germany) Expansionary Policy

Table 1.1

Economic Conditions of Germany and Japan
in 1976-78 and in 1984-87

	Current Balance (percentage of GNP)		Consumer Prices (percentage changes from previous year)		Unemployment Rates (commonly-used definition)		Budget Deficit (percentage of government bond to annual expenditure)	
	Germany	Japan	Germany	Japan	Germany	Japan	Germany	Japan
1976	0.8	0.7	4.5	9.4	4.0	2.0	15.9	29.4
1977	0.8	1.6	3.7	8.2	3.9	2.0	12.9	32.9
1978	1.4	1.7	2.7	4.2	3.7	2.2	13.9	31.3
1984	1.6	2.8	2.4	2.3	8.2	2.7	11.4	24.8
1985	2.6	3.7	2.2	2.0	8.3	2.6	8.8	23.2
1986	4.4	4.4	-0.2	0.6	7.9	2.8	8.9	21.0
1987	4.0	3.6	0.2	0.1	7.9	2.8	10.4	18.1

Sources: *OECD World Economic Outlook*, No. 46 (December 1989); *Nihon no Zaisei, 1988* (Tokyo: Okurasho Insatsukyoku, 1988)

Chapter Two

Explaining State Choice:
Domestic Preferences and Political Structure

1. Introduction

Faced with external payments imbalances, states choose different policy instruments in parallel balance of payment position. Japan, more than any other industrial country, chose to apply macroeconomic policy under both the Bretton Woods system and the floating exchange rate system of the post-Bretton Woods era. This chapter proposes a framework which analyzes state policy choice of payments adjustment policy, and offers a hypothesis which explains state choice of payments adjustment policy. This framework will be helpful to address the main question of this thesis: under what conditions does a state choose to apply macroeconomic policy with respect to payments adjustment?

This chapter is divided into three sections. The first section will examine to what extent existing literature of payments adjustment and theories of foreign economic policy are appropriate for explaining state choice of payments adjustment. In this examination, the weaknesses of both systemic-level and domestic-level approaches will be evaluated.

In the second section, an analytical framework of examining state choice of payments adjustment policy will be proposed. This analytical framework puts emphasis on two factors: (i) domestic preferences regarding the exchange rate and (ii) political structure of payments adjustment policy, which responds to domestic preferences.

In the final section of this chapter, Germany's choices for payments adjustment policy will be examined, thereby offering a counterpoint to Japan's policy choice. Germany's choices are analyzed in terms of the analytical framework proposed in the preceding section. Germany and Japan became surplus states under the Bretton Woods system and increased their external surpluses throughout the 1980s. Despite their similar positions in the international economy as surplus countries, however, their attitudes towards payments adjustment in the 1970s and the 1980s were different. Germany was more reluctant to apply its macroeconomic policy, fiscal policy in particular, to international payments adjustment than Japan.

2. Explaining Payments Adjustment Policy

This section seeks to explain Japan's choice of payments adjustment policy. Before examining existing approaches to foreign economic policy in general, it is useful to review earlier studies which relate to the problem of international payments adjustment in the 1970s and the 1980s.

(1) Earlier Studies of Adjustment Policy

There are several studies that deal with the two cases of the problem of international payments imbalances, the cases of 1977-78 and 1985-87. These studies focus on the international policy coordination of macroeconomic policy including Japan's adjustment policy.[1] With regard to the first case, Destler and Mitsuyu, Putnam and Henning, and Putnam and Bayne offer the most important insights.[2] In the

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[1] The definition of policy coordination of macroeconomic policy varies among scholars. For example, they range from "decision making that maximizes joint welfare and thereby enables these international interdependencies to be positively exploited," to "agreements between countries to adjust their policies in the light of shared objectives or to implement policies jointly." See Horne and Masson, *op. cit.*, pp. 261-262. The Bonn summit meeting in 1978, the Plaza meeting in 1985, and the Louvre meeting in 1987 are regarded as successful cases of international policy coordination by these literature in terms of joint policy making.

[2] Putnam and Henning, *op. cit.*, Robert D. Putnam and Nicholas Bayne, *Hanging Together: Cooperation and Conflict in the Seven-Power Summits*, second edition (Cambridge: Harvard University Press, 1987), pp. 62-94, I. M. Destler and Hisao Mitsuyu, "Locomotives on Different Tracks: Macroeconomic Diplomacy, 1977-1979," in I. M. Destler and Hideo Sato, eds.,

second case, Henning and Funabashi prove most helpful.[3] Only a few studies deal with both cases (Iida).[4]

All of these studies focus on the problem of how international coordination of macroeconomic policy is achieved. The study by Destler and Mitsuyu focuses on the US-Japan negotiation process in 1977-79, and explains how and why the United State and Japan came to negotiate on "normally domestic matters" such as fiscal policy.[5] Destler and Mitsuyu argue that the United States pressured Japan to bringing macroeconomic policy into the negotiations and point out that U.S. pressure was used by "Japanese officials who were expansionists and/or internationalists" to formulate fiscal expansionary policy.[6]

The study by Putnam and Henning deals with the Bonn Summit of 1978 by focusing mainly on U.S. and German policy-making processes. As for Japan's policy, it argues briefly based on Destler and Mitsuyu's work that the Japanese state was not unitary, but internally divided.[7] Putnam and Bayne also stress this characteristic of Japanese policy making

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Coping with U.S.-Japanese Economic Conflicts (Massachusetts: Lexington Books, 1982), pp. 243-293.

[3] C. Randall Henning, "Macroeconomic Diplomacy in the 1980s: Domestic Politics and International Conflict among the United States, Japan, and Europe," *Atlantic Paper*, no. 65 (New York: Croom Helm, 1987), Yoichi Funabashi, *Managing the Dollar: From the Plaza to the Louvre*, second edition (Washington, D. C.: Institute for International Economics, 1989).

[4] Keisuke Iida, *The Theory and Practice of International Economic Policy Coordination*, Ph.D. Dissertation of Harvard University, 1990.

[5] Destler and Mituyu, *op. cit.*, p. 243.

[6] *Ibid.*, pp. 264.

[7] Putnam and Henning, *op. cit.*, pp. 70-71.

process in discussing the G-7 summit meetings among the leading industrial countries.[8]

As for the case of 1985-87, both Henning and Funabashi describe the process of negotiation among the United States, Germany and Japan. Henning summarizes Japan's domestic situation in the negotiation of payments adjustment.[9] Funabashi gives a much more detailed explanation of Japan's adjustment policy than Henning. Both argue that domestic policy-making process in Japan was internally divided within government.

Iida's work, whose primary purpose is to explain international policy coordination since the 1970s using parsimonious formal theory, examines Japan's adjustment policy. Unlike other works, Iida's strength is to make a distinction among three policy instruments -- exchange rate, monetary and fiscal policies -- and to refer to the domestic context of each policy instrument. However, although his work takes the most theoretically informed approach, with regard to states policy choices, his work does not pay much attention to the differences in the divided nature of domestic politics in three states; the United States, Germany and Japan.[10]

In sum, most of these studies, whose perspectives are different from that of this thesis, have focused primarily on the process of payments adjustment among states, that is, how

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[8] Putnam and Bayne, *op. cit.*, pp. 74-75.
[9] Henning, *op. cit.*, pp. 36-38.
[10] Iida, *op. cit.*, pp. 509-510.

states go about making decision by describing the strategies of government, bureaucrats, politicians, and other agencies like central banks. In this type of analysis, the process of negotiation among states lies at the center and bargaining is the key factor which determines policy choice.

To some extent, this type of analysis tells about domestic preferences, but does not devote much attention to the incentives and constraints regarding individual policy instrument in domestic politics, nor to the changing aspect of domestic preferences regarding those policy instruments while the payments adjustment problem continued to be discussed. It also fails to recognize precisely how domestic preferences are formulated and why these preferences shape a state policy choice.[11] In other words, previous works stressed the internally divided nature of Japanese policy making, but they do not closely examine why and how this divided nature was formulated and then affected policy choice. We need to understand under what conditions policy preferences regarding policy instruments emerged and influenced state policy choice. The next section will examine whether existing approaches to explaining incentives and constraints of foreign economic policy are relevant to explaining state choice of payments adjustment policy.

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[11] For the importance of domestic bias in state policy outcome, see Kenneth A. Oye, *Economic Discrimination and Political Exchange: World Political Economy in the 1930s and 1980s* (Princeton: Princeton University Press, 1992), chapter 4.

(2) Existing Approaches to Foreign Economic Policy

There are two types of existing approaches to explaining incentives and constraints affecting a state's choice of foreign economic policy; one focuses on the international system, the other emphasizes domestic structures. Since payments adjustment policy is considered to be foreign economic policy, it is useful to review these types of existing approaches. This section will examine the weakness of systemic-level approaches, which hinder full understanding of state choice of payments adjustment policy, and suggest the need to fill a gap between systemic-level approach and domestic-level approach in explaining state choice of payments adjustment policy.

(i) Systemic-level approach

Systemic-level approaches emphasize the influence of the international distribution of power and the role of the nation-state system on foreign economic policy. In this approach, the state is considered a unitary actor. There are three major theories at systemic-level approaches: (i) theories of hegemonic stability; (ii) theories of international regimes; and (iii) game theory.

Theories of hegemonic stability argue primarily that the existence of a hegemonic power is a necessary condition for maintaining a liberal international market economy by analyzing power distribution among states.[12] According to this theory, international cooperation is unlikely to occur when the hegemonic state declines.[13] This argument thus cannot fully explain why Germany and Japan undertook cooperative behavior by applying macroeconomic policies for payments adjustment, at the urging of the United States during 1977-78 and 1985-87, a time the United States has lost its dominant, hegemonic position in the international economy.

Some have argued, however, that the United States has not declined to the extent that it loses its hegemonic position in international relations. Although other states have come close to the U.S. position, the relative distribution of power still favors the United States.[14] This type of criticism of the argument of lost hegemony suggests that since the United States remains the strongest power in

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[12] Robert Gilpin, *U.S. Power and the Multinational Corporation: The Political Economy of Foreign Direct Investment* (New York: Basic Books, 1975), Stephen D. Krasner, "State Power and the Structure of International Trade," *World Politics* 28 (April 1976), pp. 317-43, Robert O. Keohane, "The Theory of Hegemonic Stability and Change in International Economic Regimes, 1967-1977," in Ole Holsti, Randolf M. Siverson, and Alexander L. George, eds., *Changes in the International System* (Boulder: Westview Press, 1980), pp. 131-62.

[13] For the argument of the hegemonic stability theory, see Robert Gilpin, *The Political Economy of International Relations*, pp. 86-92.

[14] Bruce Russet, "The Mysterious Case of Vanishing Hegemony; or, Is Mark Twain Really Dead?" *International Organization* 39 (Spring 1985), pp. 207-32, Susan Strange, "Cave! Hic Dragons: A Critique of Regime Analysis," in Stephen D. Krasner, ed., *International Regimes* (Ithaca: Cornell University Press, 1983), pp. 337-54; "The Persistence Myth of Lost Hegemony," *International Organization*, vol. 41, no. 4 (Autumn 1987), pp. 551-75.

international relations, international cooperation can be explained by the existence of the hegemonic state. Cooperative attitudes by states, according to this theory, are products of the hegemon's influence, both benevolent and coercive fashion. However, since the definition of hegemony tend to include not only economic power but also military power, knowledge and cultural influence, it is not clear how the aggregation of these factors affects individual state policy choice in certain issue-area such as payments adjustment.

Among hegemonic stability theories, some versions aim to explain more rigorously the relations between foreign economic policy choice and international economic structure. This argument claims that the relative position of states in the international economic system leads to different foreign economic policy outcomes. David Lake, for example, argues that, although his primary focus is on U.S. trade policy, Japan would become a supporter of U.S. trade policy in the late 1980s because of its changing position in the international economy.[15] Lake also suggests that fears of retaliation promote cooperation among intermediate states. According to this analysis, Japan's policy choices are

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[15] David A. Lake, "Beneath the Commerce of Nations: A Theory of International Economic Structures," *International Studies Quarterly* 28, 1984, pp. 143-70; "International Economic Structures and American Foreign Economic Policy, 1887-1934," *World Politics*, vol. 35, no. 4 (July 1983), pp. 517-541; *Power, Protection, and Free Trade: International Sources of U.S. Commercial Strategy, 1887-1939* (Ithaca: Cornell University Press, 1988).

determined by power configuration among states. However, this argument has trouble explaining the difference between Japan's response and Germany's to adjustment problem despite their similar positions in international economic system. Therefore, it is hard to understand the causality between systemic-level variables and pattern of state policy choices without examining domestic structure.

Theories of international regimes argue that international regimes play an intervening role between the international system, with power distribution among nations, and foreign economic policy outcomes.[16] In this view, cooperative attitudes by Japan and Germany with the United States regarding payments adjustment at the Bonn and the Plaza summits can be attributed to the persistence of international regimes, which facilitate international policy coordination, despite the relative decline of U.S. economy.

However, compared to the international trade regime of the General Agreement on Tariffs and Trade (GATT), there are various arguments about whether the international monetary regime, which was established as the Bretton Woods system, broke down or still persists. According to those who argue that the Bretton Woods system collapsed, it is hard to explain coordinated efforts of states in terms of the

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[16] Stephen D. Krasner, ed., *International Regimes, op. cit.*, Robert O. Keohane, *After Hegemony: Cooperation and Discord in the World Political Economy* (Princeton: Princeton University Press, 1984).

existence of an international regime.[17] In these arguments, the breakdown of the Bretton Woods system means the end of the fixed exchange rate system whose principle was established to achieve adjustment of payments imbalances among nations in 1944. On the contrary, those who emphasize the continuity of the basic principles and norms underlying the regime, or "embedded liberalism," claim that an international regime plays an important role in facilitating coordinated behavior among nations even after the 1970s.[18] As Keohane argues, "The interest of the Europeans and Japanese in a liberal international monetary regime, coupled with their belief that maintenance of such a regime was feasible, made them willing to continue to cooperate with the United States despite its demand for a restructuring of the old Bretton Woods arrangements."[19] In this view, the definition of regime is not only explicit order, but also Krasner's broader definition of regimes as "implicit or

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[17] For the studies which argue that the Bretton Woods system broke down in the early 1970s, see Robert O. Keohane and Joseph S. Nye, *Power and Interdependence: World Politics in Transition* (Boston: Little Brown, 1977), pp. 82-83, Alfred E. Eckes, *A Search for Solvency: Bretton Woods and the International Monetary System, 1941-1971* (Austin: University of Texas Press, 1975), pp. 265-267, Fred L. Block, *The Origins of International Economic Disorder: A Study of U.S. International Monetary Policy from World War II to the Present* (Berkeley: University of California Press, 1977), pp. 203-204.

[18] John Ruggie, "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order," in Krasner, ed., *ibid.*, pp. 195-232. Benjamin Cohen describes the principles of balance-of-payments financing as "embedded liberalism" in international monetary relations, Benjamin J. Cohen, "Balance-of-payments Financing: Evolution of a Regime," in Krasner, ed., *ibid.*, pp. 315-336.

[19] Keohane, *After Hegemony, op. cit.*, pp. 209-210.

explicit principles, norms, rules and decision-making procedures around which actors' expectations coverage in a given area of international relations."[20]

According to theories of regimes, regimes affect the behaviors of states to cooperate with each other, but it is important to know how an international regime, defined in terms of these broad concepts, affects state behavior. Rational choice theorists argue that regimes alter the situation in which states interact, for example, by reducing uncertainty, limiting the number of players, and transforming the structure of payoff so that cooperation is more likely to occur.[21] Others put more emphasis on the role of norms and ideology in formulating actor's preferences.[22] Regarding payments adjustment, it is difficult to know whether or how an international regime, that is, "embedded liberalism," affects state behavior. The period of the Bretton Woods system, according to theories of international regimes, is regarded as a typical case in which international regime shaped state behavior.[23] As examined in the previous chapter, however, even under the Bretton Woods system, policy choices of payments adjustment policy were different among

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[20] Stephen D. Krasner, "Structure Causes and Regime Consequences: Regimes as Intervening variables," in Krasner, ed., *ibid.*, pp. 1-21.
[21] Robert Axelrod and Robert O. Keohane, "Achieving Cooperation Under Anarchy: Strategies and Institutions," *World Politics*, vol. 38, no. 1 (October 1985), pp. 249-251.
[22] Ruggie, *op. cit.*, Robert O. Keohane, "International Institutions: Two Approaches," in Keohane, *International Institutions and State Power* (Colorado: Westview Press, 1989), pp. 170-175.
[23] Keohane, *After Hegemony, op. cit.*, p. 184.

countries. It is therefore important to understand why some states adhered to the principle of the fixed exchange rate system and others did not in terms of payments adjustment. To do so, it is necessary first to open the "black box" of domestic politics.[24]

Systemic-level approaches have also applied in game theory to analyze international cooperation. Game theory assumes that the state is a unitary and rational choice actor, who acts based on a payoff matrix of the costs and benefits of each state.[25] Yet one of the most crucial limitations of game theory, as many scholars have pointed out, is game theory's tendency to calculate state preferences only at the international systemic-level, ignoring the fact that state preferences are quite often influenced by domestic politics. It is hard to assume state preferences only in terms of power distribution among nations.[26] In order to understand correctly incentives and constraints on state choice, it is necessary to inquire whether or not domestic

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[24] Stephan Haggard and Beth A. Simmons, "Theories of International Regimes," *International Organization*, vol. 41, no. 3 (Summer 1987), pp. 513-517.

[25] For example, Keohane, *After Hegemony, op. cit.*, Robert Axelrod, *The Evolution of Cooperation* (New York: Basic Books, 1984), Kenneth A. Oye, ed., *Cooperation Under Anarchy* (Princeton: Princeton University Press, 1986), Joseph M. Grieco, *Cooperation Among Nations: Europe, America, and Non-tariff Barriers to Trade* (Ithaca: Cornell University Press, 1990).

[26] Joanne Gowa, "Anarchy, Egoism, and Third Images: The Evolution of Cooperation and International Relations," *International organization*, vol. 40, no. 1 (Winter 1986), pp. 167-85, Benjamin Cohen, "The Political Economy of International Trade," *International Organization*, vol. 44, no. 1 (Spring 1990), pp. 276-78, Milner, *op. cit.*, p. 467.

factors affect state choice in policy formulation. If there is no significant effect of domestic factors on state choice, we could assume that state is a unitary actor.

As for Japan's foreign economic policy, international pressure is regarded as a main factor in producing policy outcomes. Thus, Japan is defined as a "reactive state."[27] International pressure is the influence from international system.[28] No one doubts that international pressure plays an important role in Japan's foreign economic policy making, especially when compared with other countries; however, the mere existence of international pressure does not account for developments in some issue areas such as market liberalization.[29] This implies that the impact of international pressures depends on issue-area. In the cases of payments adjustment policy this thesis deals with, it can be recognized that international pressure, especially the pressure from the United States, on Japan to alter its macroeconomic policy to adjust its external payment imbalances put influence on Japan's policy choice. However,

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[27] Kent E. Calder, "Japanese Foreign Economic Policy Formation: Explaining the Reactive State," *World Politics*, vol. 40, no. 4 (July 1988), pp. 517-541.
[28] The term international pressure, when used in explaining foreign economic policy, needs more precise definition. International pressure includes two kinds of external pressures. One is political pressure exerted by foreign country to alter the other country's economic policy. The other is international market pressure derived from international economic structure. *Gaiatsu*, which is used particularly regarding Japan's foreign policy, means the former kind of international pressure.
[29] One of typical examples is a market liberalization in rice.

although there was constant international pressures on Japan throughout the cases, the mere existence of international pressures does not explain why Japan decided to change its fiscal policy, despite prior strong resistance to such changes. In order to better understand what role international pressures play in domestic politics, we need to focus on the domestic-level.[30]

The process of external payments adjustment, of course, is affected by systemic-level factors. However, systemic-level approaches alone do not fully explain the nature of state choice of payments adjustment policy. Further, without knowing the systemic constraints and incentives affecting state choice, policy choices also cannot be understood. Therefore, it is important to know the relationship between international systemic-level factors and domestic-level factors. As Putnam claims, "It is fruitless to debate whether domestic politics really determine international relations, or the reverse." and "The more interesting questions are 'When?' and 'How?'"[31]

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[30] Calder particularly attributes the nature of "reactive state" to Japan's domestic political structure, that is, fragmentation of decision-making authority and state's unusual sensitivity to interest groups. Calder, *Ibid.*, pp. 528-532.

[31] Robert D. Putnam, "Diplomacy and Domestic Politics: the Logic of Two-Level Games," *International Organization*, vol. 42, no. 3 (Summer 1988), p. 427.

(ii) Domestic-level approach

In order to explain fully individual state's foreign economic policy choices, many scholars of international political economy have agreed on the importance of opening the "black box" of domestic politics. The problem is how.

In the analysis of U.S. foreign economic policy, there are two types of domestic-level approaches to opening the "black box": a society-centered approach and a state-centered approach.[32] The society-centered approach emphasizes the pluralistic nature of the society. In this approach, policy outcomes are the product of power relations among societal actors and the state is a mere reflection of societal demands. This approach focuses on interest groups, such as firms, industry associations and trade unions.[33] These studies, which focus mainly on U.S. trade policy, argue that knowing the policy preferences of interest groups is

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[32] Generally state-society means public-private distinction, but definitions of state and society are divergent among scholars. For example, in Katzenstein's definition, society represents "the relations of production (including industry, finance, commerce, labor, and agriculture)" and state derives from "the structure of political authority (primarily the state bureaucracy and political parties)." Peter J. Katzenstein, "Introduction: Domestic and International forces and Strategies of foreign Economic Policy," in Katzenstein, ed., *op. cit.*, p. 19.

[33] Early prominent works in this approach are E. E. Schattschneider, *Politics, Pressures and the Tariff* (New York: Prentice-Hall, 1935), Raymond A. Bauer, Ithiel de Sola Pool, and Lewis Anthony Dexter, *American Business and Public Policy: The Politics of Foreign Trade*, second edition (Chicago: Aldine-Atherton, 1972). For recent works, see Helen V. Milner, *Resisting Protectionism: Global Industries and the Politics of International Trade* (Princeton: Princeton University Press, 1988), Jeff Frieden, "Sectoral Conflict and Foreign Economic Policy, 1914-1940," *International Organization*, vol. 42, no. 1 (Winter 1988), pp. 59-90.

essential to understanding policy outcomes, such as protectionism.

In contrast, the state-centered approach stresses the state as an important variable in explaining foreign economic policy.[34] This approach puts emphasis on the autonomous aspects of the state in foreign economic policy, and reflects the emergent interest in the state in American political science over the past two decades; political analysis used to pay much less attention to the state than to the society.[35] In this approach, as distinct from the society-centered approach, there are a number of studies on various issues of foreign economic policy such as monetary policy and energy policy.[36]

The state-centered approach does not simply imply that the state plays an exclusive autonomous role in policy making. The contribution of this approach is to shed light

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[34] The concept of state varies depends on scholars. See Stephen D. Krasner, "Approaches to the State: Alternative Conceptions and Historical Dynamics," *Comparative Politics*, vol.16 (January 1984), pp. 223-246. Gabliel A. Almond, "The Return to The State," *American Political Science Review*, vol. 82, no. 3 (September 1988), pp. 853-873.
[35] Theda Skocpol, "Bringing the State Back In: Strategies of Analysis in Current Research," in Peter B. Evans, Dietrich Rueschemeyer and Theda Skocpol, eds., *Bringing the State Back In* (New York: Cambridge University Press, 1985), pp. 3-37.
[36] Stephen D. Krasner, "United States Commercial and Monetary Policy: Unraveling the Paradox of External Strength and Internal Weakness," in Katzenstein, ed., *op. cit.*, pp. 47-66, G. John Ikenberry, *Reasons of State: Oil Politics and the Capacities of American Government* (Ithaca: Cornell University Press, 1988), G. John Ikenberry, David A. Lake, and Michael Mastanduno, "Introduction: Approaches to Explaining American Foreign Economic Policy," *International Organization*, vol. 42, no. 1 (Winter 1988), pp. 1-32, Judith Goldstein, "Ideas, Institutions, and American Trade Policy," *International Organization*, vol. 42, no. 1 (Winter 1988), pp. 179-217.

on the importance of state-society relations in policy making. In this sense, the state-centered approach seeks to go beyond the bureaucratic politics model, which limits the scope of analysis to the policy making process among a limited group of bureaucrats.[37] For example, the argument of strong/weak state explains policy outcomes in terms of the degree of state strength to societal actors. Nevertheless, this argument is vague about how to evaluate state autonomy or state strength, and how to measure state strength to what societal actors.[38] Here, the key is to know how relations between state and society shape the formulation of foreign economic policy under the influence of international factors.

Unlike the studies of U.S. policy making, studies of Japanese foreign economic policy emphasized the role of the state, focusing upon state actors. These approaches include the bureaucratic model, ruling triumvirate model, and pluralistic model. The bureaucratic model stresses overwhelming role of bureaucrats in Japanese policy making in both the pre- and post-World War II period.[39] The ruling

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[37] For the bureaucratic politics model, for example, see Graham T. Allison, *Essence of Decision: Explaining the Cuban Missile Crisis* (Boston: Little Brown, 1971).

[38] Katzenstein, "Introduction," *op. cit.*, pp. 15-20; "Conclusion: Domestic Structures and Strategies of Foreign Economic Policy," in Katzenstein, ed., *op. cit.*, pp. 295-336; Krasner, *ibid.*; *Defending the National Interest: Raw Materials Investments and U.S. Foreign Policy* (Princeton: Princeton University Press, 1978).

[39] Seimei Tsuji, *Shinban; Nihon Kanryosei no Kenkyu* [Hereafter, for English translation, see Bibliography.] (Tokyo: Tokyodaigaku Shuppankai, 1969). American scholars have also paid attention to the role of bureaucrats. Chalmers Johnson's work on economic bureaucrats fits in this category, although his positive evaluation of the role of

triumvirate model, which was developed from the early bureaucratic model, stresses the dominant role of three actors: the Liberal Democratic Party (LDP), bureaucrats and big business.[40] The argument of "strong state" is similar to these models. According to this argument, Japan as well as France is identified as "strong state", because the Japanese state is autonomous from societal actors and powerful in making policies.[41]

Although the "pluralistic model" of Japanese policy making does not see policy making as monopolized by the ruling class, it does acknowledge that government and administrative structures have a certain impact on policy making.[42] Therein lies a key difference from the American pluralistic model, in which government and administrative

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bureaucrats contrasts to previous Japanese scholars' negative evaluation. Johnson attributes Japanese high economic growth to the industrial policies which were guided by the Ministry of International Trade and Industry (MITI). See Chalmers Johnson, *MITI and Japanese Miracle* (Stanford: Stanford University Press, 1982), John Zysman, *Government, Markets, and Growth* (Ithaca: Cornell University Press, 1987).

[40] Shigeo Misawa, "Seisaku Kettei-katei no Gaikan," in *Nihon Seiji Gakkai Nenpo* (Tokyo: Iwanami Shoten, 1967), pp. 5-33, Chitoshi Yanaga, *Big Business in Japanese Politics* (New Haven: Yale University Press, 1968). The ruling triumvirate model was also influenced by the injection of Marxist class struggle interpretation to Japanese policy making. The underlying assumption of this model is that there is unanimous consensus of interests among elites, that is, ruling triumvirate, and ruling elites monopolize Japanese policy making process.

[41] Peter J. Katzenstein, "Conclusion: Domestic Structures and Strategies of Foreign Economic Policy," in Katzenstein, *op. cit.*, pp. 295-336.

[42] For Japanese "pluralistic model", see Hideo Otake, *Gendai Nihon no Seijikenryoku Keizaikenryoku* (Tokyo: San'ichi Shobo, 1979), Michio Muramatsu, *Sengo Nihon no Kanryosei* (Tokyo: Toyokeizai Shimpo-sha, 1981), Takashi Inoguchi, *Gendai Nihon Seijikeizai no Kozu* (Tokyo: Toyokeizai Shimpo-sha, 1983).

structures do not have any significant impact on policy making.[43] In the Japanese "pluralistic model," therefore, recent studies, which argue that ruling actors are not unitary and often conflict each other, are likely to focus on the role of the LDP in policy making compared to bureaucrats.[44] By focusing on power relations between bureaucrats and the LDP, these studies help reflect the increasing role of the LDP in certain issues; still they tend to limit their focus on relations between the bureaucrats and the LDP. This dichotomous argument offers little analysis of how the interaction between state and societal actors matters in particular issue-area such as foreign economic policies and under what circumstances or in what kinds of issue-areas bureaucrats are more influential than political parties, and vice versa.

Exploring these domestic-level approaches leads us to realize that examining the state-society relations is important to understanding more precisely the incentives and constraints facing state choice in relation to international relations. We can begin with the simple assumption that any policy change which causes uneven distribution of cost and benefits needs political support. As Gourevitch claims,

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[43] Yasushi Yamaguchi points out the importance of difference of political system which shapes policy process between Japan and other countries, such as the United States. See Yasushi Yamaguchi, *Seiji Taisei* (Tokyo: Tokyo Daigaku Shuppankai, 1989).

[44] For example, Seizaburo Sato and Tetsuhisa Matsuzaki, *Jiminto Seiken* (Tokyo: Chuokoron-sha, 1986), Muramatsu, *op. cit.*

The state's autonomy or the lack thereof, the power of society or its lack of power, both turn on the interaction between goals and systems of decision making. In this sense, the autonomy of the state has a social base: for state autonomy to exist for specific purposes, the state must be able to obtain support, of differing kinds, from societal actors.[45]

Existing studies which deal with state-societal interactions apply a broad structure to explain various issue-areas.[46] However, since such interactions vary depending on issue-areas, in order to understand the policy choices more precisely, we have to examine the both state and societal (domestic) preferences in each issue-area. If we find no societal preferences in one issue-area, we have to understand why there is no societal preferences in that issue-area. If there is any representation of societal preferences in another issue-area, we have to reveal how societal preferences affect policy choice in this issue-area.

Payments adjustment policy is regarded as a typical issue-area in which a limited number of policy makers make their policy choices autonomously, apart from the society. Therefore, the choice of payments adjustment policy had been formerly argued solely in terms of bureaucratic model. This observation is true in the sense that, ultimately, a few policy makers do make policy choices, but policy choices can

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[45] Peter Gourevitch, *Politics in Hard Times: Comparative Responses to International Economic Crises* (Ithaca: Cornell University Press, 1986), p. 238.
[46] See Katzenstein's analysis of "policy network," *op. cit.*, "Conclusion."

rarely be made without considering society's supports or preferences. This thesis will examine the cases with particular emphasis on two aspects of foreign economic policy. The first aspect is how the international economy affect state choices in payments adjustment policy. The second is how state choice was related to societal (domestic) preferences regarding payments adjustment policy.

3. Analytical Framework for Payments Adjustment Policy

(1) Distributional Consequences of Policy Choice in Domestic Politics

Choosing a certain policy entails the domestic allocation of the costs and benefits which are derived from such a policy choice. Existing studies of international policy coordination of payments adjustment pay attention to the economic consequences of policy choices, but fail to recognize the effects of choosing certain policy instrument on domestic politics. Different policy instrument causes different, often uneven domestic distributional consequences. Such distributional consequences can provoke representation of domestic preferences regarding policy instruments and affect the formulation of payments adjustment policy.

Whether the domestic distributional consequences of policy choice affects payments adjustment policy depends on two factors. One is whether the distributional consequences of choosing certain policy instrument provoke domestic preferences regarding payments adjustment policy. The other factor is whether the political structure translates such domestic preferences, if any, into the formulation of payments adjustment policy

In terms of these two factors, there is conventional understanding regarding policy instruments of payments adjustment policy such as changes in exchange rates and macroeconomic policy. It is said that in exchange rate policy, there is little activity from interest groups and a limited number of bureaucrats make policy choices autonomously from domestic preferences. Thus, changes in exchange rates are relatively easily applied to payments adjustment policy and do not much affect policy choice of other policy instruments of payment adjustment policy.[47]

It is also said that in macroeconomic policy, by contrast, policy-makers are constrained by domestic political pressures, because the primary concern of macroeconomic policy is over the domestic economy and macroeconomic policy is discussed mainly in terms of domestic objectives. Fiscal policy, in particular, is difficult to change for the purpose of payments adjustment, because it needs to be authorized by

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[47] Krasner, "United States Commercial and Monetary Policy: Unraveling the Paradox of External Strength and Internal Weakness," *op. cit.*, pp. 64-66, Odell, *op. cit.*, Joanne Gowa, "Public Goods and Political Institutions: Trade and Monetary Policy Processes in the United States," *International Organization*, vol. 42, no. 1 (Winter 1988), pp. 15-32

legislature.[48] Thus, if payments adjustment required change in existing macroeconomic policy, macroeconomic policy is rarely applied for payments adjustment.

The next section begins by reconsidering the conventional understanding of policy instruments of payments adjustment, and proposes a hypothesis for explaining state choice of payments adjustment policy: domestic preferences regarding the exchange rate and political structure responding to such preferences are two important factors in explaining state choice.

(2) Politicization of Changes in Exchange Rates: Domestic Preferences

Exchange rate policy, it is generally assumed, is relatively easy to apply for payments adjustment, because changes in exchange rates do not provoke disputes in domestic politics, unlike other policy instruments such as macroeconomic policy. Scholars argue that there is little representation of domestic preferences for monetary policy including exchange rate policy. A typical observation is that "the monetary system does not bring to mind any particular groups whose vital interests are at stake."[49]

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[48] As for politicization of fiscal policy, see, for example, James M. Buchanan and Richard E. Wagner, *Democracy in Deficit* (New York: Academic Press, Inc., 1977).
[49] Janet Kelly, "International Monetary Systems and National Security," in Klauss Knorr and Frank N. Trager, ed., *Economic*

There are some explanations for this observation. Stephen D. Krasner, in a comparative study of U.S. trade and monetary policy, concludes that "there is less diffusion of power with respect to international monetary policy making."[50] Krasner regards monetary policy as unusual in U.S. decision making because "it is decided in a small number of arenas that are insulated from societal pressures."[51] John S. Odell and Joanne Gowa attribute little representation of domestic interests in exchange rate policy to the inactivity of interest groups. Odell, in examining U.S. international monetary policy in the Bretton Woods period, regards "the esoteric nature of the subject of international monetary policy and ignorance on the part of group leaders" as the cause of inactivity of interest groups.[52] According to Odell's explanation, the costs and benefits for group welfare of dollar devaluation are too diffuse to measure by anyone, and hence no activity of interest groups.

Gowa's explanation is based on Mancur Olson's logic of collective action.[53] By defining U.S. trade and monetary policy in terms of public goods, Gowa argues,

> For those groups hurt by the rise in the effective exchange rate of the dollar - whether under Bretton Woods or the subsequent floating-rate system - a dollar devaluation

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Issues and National Security (Lawrence, Kansas: Regents Press of Kansas), p. 240.

50 Krasner, *op. cit.*

51 *Ibid.*, p. 66.

52 Odell, *op. cit.*, pp. 347.

53 Gowa, *op. cit.*, Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (Cambridge: Harvard University Press, 1965).

was a distinctly non-excludable good: no individual could be prevented from benefiting from the change, whether or not he had contributed to it. Thus, there was no conceivable excludability for groups adversely affected by the overvaluation of the dollar.[54]

These conventional explanations are based on the U.S. experience, which has spawned the assumption that there is little representation of interest groups in the issue-area of exchange rate policy. Unfortunately, whether this assumption is relevant to the cases of other industrial countries requires further case studies of other countries.

Effects of changes in exchange rates, although it affect international capital transactions, are actually diverse and difficult to estimate. Although revaluation or appreciation generally lowers the price of imports and raises the price of exports, devaluation or depreciation has the opposite effects. Still, it is hard to estimate precisely the effect of changes in exchange rates on each societal actor. Thus, there is little preferences for and against exchange rate policy. Odell's and Gowa's explanations are based on this nature of economic consequences of changes in exchange rates.

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[54] Gowa, *ibid.*, p. 26. Gowa refers to the activity of U.S. domestic interest groups against the rise of the dollar during the early 1980s, but she evaluated such activity as little for the damage of the rise of the dollar. For the activity against the rise of the dollar in the United States, see I. M. Destler and C. Randall Henning, *Dollar Politics: Exchange Rate Policymaking in the United States* (Washington, D. C.: Institute for International Economics, 1989), chapter 7.

Nevertheless, if societal groups recognize or expect the costs and benefits for them caused by changes in exchange rates, there would be representation of societal preferences regarding changes in exchange rates.[55] Export-oriented industries might be against the appreciation of currency, since the competitiveness of exports would undermined by such appreciation. Industries which rely on imported intermediate products and raw materials might be for currency appreciation because the price levels of imported materials is lowered through such appreciation. For the same reason, import-competing industry might be opposed to currency appreciation. International banking probably is for currency appreciation or volatility of exchange rates, so that it can take advantage of the strong currency. Consumers also might be for currency appreciation, because appreciation stabilizes price levels.

According to conventional explanations, however, there is little representation of domestic preferences regarding changes in exchange rates in the United States, but different pattern of domestic preferences might be found in other countries. Knowing the pattern of representation of domestic preferences regarding policy instruments is important to understanding state policy choice of payments adjustment policy.

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[55] For this assumption, see Jeffery A. Frieden, "National Economic Policies in a World of Global Finance," *International Organization*, vol. 45, no. 4 (Autumn 1991), pp. 444-449.

(3) Political Structure Responding to Domestic Preferences

If the political structure translates domestic preferences into the formulation of policy choice, domestic preferences would affect state policy choices. In other words, extent to which domestic preferences affect policy choice depends on the characteristics of domestic political structure. The characteristics of political structure regarding payments adjustment policy is determined mainly by the relations between state officials (bureaucrats) and political parties.

In payments adjustment policy, there is two main policy instruments: changes in exchange rates and macroeconomic policy. In these issue-areas, state officials want to make policy choices autonomously from domestic political pressures, while political parties usually reflect domestic preferences regarding policy choice. The financial ministry and the central bank are the major responsible state officials in charge of these issue-areas. Exchange rate policy is regarded as autonomous issue-area from political parties. In macroeconomic policy, there is a common assumption regarding state officials and political parties -- state officials and political parties have different interests. The financial ministry is much more concerned with balanced-budget than political parties. The central bank is more concerned with stable price levels than political parties. Political parties, in contrast, are more concerned with employment and economic growth than the budget deficit and the risk of inflation.[56]

In political parties, however, there might be differences in policy orientations with regard to macroeconomic policy. Conservative parties pursue more restrictive policies, while left-wing parties pursue more expansionary policies.[57] Although whether this assumption is relevant is still in question, it can be assumed that the relationship between state officials and political parties is affected by the degree of the convergence of political parties' policy orientations.[58] When the policy orientations of political parties, which respond to domestic preferences, are unanimous on a desirable policy, which is different from

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[56] For U.S. case, Paul E. Paterson and Mark Rom, "Macroeconomic Policymaking: Who Is in Control?" in John E. Chubb and Paul E. Paterson, *Can the Government Govern?* (Washington, D. C.: The Brooking Institution, 1988), pp. 139-182. For the role of central banks, John T. Woolley, "Central Banks and Inflation," in Leon N. Lindberg and Charles S. Maier, eds., *The Politics of Inflation and Economic Stagnation: Theoretical Approaches and International Case Studies* (Washington, D. C.: The Brookings Institution, 1985), pp. 318-351, John B. Goodman, *Monetary Sovereignty: The Politics of Central Banking in Western Europe* (Ithaca: Cornell University Press, 1992). For the budget making, see Aaron Wildavsky, *Politics of the Budgetary Process*, forth edition (Boston: Little, Brown, 1984), Buchanan and Wagner, *op. cit.*

[57] For example, see Douglas A. Hibbs, Jr., "Political Parties and Macroeconomic Policy," *American Political Science Review* 71 (December 1977), pp. 1467-1487.

[58] For criticism of Hibbs' assumption, as for the United States, see Nathaniel Beck, "Parties, Administrations, and American Macroeconomic Outcomes," *American Political Science Review*, vol. 76 (March 1982), pp. 83-94; as for European countries, see James E. Alt, "Political Parties, World Demand, and Unemployment: Domestic and International Sources of Economic Activity," *American Political Science Review*, vol. 79 (December 1985), pp. 1016-1040.

policy orientation of state officials, political parties are influential in policy formulation. By contrast, when policy orientations are fragmented or conflicted, there is room that state officials gain an autonomous flexibility in policy choice.

Thus, in payments adjustment policy, knowing how political parties respond to domestic preferences or how political parties translate domestic preferences into their policy orientations is important to explaining state choice. Domestic preferences against exchange rate policy might prefer applying macroeconomic policy, and domestic preferences against applying macroeconomic policy might favor changes in exchange rates. How these preferences are translated into political arena depends on policy orientations of political parties.

4. Germany's Policy Choices: For the Comparison with Japan

Are the two factors proposed in the preceding section relevant to explaining state choice of payments adjustment policy? This section examines Germany's policy choices for payments adjustment in terms of these two factors to see whether these factors are relevant variables in explaining state policy choice of payments adjustment policy. Comparison with Germany, a surplus country with a similar position in the international economy since the 1960s, is useful to understanding the difference of state choices in parallel economic circumstances.

(1) Different Attitudes towards Changes in Exchange Rates: Germany and Japan

Germany and Japan pursued a similar course in the postwar period, both becoming surplus countries in the international economy. After the defeat of the World War II, they reconstructed their economies mainly on the basis of export strength. In Germany, gross national product (GNP) doubled from 1960 to 1976, and in Japan, GNP nearly tripled for the same period. In Germany, the ratio of exports to GNP was 18.5 percent in 1970, 22.8 percent in 1976, and 27.6 percent in 1984. In Japan, the same ratio was 9.5 percent in 1970, 12.0 percent in 1976, and 13.5 percent in 1984. Germany's export dependence is far larger than those of the United States and Japan (See Table 2.1).

[TABLE 2.1 ABOUT HERE]

Under the Bretton Woods system, both countries became surplus countries by expanding trade. Each maintained a payment surplus in most of the 1970s and the 1980s. In 1977, Germany increased its surplus to about $4 billion, and

Japan's surplus amounted to $11 billion in 1977 from $4 billion in 1976. The United States shifted its current account balance from a $4 billion surplus in 1976 to a $14 billion deficit in 1977. In 1985, Germany's surplus reached $17 billion, about 2.1 percent of its GNP and Japan's surplus amounted $49 billion, about 3.7 percent of its GNP. The United States accumulated its current account deficit to $113 billion, about 3 percent of its GNP (See Table 2.2).

[Table 2.2 About Here]

Despite their similar positions in the international economy in terms of balance of payment position, facing increasing external surplus, Germany and Japan chose different policy instrument under the Bretton Woods system. Germany chose revaluation, while Japan applied expansionary macroeconomic policy. During the 1970s and the 1980s, despite the similar domestic problem of budgets deficits, German and Japanese attitudes toward adjustment of external surplus were diverged. Germany was more reluctant to apply its fiscal policy to payments adjustment than Japan. What made this different policy choices in adjustment policies in Germany and Japan?

There are two possible explanations. The first explanation attributes the difference to the different structures of trade with the United States between Germany and Japan. Japan was more dependent on the United States in trade than Germany, although total export dependence ratio was smaller than that of Germany, and hence Japan was more reluctant to revalue or appreciate its currency than Germany, because the higher value of its currency would make Japanese exports more expensive in the United States (See Table 2.3).[59]

[TABLE 2.3 ABOUT HERE]

This difference of trade structures might be a part of explanation of the different attitude of two countries during the Bretton Woods system, but does not fully explain two countries' attitudes during the 1970s and the 1980s. In the late 1960s, Japan heavily relied its exports on U.S. market, and Japan did not choose revaluation, despite U.S. implicit request to revalue the yen. Japan's export to the United States was still larger than Germany's export to the United States after the 1970s, but Japan was more likely to agree to apply macroeconomic policy at the same time of yen

[59] For the argument that power arises from an asymmetrical interdependence, see Albert Hirschman, *National Power and the Structure of Foreign Trade* (Berkeley: University of California Press, 1945), Robert O. Keohane and Joseph S. Nye, Jr., *op. cit.*, Klaus Knorr, "International Economic Leverage and Its Uses," in Klaus Knorr and Frank Trager, eds., *op. cit.*, pp. 99-126.

appreciation with respect to payments adjustment than Germany.

It is therefore hard to know whether different trade relations with the United States is a direct source of different attitudes between Japan and Germany. It needs to examine how trade dependence was perceived in domestic politics of Japan.

The second explanation is related to the first. It is argued that since Japan's export dependence on the United States was larger than Germany's dependence, U.S. political pressure such as threat of protectionism put more pressures on Japan than on Germany. This is a powerful explanation. As for the different attitudes of two countries during the 1970s and the 1980s, in this explanation, threat of protectionism could put more pressures on Japan to reduce trade surplus than on Germany. However, it does not explain the different policy choices of two countries in the late 1960s, during which period Japan's trade dependence on the United States was larger than Germany, but Japan did not apply revaluation facing the pressures from the United States.

Therefore, the mere existence of political pressures does not fully explain the different attitudes between Germany and Japan in the postwar period. Knowing in what domestic structure political pressures such as threat of protectionism could have influence on policy makers is essential for understanding the influence of international pressure on policy choice.

This thesis claims that different attitudes of Germany and Japan toward adjustment of payments imbalances in the postwar period can be attributed to different patterns of representation of domestic preferences regarding currency appreciation and domestic political structure which responds to such domestic preferences. The next section will review Germany's choices of payments adjustment policy.

(2) Germany's Choice: Revaluation in the 1960s

Under the Bretton Woods system, Germany had to deal with the dilemma between domestic price instability and external payment surplus in the 1960s. Under the fixed exchange rate system, maintaining stable exchange rate was generally perceived as one of the IMF's principles. However, in the Bretton Woods period, Germany chose to apply revaluation when it was faced with external payment surplus.

Germany revalued in 1961 and 1969.[60] In both cases, debates on revaluation of the Deutsche mark provoked domestic preferences regarding policy instruments of payments adjustment policy. Germany reconstructed its economy rapidly by the end of the 1940s and achieved rapid economic growth

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[60] The Deutsche mark was also revalued at the Smithsonian Agreement in 1971. Since this revaluation was as a result of international negotiation, this case was omitted from examination here.

based on export strength during the 1950s. From 1950 to 1958, export increased more than four times, and import expanded by about three times.[61] Export increases, more than import expansion, yielded a current account surplus and the balance of payment surplus as a whole. During the first half of 1950s, Germany enjoyed expansion without inflation, the result of its monetary and fiscal stabilization program.

By 1955, however, Germany began to recognize the dilemma between rising prices in the domestic economy and a payment surplus.[62] A deflationary policy of rising interest rates proved to be self-defeating because such an attempt attracted more capital inflows under increasing capital movements across borders.[63] During the 1960 and 1961 debates, domestic politics were divided between domestic preferences for and against revaluation. Within the government, the Minister of Economic Affairs, Ludwig Erhard, introduced the idea of revaluation in the late 1950s.[64] Finance Minister Etzel supported revaluation. The Bundesbank, the central bank, was not in favor of revaluation and argued that inflationary countries should first take

[61] For German economy in the 1950s, see Patrick M. Boarman, *Germany's Economic Dilemma: Inflation and the Balance of Payments* (New Haven: Yale University Press, 1964).
[62] This situation was termed as "imported inflation" in Germany.
[63] Otmar Emminger, "The D-mark in the Conflict Between Internal and External Equilibrium, 1948-75," Essays in International Finance, Princeton University, no. 122 (June 1977), pp. 12-13.
[64] Hugo M. Kaufmann, "A Debate Over Germany's Revaluation 1961: A Chapter in Political Economy, " *Weltwirtschaftliches Archiv* 103 (1969), pp. 193-198.

responsibility for reducing their domestic inflationary pressures.[65] Chancellor Konrad Adenauer of the ruling Christian Democratic Union (CDU), which was supported by industry and banking sectors, also opposed changes in the exchange rate.

Societal groups also participated in this debate. The saving institutions, whose businesses depended on currency stability, recognized that payment surpluses posed a major threat to the domestic price stability, and strongly supported revaluation.[66] Industry, most of which relied on exports, and the commercial banking sectors, which were closely related to industry, were opposed to revaluation. The Federation of German Industry (BDI) in particular opposed Erhard by claiming that revaluation would damage the entire economy.[67] The BDI pressured the government through Adenauer and "labeled favoring revaluation a crime."[68] Erhard blamed industry by saying the "egoism of pressure groups which flourished uninhibitedly in Germany."[69]

The attitudes of labor and the Social Democratic Party (SPD), whose major supporter was organized labor, were ambiguous. They supported a fiscal plan to combat inflationary pressures, which would eventually lead to

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[65] Boarman, *op. cit.*, pp. 284-286, Kaufmann, *ibid.*, pp. 191-193.
[66] Kaufmann, *op. cit.*, pp. 201-202.
[67] Boarman, *op. cit.*, pp. 289-291, Kaufmann, *op. cit.*, pp. 202-205.
[68] Kaufmann, *Ibid.*, p. 205.
[69] *Frankfurter Allgemeinene*, September 26, 1960, cited in *Ibid.*

revaluation, but they were initially opposed revaluation. Until late 1960, because labor and SPD hoped that alternative methods such as lowering tariffs and eliminating import quotas would be effective.[70]

In March 1961, under inflationary pressures, the government decided to revalue the Deutsche mark by 5 percent, a smaller change than had been expected. Since the BDI felt betrayed by the CDU's decision of revaluation, it suspended monthly contribution payments to the CDU.[71] Erhard clearly stated that Germany's major concern was the maintenance of internal stability in his announcement of revaluation:

" Revaluation will mean an increase in the prices of our exports and to that extent cause some difficulties for the export industries--- on the other hand, the German price level and to that extent contribute to the preservation of greeted [internal] stability---."[72]

Germany was faced with a similar dilemma in 1968 after the recession of 1966-67. Payment surplus was increasing combined with speculative capital inflows and inflationary pressures were intense. This time, the Bundesbank and members of the Council of Experts advocated revaluation to protect domestic stability.[73] Instead of accepting revaluation, the CDU-SPD Grand Coalition government

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[70] Kaufmann, *op. cit.*, pp. 199-200.
[71] *Ibid.*, p. 208.
[72] Erhard's speech on revaluation of the Deutsche mark.(Deutsche Bundesbank, *Auszuge aus Presseartikeln*, no. 21, March 13, 1961) cited in Boarman, *op. cit.*, p. 297.
[73] Michael Kreile, "West Germany: The Dynamics of Expansion," in Peter Katzenstein, *Between Power and Plenty, op. cit.*, p. 215.

introduced a 4 percent special export tax and a 4 percent tax rebate on imports.[74]

The issue of revaluation became the center of political debates, as capital flows increased in the spring of 1969. The Minister of Economics, Karl Schiller, and the SPD proposed a 7 percent revaluation as a solution. In contrast, the CDU and its supporters in industry, commercial banking and agricultural sectors strongly opposed to revaluation and proposed tighter fiscal policy. Their interests lay in an undervalued Deutsche mark.[75] Party politics backed by domestic preferences made revaluation difficult. However, the SPD-FDP (Free Democratic Party) coalition government, after winning the Bundesdag elections in October 1969, decided to revalue the Deutsche mark by 9.3 percent in late 1969.[76]

In these two cases, the German government and the Bundesbank finally decided to give priority to domestic price stability over maintaining the exchange rate. To achieve an external payments adjustment, Germany chose to apply changes in exchange rates, instead of expansionary macroeconomic policy.

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[74] Kreile, *ibid.*

[75] Agriculture sector got benefits from undervaluation of the Deutsche mark, because it was protected from imports and subsidized in exporting according to a Common-Market harmonization scheme. See William Pollard Wadbrook, *West German Balance-of-Payments Policy: The Prelude to European Monetary Integration* (New York: Praeger, 1972), p. 80.

[76] Kreile, *ibid.*, p. 216, Emminger, *op. cit.*, pp. 25-26.

(3) Conflicting Domestic Preferences and Political Structure

These cases show that in Germany there were not only domestic preferences against revaluation, but also domestic preferences for revaluation. Thus, representation of domestic preferences was in conflict over a desirable policy choice. Industry, commercial banking, and agriculture opposed revaluation, even as labor and the saving sectors supported it.

These conflicting domestic preferences were conveyed by political parties into political debates regarding policy instruments, and thus, translating particular domestic preferences into policy choice was not easy, given the different policy orientations of various political parties. The CDU, backed by anti-revaluation groups, delayed the decision of revaluation, while the SPD, supported by labor, proposed revaluation. The conflict among political parties over the most appropriate policy instrument meant that domestic preferences against revaluation could not easily influence the formulation of payments adjustment policy. As a result of these domestic political conditions, there was room for the economic principle of price stability, emphasized by the Bundesbank, to play an important role in policy choice.[77] In Germany's case of adjustment policy under the Bretton Woods system, since changes in exchange

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[77] Goodman emphasizes the autonomy of the Bundesbank in formulating monetary policy in Germany, which puts priority on price stability. Goodman, *op. cit.*

rates were chosen, macroeconomic policy was not applied for payments adjustment.

By 1973, the German government and political parties concluded that export success would no longer cope with domestic price stability under the fixed exchange rate system. Germany shifted to a floating exchange rate relatively smoothly, compared with Japan after the U.S. suspension of dollar convertibility into gold. The shift from the Bretton Woods system to a floating exchange rate system affected the formulation of payments adjustment policy.

Following this shift, representations of domestic preferences against and for revaluation were reduced. Industry and commercial banking sectors, which had most strongly opposed revaluation, came to express less concern about the level of exchange rate, despite large export dependence ratio to GNP.[78] From 1972 to 1976, although the Deutsche mark appreciated by 21 percent, compared to 2 percent yen appreciation in Japan, there was little debate on the high value of the Deutsche mark in itself.[79] In the midst of the appreciation of the Deutsche mark after the Plaza Accord, only 36 percent of German firms answered that the appreciation of the Deutsche mark had negative affect on

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[78] Even the CDU's supporters in banking and industry did not much concern about change in exchange rate after 1973. Goodman, *Ibid.*, p. 64.

[79] Statement of President of German Chamber of Commerce in Japan cited in *Nihon Keizai Shimbun*, December 6, 1977.

their profitability.[80] Previous experiences of revaluation, the high denomination ratio of exports in the Deutsche mark, and structural change of German industries were main causes of the change of domestic preferences towards the exchange rate.[81] Therefore, external payments adjustment was left to the mechanism of a floating exchange rate system in Germany.

Moreover, with few domestic preferences and, hence, indifference of political parties to exchange rate policy, macroeconomic policy was seldom discussed in relation to external payments adjustment. Regarding macroeconomic policy, after the shift to a floating exchange rate system, the Bundesbank was given a more autonomous role in anti-inflation policy than in the Bretton Woods period, and the formulation of macroeconomic policy was constrained by the concerns over the domestic economy.[82] As a result of these changes associated with the shift to a floating exchange rate system, although international pressures which urged for expansionary policy was strong, macroeconomic policy was

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[80] By contrast, 83 percent of Japanese firms recognized the negative effect of a high yen in the comparative survey of Japanese and German firms in the midst of the appreciation of the yen and the Deutsche mark (almost the same percentage of appreciation) in 1986. Survey conducted by IFO and Keidanren cited in *Nihon Keizai Shimbun*, February 5, 1987. For Keidanren's survey, see *Keidanren Geppo*, November 1986, pp. 89-94.

[81] For structural change in German industry, see, Christian Deubner, "Change and Internationalization in Industry: Toward a Sectoral Interpretation of West German Politics," *International Organization*, vol. 38, no. 3 (Summer 1984), pp. 501-535.

[82] Peter J. Katzenstein, *Policy and Politics in West Germany* (Philadelphia: Temple University Press, 1987), p. 94.

difficult to apply with respect to external payments adjustment in Germany.

4. Summary

This chapter shows that it is important to examine how and through what mechanisms international factors affect state policy choice. The early part of this chapter proposes the hypothesis of state policy choice of payments adjustment policy. In this hypothetical framework, two domestic-level factors are emphasized to explain the difference in state policy choices. The one factor is domestic preferences regarding the exchange rate, and the other is political structure, which responds to domestic preferences.

Examining Germany's payments adjustment policy demonstrates that the hypothesis of this thesis is relevant to explaining Germany's choices of payments adjustment policy in the postwar period. Conflicting domestic preferences towards currency appreciation and diffused policy orientations of political parties responding to such domestic preferences are important factors in explaining why Germany chose revaluation in the 1960s. The absence of strong domestic preferences against a high Deutsche mark and little political debates over the exchange rate were attributable to Germany's reluctant attitude toward applying expansionary macroeconomic policy for payments adjustment after the 1970s.

Regarding the different patterns of representation of domestic preferences in exchange rate policy among states, Odell argues, "The relatively closed nature of the U.S. economy attenuated the actual connection between international monetary policy and group welfare." He hypothesizes that "In structurally more open economies like West Germany, we might look for more widespread and intense interest-group participation on international monetary issues."[83] Odell's hypothesis is correct in that Germany did see a representation of domestic preferences relating to exchange rate policy in the 1960s. However, it fails to explain whether or not, and how such domestic preferences influenced state policy choice. Although it is not entirely clear what "structurally open economies" mean, if the criteria is the degree of trade dependence, Japan's pattern of domestic preferences regarding change in exchange rate would be different from Germany's; Japan's trade dependence was much smaller than Germany (See Table 2.1).

The next three chapters will examine Japan's policy choices of payments adjustment policy and explain how domestic preferences regarding exchange rate policy and political structure affected state choice of policy instrument in the post-World War II period.

[83] Odell, *op. cit.*, pp. 347-348.

Table 2.1
Export Dependence of Germany, Japan and the United States
(Percentage of Exports in GNP)

	Germany	Japan	the U.S.
1965	15.6	9.3	3.8
1966	16.5	9.3	3.8
1967	17.6	8.4	3.8
1968	18.7	8.8	3.8
1969	19.0	9.3	3.9
1970	18.5	9.5	4.2
1971	18.1	10.4	3.9
1972	18.1	9.5	4.1
1973	19.4	8.9	5.2
1974	23.4	12.1	6.8
1975	21.5	11.2	6.8
1976	22.8	12.0	6.6
1977	22.8	11.7	6.2
1978	22.1	10.0	6.5
1979	22.5	10.2	7.4
1980	23.6	12.2	8.3
1981	25.7	13.0	7.8
1982	26.8	12.8	6.8
1983	25.7	12.4	6.0
1984	27.6	13.5	5.9
1985	29.1	13.2	5.5
1986	27.1	10.1	5.4
1987	26.1	9.6	5.6

1988	26.8	9.2	6.6
1989	28.4	9.7	7.0

Source: *International Financial Statistics Yearbook* (Washington, D. C.: International Monetary Fund, 1990).

Table 2.2

Balance of Payments of Germany, Japan and the United States
($ Billions)

	Current Account			Trade Balance			Total Balance		
	Germany	Japan	U.S.	Germany	Japan	U.S.	Germany	Japan	U.S.
1970	0.85	1.99	2.33	5.69	3.96	2.59	6.28	1.19	- 9.83
1971	0.94	5.80	- 1.45	6.66	7.76	-2.27	5.04	10.46	-29.59
1972	1.16	6.64	- 5.78	8.40	8.94	-6.42	4.88	2.99	-10.29
1973	5.19	-0.13	7.07	15.84	3.64	0.91	9.47	-6.21	- 5.02
1974	10.63	-4.72	1.94	21.90	1.35	-5.51	-0.51	1.26	- 8.78
1975	4.41	-0.68	18.06	16.91	4.94	8.90	-1.33	-0.66	- 5.31
1976	3.72	3.71	4.18	16.02	9.80	-9.47	3.71	3.80	-10.54
1977	3.98	10.91	-14.49	19.47	17.16	-31.11	3.24	6.61	-34.85
1978	9.16	16.54	-15.40	24.16	24.30	-33.94	10.24	10.17	-33.85
1979	-5.65	-8.74	- 0.97	16.45	1.74	-27.54	-2.25	-12.88	7.19
1980	-13.90	-10.75	1.84	8.89	2.13	-25.50	-17.37	5.11	- 8.41
1981	-3.29	4.77	6.16	16.18	19.96	-27.99	0.02	3.57	- 2.09
1982	4.98	6.85	- 7.00	24.73	18.08	-36.44	2.33	- 4.87	0.91
1983	5.41	20.80	-44.31	21.42	31.46	-67.08	- 3.46	1.27	- 5.70
1984	9.75	35.00	-104.21	22.29	44.26	-112.51	- 2.92	1.83	- 1.44
1985	17.00	49.17	-112.75	28.51	55.99	-122.16	4.30	0.29	10.17
1986	40.09	85.83	-133.23	55.74	92.82	-145.05	5.45	15.54	-28.35
1987	46.12	87.02	-143.70	69.88	96.42	-159.49	26.07	38.72	-50.30
1988	50.47	79.61	-126.58	79.41	95.00	-127.21	-22.39	15.76	-38.38
1989	55.48	56.78	-105.90	76.71	77.11	-113.24	-10.49	-12.77	19.50

Source: *International Financieal Statistics Yearbook, 1990* (Washington, D. C : IMF)

Table 2.3

Trade dependence of Germany and Japan on the United States, 1971-1986

	Export dependence on the U.S. (%)		Import dependence on the U.S. (%)	
	Japan	Germany	Japan	Germany
1971	31.6	9.7	25.4	9.2
1972	31.3	9.3	25.0	7.6
1973	25.9	8.4	24.6	7.6
1974	23.3	7.5	19.8	7.7
1975	20.2	5.9	19.1	7.6
1976	23.7	5.6	17.7	7.2
1977	24.8	6.1	17.0	6.7
1978	25.8	7.1	18.3	6.3
1979	25.9	6.6	18.2	5.8
1980	24.5	6.1	16.8	6.6
1981	25.7	6.5	17.6	7.1
1982	26.4	6.6	18.2	6.8
1983	29.5	7.6	19.3	6.4
1984	35.6	9.6	19.5	6.5
1985	37.6	10.4	19.6	6.3
1986	38.7	10.5	23.9	6.0

Source: Nihon Ginko Tokeikyoku, *Nihon Keizai wo Chushin tosuru Kokusai Hikaku Tokei* [Comparative Statistics Relating To Japan], each year.

Chapter Three

Absence and Emergence of Domestic Preferences: The Exchange Rate and The Domestic Economy

1. Introduction

This chapter will examine Japan's policy choice of payments adjustment policy under the Bretton Woods fixed exchange rate system. Under the Bretton Woods system, Japan was faced with both balance of payments deficit and surplus, and in both cases, applied macroeconomic policy for payments adjustment.

Until the late 1960s, Japan experienced external payment deficit cyclically. During the 1950s and early 1960s, Japan applied macroeconomic policy to achieve adjustment of payment deficit without resorting to devaluation. From the late 1960s until the breakdown of the fixed exchange rate system, by contrast, Japan had payment surplus and chose to apply expansionary macroeconomic policy to achieve external payment imbalances, instead of applying further revaluation.

This chapter will examine whether domestic preferences regarding change in exchange rate emerged during payment imbalances, and how such domestic preferences, if any, were translated through the political structure into the formulation of payments adjustment policy. If there was no domestic preference, we have to know why not.

The chapter will, consider first Japan's choice for adjusting external deficit in the 1950s and in the 1960s. Second, it will examine the initial case of adjustment of external surplus, which Japan would deal with later in the post Bretton Woods era.

2. Policy Choice for Payment Deficit: Devaluation or Tight Macroeconomic Policy

(1) Establishing the Exchange Rate for the Yen

Throughout the Bretton Woods period until 1971, Japan never changed its exchange rate.[1] In other words, Japan never subordinated its exchange rate policy to payments adjustment when faced with payment imbalances during this time. Compared with other industrial states which executed changes in exchange rates in face of payment imbalances, Japan is a unique example as well as the United States, which was a key currency state. Even when about thirty countries devalued their currencies following the Britain's devaluation of the sterling in 1949, Japan did not change its par value

[1] Exchange rate is used here interchangeably with par value.

of \$1=¥360, although the sterling area was a main market for Japan's exports.

To understand why this par value had not been changed, it is essential to understand how this par value was established in the first place after the end of World War II. This section emphasizes two problems. The first concerns the problem of a level of exchange rate; or how a level of exchange rate for the yen was determined. The other is the perception of changes in exchange rate with respect to payments adjustment: to what extent changes in exchange rate were considered as a possible policy instrument for payments adjustment in domestic political arena under the Bretton Woods system.

(i) Level of Exchange Rate for the Yen

In the immediate post-war era, the Japanese economy was shattered and isolated from the international economic system. New arrangements for the international economic system, that is, the Bretton Woods system, did not allow Japan to participate in the IMF and the GATT.[2] In order to enter the international economic system of Bretton Woods, Japan had to establish an exchange rate for the yen regarded by many as the first crucial necessity. As early as 1946, the Bank of Japan realized that in order to join the

[2] As for Japan's participation in the GATT, see Gardner Patterson, *Discrimination In International Trade: The Policy Issues 1945-1965* (Princeton: Princeton University Press, 1966), Chapter 6.

international economic system, Japan had to accept a much lower level of exchange rate for the yen than in the pre-war period.[3]

This step to reenter the international economic system was initiated not by the Japanese government but by the direction of the Supreme Commander for the Allied Powers (SCAP) in the occupation period. The special mission for examining the problem of exchange rate was dispatched to Tokyo from Washington by Under Secretary of Army William H. Draper, Jr.

During the immediate post-war period, there was no single exchange rate which could apply to both exports and imports. Indeed, exports and imports were funneled through separate accounts: the Japanese Boeki-cho (Board of Trade) dealt with Japanese exporters and importers in yen accounts, and the SCAP dealt with foreign exporters and importers in dollars, sterling or other hard currencies. As a result of these separate dealings, exchange rates were widely dispersed depending on both what kinds of the goods and whether an item was for export or domestic use. Imports were generally priced considerably lower than exports at yen-dollar price ratios. In late 1948, the average exchange rate for exports was \$1=¥340 and \$1=¥160 for imports.[4]

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[3] Nihon Ginko Chosakyoku, "*Bureton Uzzu Tsukakyotei to Nihon Sanka no Hozu*," (January, 1946), pp. 17-18.
[4] Okurasho Zaiseishishitsu, ed., *Showa Zaisei-shi*, vol. 3 (Tokyo: Toyokeizai Shimpo-sha, 1976), p. 426.

The absence of a single commercial exchange rate for the Japanese yen came to be regarded as an obstacle to achieving economic stability and growth in post-war Japan, not only by the U.S. government but also by the SCAP.[5] The mission directed by Ralph A. Young, Associate Director of Division of Research and Statistics in Federal Reserve System, submitted a report on an exchange rate for the yen in June 1948. The Young Report, pointing out the inflationary effect of the absence of fixed exchange rate for the yen on the domestic economy, recommended that a single general exchange rate be established to stabilize the domestic economy as early as possible (preferably by October 1, 1948).[6] In this report, a single general rate within range of 270 and 330 yen per dollar was recommended as an appropriate level of exchange rate.[7] This rate was determined on the basis of two principles; "to sustain, and later expand, Japanese exports" and to "encourage more efficient production in 'high-cost' industries."[8] As for a change in the exchange rate, this report, besides applying

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[5] Letter from William H. Draper, Jr. to Ralph A. Young, May 14, 1948; *Showa Zaiseishi*, vol. 20 (Tokyo: Toyokeizai Shimpo-sha, 1982), p.595.
[6] According to the Young Report, because of the absence of a single general exchange rate for the yen, the Japanese government paid large amount of subsidies for exports and imports, which led to the increase in money supply.
[7] The rate of $1=¥300 was recommended if the rate was introduced immediately, but if introduced later, the report argued, the rate would be within the range from 270 to 330 yen par dollar by taking change of economic situation into account. Young Report, June 12, 1948, Ministry of Finance Document, *Ibid.*, pp. 597-600.
[8] *Ibid.*, p. 599.

the IMF principle, admitted the possibility of "on-the-spot changes in the initial exchange rate within specified limits at the discretion of SCAP."[9]

Due to the differences of opinions between the SCAP on the one hand, and the Departments of State and the Treasury on the other, regarding the timing of establishing exchange rate, the recommendation by the Young Report was not fulfilled by October 1948, the projected starting date. The State Department and the Treasury Department insisted upon the early establishment of a single exchange rate for the yen because of concerns over the future of the international economic system. In their view, allowing Japan to maintain a multiple exchange rate system indefinitely would complicate the relationship between the United States and other countries, because the United States had pressed them "not to adopt multiple rates and to go to the IMF."[10] Yet the SCAP disagreed on timing by claiming that the establishment of a single exchange rate should be preceded by substantial recovery of Japanese economy.[11]

Establishing a single general exchange rate became one of the primary objectives of Japan's economic recovery plan after the Nine-Point Economic Stabilization Program was determined by the National Advisory Council on International Monetary and Financial Problems (NAC) in December 1948. This

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[9] *Ibid.*, p. 600.
[10] Draft of the Minutes on NAC Meeting No. 98, June 28, 1948, U.S. Treasury Department Document, *Ibid.*, p. 606.
[11] *Ibid.*, p. 605.

program was conducted under the supervision of Joseph M. Dodge, who was dispatched as a financial adviser to the SCAP by President Truman in February 1949.

Dodge focused on controlling inflation by balancing the national budget, but he denied at the beginning of his plan to take devaluation of the yen for that purpose.[12] The primary purpose of his economic reform program, known as the "Dodge Line," was to achieve true balance in consolidated budget. Dodge's proposed national budget for 1949 was called an "ultra-balanced budget," because it not only eliminated the deficit, but also created a surplus of 150 billion yen.[13] As for exchange rates, Dodge emphasized two principles: fixing a rate at a level which would stimulate exports without unequally slowing imports, and maintaining a new rate once it was fixed. He recommended the rate of $1=¥330 on the basis of an estimation that over 80 percent of the Japanese exports in terms of value could move at the rate of $1=¥330 or higher and that the reminder should require extensive rationalization.

Although NAC stated its willingness to accept SCAP's recommendation that the rate be fixed at 330 yen per dollar, it showed its preference to the rate of $1=¥360 by saying "it strongly recommends that consideration be given to fixing a rate up to 360 yen per dollar."[14] NAC pointed to the

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[12] Hayato Ikeda, *Kinko Zaisei* (Tokyo: Jitsugyo no tomo-sha, 1952), p. 4.
[13] In 1948, there was a deficit of 88.7 billion yen.
[14] Memorandum of NAC, March 25, 1949, NAC Document no. 807 (*Showa Zaiseishi*, vol. 20, *op. cit.* p. 624.)

evolution of inflation in Japan, and argued that a rate of 330 yen per dollar might "overvalue the yen to a degree which would require subsequent modification in the interest of achieving SCAP's foreign trade objectives."[15]

General Douglas MacArthur of the SCAP finally announced the establishment of the single general rate of 360 yen per dollar on April 23, 1949. According to Dodge, this change from a rate of 330 yen to a rate of 360 yen per dollar was based on the consideration that since a rate of 330 yen per dollar might overvalue the yen, a rate of 360 yen per dollar would be suitable for maintaining stable economy.[16] Although Japan was not yet a member of the IMF, this rate was assumed by the U.S. government to have the same rigidity as any other member countries' exchange rates registered with the IMF. Changes in exchange rates would be allowed only with the consent of NAC.[17]

(ii) Possibility of Changing The Exchange Rate

The Japanese side was initially reluctant to fix a single general rate because of an unstable inflationary domestic economy.[18] Industries which were eager to export were concerned about the level of the exchange rate.

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[15] *Ibid.*, pp. 623-624.
[16] Okurasho Zaiseishishitsu, ed., *Tai-Senryogun Kosho Hiroku: Watanabe Takeshi Nikki* [hereafter *Watanabe Nikki*] (Tokyo: Toyokeizai Shimpo-sha, 1982), p. 348.
[17] *Asahi Shimbun*, April 25, 1949.
[18] The Bank of Japan gave up establishing a single general rate, and preferred to have multiple exchange rates. Toshihiko Yoshino, *Sengo Kinyushi no Omoide* (Tokyo: Nihonkeizai Shimbun-sha, 1975), p. 186.

According to a survey of the preferences of fourteen industrial organizations and forty firms toward the level of the exchange rate, the preferred rate varied from $1=¥190 to $1=¥700. While only three organizations and four firms supported fixing a single general exchange rate, seven organizations and sixteen firms opposed it. Six organizations and eight firms answered that they would manage their profitability at a level within the range of 300 yen and 350 yen per dollar, and five organizations and twenty two firms denied their profitability within such a level of exchange rate.[19] In 1948, textile occupied more than 60 percent of exports and exchange rates for cotton textile were from $1=¥250 to $1=420. Kumakichi Nakashima, president of the Japan Foreign Trade Council (Nihon Boekikai) whose members were mostly textile firms wrote a letter to the chief of the Economic and Science Section (ESS) of the SCAP to ask for subsidies for export-oriented industries, imports traders and inefficient producers as a pre-condition to fixing a single exchange rate.[20]

The Japanese government estimated that 60 percent of exports at the rate of 300 yen per dollar and 40 percent at the rate of 350 yen per dollar would be in trouble. By early 1949, however, the government and industries were prepared to accept a single general exchange rate. The Japanese

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19 *Nihon Keizai Shimbun*, July 9, 1948.
20 Letter from Kumakichi Nakashima to General William F. Marquat, January 5, 1949. Suitland Papers. (*Showa Zaiseishi*, vol. 20, *op. cit.*, pp. 612-613.)

government concluded that with export and import subsidies, at a rate of 350 yen per dollar, 80 percent of exports could move.[21]

The new exchange rate of 360 yen per dollar was generally perceived as reasonable by the Japanese government and industries. Since they had expected a rate of 330 yen per dollar which the SCAP recommended, the new rate was lower price at yen-dollar ratio than they had anticipated. Shoko-sho (Ministry of Industry; predecessor of Ministry of International Trade and Industry: MITI) estimated that 75 percent of exports could move at the new exchange rate and that if rationalization of industry made progress, 80 percent of exports could move.[22]

Although there were diffused responses from industries, the new rate did not provoke strong resistance. President of Keizaidantai Rengokai (Keidanren: Federation of Economic Organization), although he asked for special policy for the sake of industries which were expected to get damaged by the new rate, told that the new rate was reasonable.[23] The Japanese government and industries agreed that the rate of 360 yen per dollar played a central role of economic recovery and thus should be maintained as long as possible. The new rate did not decrease exports during the next several months.

As early as September 1949, however, the British

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[21] *Showa Zaiseishi*, vol. 15 (Tokyo: Toyokeizai Shimpo-sha, 1976), pp. 392-394.
[22] *Asahi Shimbun*, April 24, 1949.
[23] *Ibid.*

sterling was devalued by 30.5 percent. Britain was confronted with a large outflow of sterling reserves in the summer of 1949 and from June to September, foreign reserves declined by almost 20 percent. Devaluation was regarded as an unavoidable policy in order to stop the outflow of reserves.[24] About thirty countries followed to devalue their currencies in 1949 including major industrial countries such as Germany, France, Italy and Canada.[25]

This series of international devaluation called the newly fixed exchange rate for the yen into question. In the markets of the countries which devalued their currencies, devaluation raised the price of Japanese exports.[26] Japanese exports, especially textile, which competed with British textile products, were expected to lose competitiveness in the world market. Thus, export-oriented industries were in favor of devaluation of the yen following other countries. However, the Japanese government immediately decided that it would not devalue the yen and maintain its par value.[27] Rationalization of industries was emphasized as a necessary step to maintaining par value, and subsidizing for exports was introduced. Minister of Finance, Hayato Ikeda, asked Dodge not to devalue the yen because devaluation would disturb the economic recovery plan, which was constructed

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[24] de Vries and Horsefield, *op. cit.*, pp. 97-99.
[25] Germany devalued by 20.6 percent, France by 22.3 percent, Italy by 7.9 percent and Canada by 9.1 percent.
[26] About 60 percent of Japan's export was toward the market of the staring area. Main export item was textile.
[27] *Asahi Shimbun*, September 20, 1949.

based on the rate of 360 yen per dollar.[28] On the U.S. side, although there was difference of opinions on the desirability of devaluation of the yen between the SCAP and the U.S. government,[29] SCAP General MacArthur finally announced in October 1949 that the yen would not be devalued.[30]

Even after this episode, debates on revaluation of the yen continued until the late 1950s, because the rate of 360 yen per dollar was considered as an overvalued rate for domestic economic condition.[31] However, such debate subsided as Japan's economy expanded as a result of a boom caused by the special procurements of Korean War, and the deflationary policy of the "Dodge Line" was ended in the late 1950s.

After the Peace Treaty, which restored the sovereignty to Japan in 1951, Japan was accepted in the IMF in 1952. The rate of 360 yen per dollar was officially accepted by the IMF, and Japan was obliged to eliminate its payment imbalances within a framework of the fixed exchange rate system of the Bretton Woods system. The possibility of changing in exchange rate ($1=¥360), therefore, was left to the degree of Japan's payment imbalances; whether Japan's payment imbalances were "fundamental disequilibrium" or not.

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28 *Asahi Shimbun,* October 12, 1949.
29 *Watanabe Nikki, op. cit.*, pp. 383-384.
30 *Asahi Shimbun*, October 16, 1949.
31 Debates over the question of whether the yen was overvalued in the 1950s and when the yen became undervalued were unsettled in Japan. For the debates, see, for example, Miyohei Shinohara, "360-yen reito eno Kasetsu," in Shinohara Miyohei Chosakushu, vol. 3 (Tokyo: Chikuma Shobo, 1987), pp. 5-21, Shozaburo Fujino, "Sengo Nihon no Kokusaishushi-360 yen Endaka-ron," *Keizai Kenkyu* (April 1988), pp. 97-108.

(2) Payment Deficits in the Period of High Economic Growth

(i) Deflationary Macroeconomic Policy for Payments Adjustment

Throughout the period of the 1950s and the early 1960s, Japan's balance of payment position was likely to reflect deficit. Cyclically, Japan had payment deficits in 1953, 1957, 1961 and 1964. As a policy instrument for payments adjustment, Japan applied tight macroeconomic policy to eliminate its external deficit instead of devaluation through this period. In other words, macroeconomic policy was always subordinated to payments adjustment consideration. Japan's choice contrasts with the choices of other industrial states. France, for instance, facing a payment deficit during the same period, devalued the franc in 1957 by 20 percent and in 1958 by 17.5 percent.[32] In the latter case, in particular, French government took an inflationary macroeconomic policy at the same time.[33]

Faced with a payment deficit, there were alternative policy instruments for eliminating external imbalances such as macroeconomic policy and devaluation. However, devaluation was omitted from Japanese policy makers' consideration. In the early 1950s, it was feared that

[32] In 1958, the French government decided upon a large-scale devaluation, although a 10-12 percent devaluation would have been reasonable. Devaluation improved the balance of payment situation at least until 1963. See Pierre Dieterlen and Huguette Durand, "Monetary Policy in France," in Karel Holbik, ed., *Monetary Policy in Twelve Industrial Countries* (Boston: Federal Reserve Bank of Boston, 1973), p. 141.
[33] Michaely, *op. cit.*, p. 115.

devaluation would distract from the economic recovery plan by increasing the price of imports, which was important for building Japan's industrial infrastructure. Maintaining par value had been also perceived as a rigid rule of the Bretton Woods system not only by the Japanese government but also by industrial sectors since 1949.[34]

As a result of not applying exchange rate policy, Japan's choice for adjustment of payments imbalances was to tighten macroeconomic policy. Macroeconomic policy was therefore determined according to classical "rules of the game," that is, macroeconomic policy was always applied in response to changes in payment imbalances.[35] When Japan had to deal with a conflict between continuing economic growth and the adjustment of payment imbalances or payment deficits, Japan placed priority on payments adjustment over economic growth. The Japanese government chose to apply disinflationary monetary and fiscal policy to slow down domestic economic growth which led to decrease in imports. After domestic economic growth slowed down and balance of payment improved by decrease in imports and increase in exports, then tight macroeconomic policy was loosen. This

[34] For example, the Finance Minister stated in response to the request for devaluation of the yen in January 1954 that "there is no intention to change in monetary policy which has been based on the rate of 360 yen par dollar since Japan joined the IMF." *Shugiin Kaigiroku*, No. 6 (January 28, 1954), p.55.

[35] Yukio Noguchi, "Nihon de Keynes Seisaku wa Okonawaretaka," *Kikan Gendai Keizai*, No. 52, (1983), pp. 163-183, Kosai Yutaka, "Kodo Seichoki no Keizaiseisaku," in Yasukichi Yasuba and Takenori Inoki, eds., *Nihon Keizaishi*, vol. 8 (Tokyo: Iwanami Shoten, 1989), p. 230.

pattern of applying macroeconomic policy to payment imbalances was found every time when balance of payment showed deficit.

This pattern was related to Japan's limited foreign currency reserves. Compared to most other industrial countries, Japan's foreign currency reserves were much smaller until the late 1960s.[36] To achieve economic growth, extra foreign currency reserves were allocated to expand domestic economy instead of being changed into gold or accumulated in dollar reserves.[37] The limited foreign currency reserves put restraints on macroeconomic policy.

In applying macroeconomic policy according to the "rules of the game," domestic economic growth was limited by the equilibrium of balance of payment.[38] Japan, instead of changing its exchange rate, chose to slow economic growth even in this period of "rapid economic growth plan." As Michaely examines, in monetary policy, Japan was one of most responsive of all the industrial countries to payments adjustment. To cope with payment deficits, Japan usually applied two instruments. One was to increase the cost of central bank credit by raising the discount rate, thereby

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[36] Even in 1964 when Japan's foreign reserves amounted three times as large as the level of 1954, percentage of foreign reserves to total imports was 25.2 percent, while the average of percentage of industrial states was 42.6 percent and the average of developing states was 30.2 percent.

[37] Until 1968, Japan's foreign reserves were about twenty billion dollars, which were much smaller than other industrial countries.

[38] In Japan, the limitation by the equilibrium of balance of payment was called "ceiling of the balance of payment."

restraining commercial banks lending. The other was to direct control of credit, which was known as the "discount window operation." This control was not on formal basis. The Bank of Japan determines the amount of credits that each city banks and long-term credit banks extend to the public, and imposes its view by moral suasion.

In 1953 and 1954 when balance of payment showed deficits because of domestic economic growth and expansion of imports, Japan raised the discount rate three times.[39] This was the first time the discount rate had been changed since October 1951.[40] Facing similar payment deficits in 1957, 1961 and 1964, Japan also raised the discount rate and reinforced the "discount window operation" to cope with the adjustment of payment imbalances.

As for fiscal policy, Michaely concludes that "budgetary policy in Japan did not serve as an instrument for adjusting balance-of-payments disequilibria."[41] However, throughout the 1950s and the early 1960s, although the size of budget increased, the Japanese government maintained a "balanced-budget" policy and tight fiscal policy was maintained when Japan was faced with payment deficits until the mid-1960s. The definition of balanced budget varies

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[39] Until 1962, the Bank of Japan applied a system of "multiple discount rates." In this system, each bank was allocated a quota of loans from the Bank of Japan applying different discount rates.
[40] P. R. Narvekar, "The 1954-55 Improvement in Japan's Balance of Payments," *IMF Staff Papers*, vol. 6, no. 1 (November 1957)), pp. 143-169.
[41] Michaely, *op. cit.*, p. 173.

depending on what kinds of accounts are to be concerned. A strict definition entails balancing all accounts of budget; a more forgiving definition considers only the general account. The principle of balanced-budget imposed by the "Dodge Line" intended to cope with an increasingly inflationary domestic economy was very strict aiming at eliminating a budget deficit regarding all accounts and to produce surplus. Although Japan adhered to the principle of a balanced-budget, the strict "Dodge Line" principle did not last long, lapsing into a balanced-budget only on the general account. This principle was maintained until 1965, when the bond was issued for the first time after the end of the World War II.[42] Although the size of the budget increased almost every year based on a natural increase in tax revenue, the Fiscal Investment and Loan Program (*zaiseitoyushi*) were postponed to be carried out in face of payment deficits.

(ii) Political Structure and Policy Formulation; State Officials vs. Political Parties

Policy choice of tight macroeconomic policy as a result of not applying exchange rate policy for payments adjustment was not determined without political debates between state officials (the MOF and the Bank of Japan) and political parties. Policy choice of tight macroeconomic policy for adjusting external payment deficit conflicted with economic

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[42] For the process of political decision of issuing bond in 1965, see Jiro Yamaguchi, *Okurakanryo Shihai no Shuen* (Tokyo: Iwanami Shoten, 1987).

growth policy pursued by the LDP government in the late 1950s and in the 1960s.

Monetary policy, such as changes in the discount rate and "discount window operation," was conducted primarily by the Bank of Japan subject to the approval of the MOF. In this sense, political parties were not given much leeway in monetary policy. However, when policy orientations differed between the Bank of Japan and the LDP, the LDP put pressure on the Bank of Japan through the MOF.[43]

In fiscal policy, the policy making process was usually more complicated and allowed more room for political pressures than in monetary policy, because budget making and tax policy require an approval of legislature. In budget making, before the LDP took office in 1955, the MOF played a dominant role under the guidance of the "Dodge Line."[44] After 1955, however, despite the MOF belief that a strong majority would eliminate legislative amendments and allow the pursuit of rational and consistent policy, the budgeting process was exposed to more political pressures from a strong majority party.[45] Political parties, regardless of whether they were conservative or left-wing, supported both tax-cut

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[43] Eisuke Sakakibara and Yukio Noguchi, "Okurasho, Nichigin Ocho no Bunseki," *Chuokoron*, vol. 92, no. 8 (August 1977), pp. 96-150.
[44] John Creighton Campbell, *Contemporary Japanese Budget Politics* (Berkeley: University of California Press, 1977), p. 220. Since 1955, the LDP has been in power.
[45] *Ibid.*, pp. 220-227.

and fiscal expansion.[46] Since the MOF had an interest in maintaining the principles of a balanced budget, which meant financing budgets without issuing bonds, the budgeting process was a negotiation mainly between the MOF and the LDP, in particular the Policy Affairs Research Council (PARC) on the size and the allocation of budget.[47]

In January 1957, after the expanded budget plan was introduced by the Ishibashi Cabinet which had advocated an expansionist policy, balance of payment began to show deficit due to increase in imports. The Bank of Japan decided to raise the discount rate in response to the payment imbalance. This decision encountered opposition from the cabinet and Finance Minister, although the discount rate was finally raised in March.[48]

This conflict intensified in the period of "rapid economic growth plan." During the first half period of the 1960s, the Ikeda Cabinet promoted a high economic growth policy. This policy, known as the "Income Doubling Plan," aimed at a 7.2 percent of annual growth rate. Since this policy was based on the principles of low interest rate and

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[46] For the details of the argument of "small government," see Nobuhiro Hiwatari, *Sengo Nihon no Shijo to Seiji* (Tokyo: Tokyo Daigaku Shuppankai, 1991), pp. 186-208.
[47] For the PARC in budgeting, see Campbell, *op. cit.*, pp. 121-134. For the general description of the PARC, see Nihon Keizai Shimbun-sha, ed., *Jiminto Seichokai* (Tokyo: Nihonkeizai Shimbun-sha, 1983).
[48] Masamichi Yamagiwa, the Governor of the Bank of Japan, talked about strong political pressures from the government during this period; Yamagiwa Masamichi Denki Kankokai, *Yamagiwa Masamichi* (Tokyo: Yamagiwa Masamichi Denki Kankokai, 1979), pp. 585-590.

higher budget expenditure, policy choice for payments adjustment, that is, tight macroeconomic policy, conflicted with Ikeda's policy. According to Ikeda's plan, payment deficit would be eliminated by expanding exports which required expansionary policy. In pursuit of economic growth policy, the budget of 1961 which was approved by the Diet in April was larger budget than that of the preceding year by 24 percent. From the beginning of 1961, however, balance of payment continuously showed a deficit due to the rapid increase of imports which was encouraged by domestic economic growth. The Bank of Japan advocated a tighter macroeconomic policy by raising the discount rate, but could not secure agreement from the Ikeda Cabinet until July.[49]

The conflict between the MOF and the LDP (other political parties also proposed expansionary budget) was apparent also in the process of making the 1962 budget. The MOF aimed to achieve "sound budget" by reducing the size of budget in order to adjust payment imbalances, while the LDP proposed a plan of "sound growth budget," which emphasized expansionary plan.[50] In the 1962 budget, the general account increased by 24.3 percent from the previous year and amounted to 17 percent in GNP, compared to 15 percent in GNP in the 1961 budget, although it was still within the limit of

[49] Nihon Ginko Hyakunenshi Hensan Iinkai, ed. *Nihon Ginko Hyakunenshi*, vol. 6 (Tokyo: Nihon Ginko, 1986), pp. 36-39.
[50] Ichiro Noutomi, Yoshihiro Nakamura, Kazuaki Iwamoto and Takuma Furukawa, *Sengo Zaiseishi* (Tokyo: Zeimu Keiri Kyokai, 1988), pp. 159-160.

balanced budget principle with issuing no bond. This budget was a product of compromise between the MOF and the LDP.

(iii) Impact of the Norm of the Fixed Exchange Rate on Political Structure

What kinds of factors settled this dispute between the state officials and political parties when confronted with external payment deficit? The consensus on maintaining par value played an important role. Since there was a firm consensus on preserving the fixed exchange rate among government officials, political parties and societal groups, tight macroeconomic policy was legitimated when payment imbalances got aggravated. After facing payment deficit in 1953, when tight macroeconomic policy was applied, political parties sought to change the exchange rate instead of pursuing deflationary policy at the Diet. However, the Finance Minister denied the possibility of such changes and emphasized the importance of maintaining its exchange rate. After that time, such debates did not emerge in domestic politics until the late 1960s.[51]

In Japan, policy choice of not applying exchange rate policy for payment deficit led to tight macroeconomic policy as a policy instrument. This policy choice was made possible by the consensus of maintaining the exchange rate, especially

[51] *Shugiin (19th) Yosan Iinkai Kaigiroku*, No. 1, p. 27, No. 15, pp. 4-5, No. 33, p.2. There was no record found regarding debate over changes in exchange rates in the Diet after 1957.

among state officials, which was regarded in Japan as the rigid principle of the Bretton Woods system.[52] Thus, the norm of the fixed exchange rate system contributed to limiting the penetration of political pressures for expansionary policy into the formulation of macroeconomic policy in domestic politics.

In monetary policy, since it was regarded as most effective policy instrument for payments adjustment, maintaining the "rules of the game" in response to payment deficit gave the Bank of Japan a legitimate role in formulating disinflationary policy. In fiscal policy, the norm of the fixed exchange rate system also strengthened the role of the MOF in formulating fiscal policy. Facing payment deficit, the MOF could pursue the principle of balanced budget to achieve adjustment of payment deficit, against the demand of expansionary policy by political parties.

As far as there was a consensus among the government and the society on maintaining the exchange rate in face of external payment deficit, the MOF and the Bank of Japan could play a relatively autonomous role in the formulation of macroeconomic policy from political parties and avoid making expansionary macrceconomic policy.

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[52] Many policy makers of the MOF and the Bank of Japan stated later that this recognition was common among policy makers. See, for example, comment by Vice Finance Minister in 1971, Iichiro Hatoyama in Hiroshi Ando, *Sekinin to Genkai, Jo* (Tokyo: Kinyuzaiseijijo Kenkyukai, 1987), p. 100.

(iv) Little Domestic Preferences Regarding Policy Instruments

The policy choice of applying deflationary macroeconomic policy instead of devaluation might have destabilized the domestic economy, thereby provoking political pressures for devaluation. In France in the 1950s, the government did not exclusively relied on deflationary macroeconomic policy for adjusting payment deficit and chose devaluation, because it feared that a tight macroeconomic policy would increase social unrest and alienate societal groups such as peasants and shopkeepers, -- the electoral bases of the Gaullist government.[53] In Japan, tight macroeconomic policy in response to payment deficits got little opposition from the society. There are two factors which contributed to the lack of opposition from society.

First, tight macroeconomic policy, Yutaka Kosai argues, has a quick, rather positive impact on payment imbalances every time when balance of payment showed deficit; thus tight policies would loosen in a relatively short time.[54] Given this short period of a tight policy, temporary recession did not put negative effect on the domestic economy and therefore did not provoke much opposition from the society. During this period, price level was not aggravated and the growth rate increased (See Table 3.1). Thus there was little opposition to a tight macroeconomic policy, and hence little

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[53] Goodman, *op. cit.*, p.105.
[54] Kosai, *op. cit.*, p.217.

representation of domestic preferences for changes in exchange rate.

[TABLE 3.1 ABOUT HERE]

Second, uneven domestic distributional consequences of applying deflationary policy were neutralized by policy measures. Economic slow down as a result of policy choice for adjustment policy caused domestic distributional consequences on the society. Certain societal groups --small-scale business in particular-- were assumed to be more burdened than others from tight macroeconomic policy for payments adjustment. In the economic policy debate in the Diet, political parties asked for special measures for small-scale businesses, in exchange for agreeing with deflationary macroeconomic policy.[55] Not only the LDP but also opposition parties such as the Japan Socialist Party (JSP) sought to aid small-scale business. Special measures toward small-scale businesses were apparent in the allocation of the budget and other credit policies.[56] The growth rate of percentage of measures for small-scale businesses in the general account

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[55] Kokkai, *op. cit.*, *Shugiin (26 th)Yosan Iinkai Kaigiroku*, no. 2.

[56] For Japan's small-scale business policy during this period, see Kent E. Calder, *Crisis and Compensation: Public Policy and Political Stability in Japan* (Princeton: Princeton University Press, 1988), pp. 318, pp. 340-344.

increased rapidly, although the percentage of the total expenditure was small.[57]

Since domestic distributional consequence of deflationary policy was neutralized by policy measures, policy choice of applying deflationary policy did not provoke the debate over policy choice in response to payments adjustment. Little domestic preferences regarding policy instruments allowed state officials to pursue a macroeconomic policy for payments adjustment.

3. Policy Choice for Payment Surplus: 1968-71

(1) Change in Balance of Payment Position

(i) Payment Surplus as "Fundamental Disequilibrium"

Although balance of payment showed repeatedly deficit during the 1950s and the early 1960s, Japan's balance of payment turned into surplus in April 1968. After 1968, the payment surplus increased continuously mainly because of an increase of exports and an inflationary international economy. With the accumulation of payment surplus, Japan was confronted with a new adjustment problem of payment imbalances.

[57] From 1955 to 1965, measures for small business increased by 8.3 times, while the general account increased by 3.7 times. The percentage of measures for small business of the total expenditure was 0.3 percent in 1955 and 0.6 percent in 1965.

During 1969 and 1970, however, the debates regarding adjustment of payment surplus were not over which policy instruments to be applied for payments adjustment, but over whether a payment surplus constituted a "fundamental disequilibrium." Since balance of payment showed large deficits in 1967, Japanese policy makers were cautious to acknowledge the fundamental change in balance of payment position and therefore denied the possibility of change in exchange rate, which was to be used only to correct "fundamental disequilibrium."

While a payment surplus was not regarded as "fundamental disequilibrium" in Japan, Japan's surplus was criticized as structural payment imbalance internationally. The United States, which was facing a chronic balance of payment deficit, and an increasing trade deficit with Japan since 1965, regarded Japan's surplus as structural and urged Japan to take the necessary measures to eliminate its payment surplus, thereby also reducing the U.S. deficits.[58] In the seventh meeting of the US-Japan Joint Committee on Trade and Economic Affairs, established in 1961 to discuss economic problems between the two countries, the United States claimed that Japan had shifted structurally from a deficit country to a surplus country, and asked Japan to adjust its payment surplus by abolishing controls on imports, increasing capital

[58] For U.S. policy of adjusting its external deficit after the late 1950s and Japan's response to it, see Yoshiko Kojo, "Bureton Wuzzu Taisei no Henyo to Nihon no Toio: Amerika no Kokusai Shushi no Chosei o Megutte," May 1992. mimeo.

outflows, and expanding overseas economic aid especially in Asia. However, Japanese policy makers insisted that the payment surplus was a temporary disequilibrium, not a fundamental one.[59]

In addition to the United States, international organizations such as the OECD and the IMF also pointed to the structural change in Japan's balance of payment position. The OECD reported annually each member country's economic condition in its Economic Survey.[60] In the 1969 OECD review on Japan, there were conflicting opinions between the OECD and Japan. The OECD estimated that Japan had shifted to a surplus country, while Japan claimed that the payment surplus was the temporary result of the economic boom in the United State.[61] The report by the OECD which was submitted in August claimed:

The main concern of the present Survey has been to examine to what extent the recent atypical behavior of the current balance of payments may mark a lasting departure from the previous pattern of developments - a question of basic importance for the future course of policy and for Japan's international economic relations. Naturally, great caution is required in any assessment of balance of payments prospects; and it is only 1 1/2 years ago that Japan was in an apparently serious external payments situation. Nevertheless, the evidence seems rather strong that the improvement of the external position is largely of a more permanent character. Signs of an underlying improvement of the current account had already appeared in earlier years. And the analysis undertaken in this report suggests that the

[59] *Asahi Shimbun*, July 30, July 31, 1969.
[60] Economic Survey is based on the discussion with member countries including a country under review.
[61] *Asahi Shimbun*, September 1, 1969.

beginning of this trend could be traced as far back as 1964.[62]

The survey acknowledged the surplus status of Japan by saying, "The prospects, therefore, are that Japan may remain an important surplus country for some time to come, though the size of the surplus may depend significantly on relative cyclical conditions at home and in the major foreign markets."[63]

In the course of the 1969 Article VIII consultation with the IMF, the IMF staff also foresaw possible threats to Japanese domestic economic stability from its strong balance of payments position. According to the IMF, "the extremely favorable competitive position of Japanese exports in world markets might --- be underestimated by the [Japanese] authorities."[64]

(ii) Japan's Perception of Payment Surplus and Policy Choice

Despite international acknowledgment which regarded Japan's payment surplus as structural, however, the Japanese government claimed until early 1970 that its payment surplus was temporary, and there was therefore no argument domestically on which policy instrument should apply for payments adjustment. Even the possibility of applying exchange rate policy for payments adjustment, that is,

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[62] OECD, *Economic Surveys JAPAN* (August 1969), p. 39.
[63] *Ibid.*, p. 41.
[64] de Vries, *op. cit.*, p. 494.

applying revaluation of the yen, was not referred until the Deutsche mark was revalued in October 1969. In the IMF-World Bank annual meeting in September 1969, the Japanese Finance Minister, Takeo Fukuda, emphasized the importance of maintaining the present monetary system for restoring international equilibrium and claimed, "the maintenance of a given parity is probably in most cases the most realistic and persuasive policy objective conducive to proper management of an economy."[65]

From 1969 until early 1971, for payments adjustment policy, the Japanese government applied various policy instruments except for revaluation. The rate of revaluation of the Deutsche mark in 1969, -- 9.29 percent -- was larger than the Japanese government had expected. The Japanese government was afraid that international pressures for revaluation of the yen would be intensified because Japan was accumulating payment surpluses like Germany.[66] By the early 1970, it became clear that Japan's surplus was structural.[67] In 1969, surplus amounted to $2.3 billion from $1.1 billion in 1968. The measures taken by the Japanese government to eliminate payment surpluses were stimulating exports of capital, liberalizing control of imports, and increasing

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[65] International Monetary Fund, *Summary Proceedings of the Annual Meeting of the Board of Governors 1969* (Washington, D. C.: International Monetary Fund, 1969), p. 32.
[66] *Asahi Shimbun*, October 25, 1969, evening edition.
[67] The 1969 White Paper of Economic Planing Agency, which was accepted by the cabinet, acknowledged that payment surplus was structural. *Keizai Hakusho 1969* (Tokyo: Okurasho Insatsukyoku, 1969), p.112.

overseas aid. However, despite these measures, payment surplus did not decrease substantially.[68]

In late 1970, the government finally chose to shift its macroeconomic policy from tight policy to expansionary policy to achieve adjustment of payment surplus.[69] Japan's longest boom came to an end in the late summer of 1970, although GNP still increased by 10.9 percent in 1970, which was much larger than those of other industrial states, but balance of payment surplus still persisted. From October 1970 to May 1971, the Bank of Japan lowered its discount rate by three successive cuts of 0.25 percent each.

(2) Emergence of Domestic Preferences

(i) Domestic Preferences Against Revaluation

After Germany decided to shift its monetary system to a floating exchange rate system in May 1971, debates over which policy instruments to apply to eliminate the payment surplus including change in exchange rate intensified among government officials, political parties, economists and

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[68] *IMF Annual Report 1970* (Washington, D.C.: International Monetary Fund), pp. 80-81.

[69] Japan was faced with a new situation, that is, increasing payment surplus externally and continuing economic growth domestically after 1968. Since price of good was likely to rise after late 1968, the Bank of Japan decided to raise the discount rate to prevent inflation in August 1969. This was the first time in post World War II period to restrain macroeconomic policy for the domestic purpose, but this tight policy led to increase in payments surplus, through expanding exports.

societal groups in Japan. Most societal groups were opposed to revaluation for adjustment of payment surplus.

According to the opinion poll conducted by the Nihon Keizai Shimbun and the Japan Economic Research Center in June 1971, which asked politicians, business leaders, economists, labor organizations and consumer groups about revaluation of the yen, 78 percent considered the present exchange rate appropriate and 72 percent were against revaluation, while only 28 percent supported revaluation. Among business leaders 91 percent were opposed to revaluation, while only 36 percent of economists were against revaluation. This opinion poll showed how unanimously revaluation of the yen was opposed in Japan except by some economists.[70]

In 1970, Japan's export dependence was 9.8 percent, smaller than that of every industrial country except for the United States. However, the growth rate of export during the 1960s was 16.9 percent, which was much larger than 9.5 percent, the average growth rate of industrial states. The export dependence rate of the manufacturing industry as a whole was 8.6 percent in 1970. The ratio was high in export-oriented industries such as steel, electronic products, textile, and automobile.[71] Export-oriented industries were

[70] *Nihon Keizai Shimbun*, July 1, 1971.
[71] Export dependence rates in 1970 were 23.9 percent in steel, 13.2 percent in electronic products, 12.9 percent in textile, 22.8 percent in automobiles, and 55-60 percent in shipbuilding. Akihiko Ishizaki, *Nichibei Keizai no Gyakuten* (Tokyo: Tokyo Daigaku Shuppankai, 1990), pp. 54-55. As for shipbuilding, Nihon Kogyo Ginko, *En Kiriagego no Wagakuni Sangyo no Kokusai Kyosoryoku* (February 1973).

therefore expected to be hit most severely by any revaluation of the yen.

There were various arguments regarding policy instruments for payments adjustment in this period, which can be categorized into three types. The first and the second types of argument, which were majority's opinions, opposed applying exchange rate policy for payments adjustment, while the third type claimed that exchange rate policy should be applied for payments adjustment.

The first and the second types of argument were not mutually exclusive. The underlying claim of these arguments was that revaluation would cause fatal damage to industry as a whole and destabilize the domestic economy. They emphasized that maintaining the exchange rate was the international principle of the Bretton Woods system and Japan's payment surplus did not constitute a "fundamental disequilibrium."[72]

The first type of argument attributed the cause of payment surplus to the regulated nature of Japanese domestic economy. Although Japan moved to Article VIII status country of the IMF in 1964, which was required not to take any restrictions on the payments and transfers for current international transactions without approval of the IMF, there were still restrictions on imports and similar impediments both to trade and to capital transactions. Liberalization of

[72] See, for example, the discussion among economists regarding how to adjust payment surplus in 1971; *Ekonomisuto*, August 10, 1971, pp. 17-19.

these restrictions, according to the first type of argument, should be the first consideration and would be helpful to eliminating payment surplus without applying revaluation. The MOF and the Bank of Japan took this stance for payments adjustment.[73] Business organizations such as Keidanren proposed to facilitate trade and capital liberalization in order to avoid revaluation.[74]

The second type of argument emphasized the effects of macroeconomic policy on payments adjustment. In this argument, expansionary macroeconomic policy would not only eliminate payment surplus, but also cope with the domestic demand for improving a standard of life.[75] Expansionary macroeconomic policy would encourage imports and discourage exports and thereby adjust payment surplus. Although there was a possibility of facilitating inflation by applying expansionary macroeconomic policy for adjusting payment surplus, supporters of this argument emphasized the importance of maintaining exchange rates even at the expense of price stability.[76] Since consumer price was gradually increasing in the late 1960s, while the rate of unemployment was stable, there was the risk of inflation from following an expansionary macroeconomic policy (See Table 3.2). This type

[73] Inside the MOF and the Bank of Japan, even arguing about possibility of yen revaluation publicly was prohibited officially. See, Tadashi Sasaki, "'Endaka Zaiakuron' kara Nukekirenakatta Nihon," *Toyokeizai*, September 29, 1982, p.38.
[74] *Keidanren Geppo*. vol. 19, No. 6 (June 1971), pp. 2-3.
[75] In the late 1960s, environmental pollution became a serious social issue in Japan.
[76] For example, see Kamekichi Takahashi, "En Kiriage ni Hantai suru," *Toyokeizai*, January 24, 1970, pp. 92-96.

of argument was revealed in the arguments of political parties based on preferences of societal groups such as industries, labor and consumers, which opposed revaluation and preferred fiscal expansion to improve a standard of life, although their ideas of how to allocate budget were different among the LDP and the opposition parties.[77]

[TABLE 3.2 ABOUT HERE]

By contrast, in the third type of argument, those who proposed revaluation claimed that without revaluation, it would be difficult to adjust payment surplus and that domestic economic objectives, stable price level in particular, should not be sacrificed for the sake of adjustment of payment surplus.[78] The best way to adjust surplus without hurting domestic economic objectives therefore was to revalue the yen. In the interpretation by this argument, maintaining the exchange rate was not the rigid principle of the Bretton Woods system, and Japan's payment surplus was a kind of "fundamental disequilibrium."

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77 The LDP proposed increase in public works spending, while opposition parties advocated increase in social welfare spending.

78 "Nihon Keizai no Genjo to En Mondai," *Ekonomisuto,* August 10, 1971, pp. 22-35.

This type of argument was advanced mainly by economists, but found little support from other societal groups.[79]

(ii) Avoiding Revaluation

With accumulating payment surplus and international political pressures for revaluation, the Japanese government had to choose other policy instruments than revaluation to eliminate payment surplus. The policy package called the "Eight Point Program to Avoid Yen Revaluation" was determined on June 4, 1971.[80] This package policy consisted of eight policy instruments; rapid implementation of import liberalization and preferential tariffs for imports from less developed countries, acceleration of tariff-reduction, promotion of the liberalization of restrictions on international investment, removal of nontariff trade barriers, expansion of foreign aid, establishing orderly exports and flexible management of fiscal and monetary

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[79] In July 1971, a group of scholars of modern economics proposed "crawling peg currency realignment." However, it was criticized widely by the media. For the content of the proposal, see Kawase Seisaku Kenkyu-kai, "Yen-reito no Kokizami Chosei ni tsuiteno Teigen," *Ekonomisuto*, August 10, 1971, pp. 36-48.

[80] As for US political pressures for revaluation of the yen, Coombs told that neither Federal Reserve representative attending the Bank of International Settlement meetings in 1970-71 nor Nixon officials attending US-Japan negotiations asked Japanese officials for revaluing the yen. See, Charles A. Coombs, *The Arena of International Finance* (New York: John Wiley & Sons, 1976), pp. 210-211. This observation was coincided with Japanese official's statement. This, however, does not mean that there was little US political pressures. US officials, as Gowa argues, often pointed out the undervaluation of the yen, although these voices did not express a clear-cut policy regarding change in exchange rate. See, Gowa, *Closing the Gold Window, op. cit.*, pp. 142-144.

policy.[81] These measures reflected the first and the second types of arguments regarding policy instruments for payments adjustment in order to avoid revaluation of the yen. Liberalization of restrictions on international transactions and expansionary macroeconomic policy were the main policy instruments of this package policy.

These policies which were planned mainly by the MOF were generally supported by societal groups.[82] As for expansionary macroeconomic policy, the Japanese government decided to increase spending for the Fiscal Investment and Loan Program. The Bank of Japan lowered the discount rate in May and July 1971 for the purpose of eliminating payment surplus.[83] Because of opposition from domestic interests in each sector, however, liberalization of restrictions on imports was not pursued as had been expected. A typical case involved liberalization of agriculture products, which was one of the urgent demands of the U.S. government. Strong oppositions from farmers and the Ministry of Agriculture made liberalization difficult in the early stage.[84] As for the abolition of the export promotion tax system, MITI opposed the plan of abolishing export promotion taxes proposed by the

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[81] For the details, see Robert C. Angel, *Explaining Economic Policy Failure: Japan in the 1969-1971 International Monetary Crisis* (New York: Columbia University Press, 1991), pp. 83-84.
[82] For example, see Keidanren, "En Taisaku Hachikomoku no Suishin ni Kansuru Iken," *Keidanren Geppo*, vol. 19, no, 8 (August 1971), pp. 34-36.
[83] *Nihon Ginko Hyakunenshi*, *op. cit.*, vol. 6, pp. 312-313.
[84] *Ekonomisuto*, *op. cit.*, pp. 40-41, Angel, *op. cit.*, pp. 90-91.

MOF. As it turned out, shipping and shipbuilding industries had asked the LDP to press the government not to promote the rapid abolition.[85]

4. Policy Choice After the "Nixon Shock": Expansionary Policy in 1971-1973

President Nixon's announcement of suspending the gold-convertibility of the U.S. dollar and imposing a temporary 10 percent surcharge on imports on August 15, 1971 was a surprise for Japan, which was in Japan called the "Nixon Shock." The "Nixon Shock" forced Japan to revalue the yen, an action Japan had long sought to avoid. After the foreign exchange market was kept open to buy dollars for about two weeks, Japan decided finally to let the yen float on August 28.[86] This shift meant a *de facto* revaluation of the yen.[87]

The international discussions on the reform of the international monetary system reached an agreement on December 18 on an exchange rate realignment.[88] In the Smithsonian Agreement of the Group of Ten countries, Japan,

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[85] *Ekonomisuto*, August 3, 1971, pp. 38-39. See, discussion in the Special Committee for the Shipping and Shipbuilding Industries of the LDP, "Sogoteki Taigai Keizaiseisaku ni Taisuru Moushiire," July 15, 1971, in Ichiro Murakawa Collection of the LDP documents.
[86] Only Japan kept markets open among industrial states. For the chronological details of this process, see Angel, *op. cit.*, chapter 5.
[87] The exchange rate of the yen on August 28 was $1=¥341.30, which meant 5.2 percent revaluation.
[88] For the details of international discussions, see Williamson, *op. cit.*, pp. 53-67.

under international pressure, accepted a revaluation of the yen by 16.88 percent, the largest rate of revaluation among countries.[89] Despite the efforts among countries at the Committee of Twenty (C-20) meetings to restore a fixed exchange rate system, the decision was taken to let exchange rates float in March 1973. Conflicting national interests contributed to the failure of the agreement.

From the "Nixon Shock" until the installation of a floating exchange rate system in February 1973, Japan's policy choice for payments adjustment was shaped by a domestic preference against further revaluation and political pressures for expansionary macroeconomic policy as the alternative policy instrument to further revaluation. This section will examine first how domestic preferences regarding exchange rate policy emerged after the "Nixon Shock"; and second, how such domestic preferences affected policy choices for payments adjustment through political structure.

(1) Domestic Preferences and Political Parties

Whether domestic preferences can affect policy formulation depends on to what extent representation of

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[89] For Japanese attitudes toward an exchange rate realignment, see Yusuke Kashiwagi, *Gekido-ki no Tsuka Gaiko* (Tokyo: Kinyuzaiseijijo Kenkyukai, 1972), pp. 3-22, Masaru Hayami, *Hendo-sobasei Jyunen: Kaizunaki Kokai* (Tokyo: Toyokeizai Shimpo-sha, 1982), Chapter 2, Paul Volcker and Toyoo Gyohten, *Changing Fortunes: The World's Money and the Threat to American Leadership* (New York: Times Book, 1992), pp. 95-100.

domestic preferences provokes political debate. After the "Nixon Shock," there was overrepresentation of domestic preferences against further revaluation and this representation affected policy orientations of political parties, regardless of the LDP or the opposition parties. Opposition to a further revaluation came most strongly from export-oriented industries, but export-oriented industries included not only big firms, but also small-scale businesses. In addition to industry, labor was also vocal in opposing a further revaluation.

Export-oriented industries, which would be damaged from a yen revaluation, expressed opposition to the government's decision of revaluation. These sectors, in addition, asked the government to compensate for the loss which would be caused by any yen revaluation.[90] Export-oriented industries organized associations of each industry and were important members of peak business organizations. Keidanren was the most important and influential organization.[91]

The initial response of business organizations toward the government's decision was ambiguous. Peak business associations such as Keidanren and Keizai Doyukai, whose members were mainly big firms, stated that the government's decision to let yen float after the "Nixon Shock" was understandable, considering the present international

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[90] Angel, *op. sit.*, pp. 159-160.
[91] There are three other major peak associations; Keizai Doyukai (the Committee for Economic Development), Nikkeiren (the Federation of Employers Organizations, and Nissho (the Japan Chamber of Commerce and Industry).

economic situation. However, responding to the complaints of export-oriented industries, Keidanren made another statement asking the government to compensate industry for its projected losses, which would be caused by revaluation of the yen. The compensatory measures were special measures towards small-scale businesses and stimulative measures for the domestic economy by tax cut and/or public works spending.[92]

Export-oriented small-scale businesses were expected to be hit severely by the yen revaluation. Exports of small-scale business was 40.2 percent of total exports and 43.5 percent of exports to the United States.[93] Moreover, local small-scale business manufacturing regions were regarded as most severely damaged by the revaluation of the yen. There were 120 manufacturing regions which exported more than ten percent of products in each industry. The number of manufacturing regions in textile amounted to 49, and that of miscellaneous merchandise such as shoes, toys and bags was 36. Exports by these 120 manufacturing regions amounted to 43 percent of total exports of small-scale business. While average of percentage of exports by small-scale businesses was 7.5 percent, average of exports by these 120 regions was 35.7 percent.[94]

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[92] Keizaidantai Rengokai, "Heika Chosei Taisaku ni kansuru Iken," October 12, 1971, *Keidanren Geppo*, vol. 19, no. 11 (November 1971), pp. 8-9.
[93] Otsu Takafumi, "Nikuson Shinseisaku go no Cyushokigyo Kinkyutaisaku," *Fainansu*, no. 72 (November 1971), pp. 13-19.
[94] *Chushokigyo Hakusho 1972* (Tokyo: Okurasho Insatsukyoku, 1972). Tsubame of Niigata prefecture, manufacturing region of western tableware, got special attention as a symbol of suffering from the yen appreciation not only in the debate at

Therefore, export-oriented small-scale manufactures were especially active in pressing political parties and the government.[95] Since export-oriented small-scale businesses were mainly local industries and located nationally, they consisted of electoral bases of political parties, regardless of the LDP and the opposition parties. Therefore, political parties were sensitive to small-scale business policy.[96] Small-scale business policy was one of the issue-areas with low partisan conflict among political parties.[97] Association of small-scale business, Zenkoku Chushokigyodantai Chuokai (National Association of Small-Scale Business), was active in calling for compensation and anti-recession policy through public works spending.[98]

Labor also opposed strongly a further revaluation, because they feared the deflationary effect of revaluation of

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the Diet, but also by the media. 83 percent of western tableware products was exported, and 95 percent was produced in Tsubame. *Tosyo* (October 1971), pp. 29-31.

[95] MOF official recalls that every day organizations of small-scale businesses strongly lobbied against further revaluation. Takehiro Sagami, "Sengo Keizaishi Saidai Ibento no Hiwa, ge," *Toyokeizai*, Special spring Issue, 1983, p. 88.

[96] Hiwatari argues that in Japan the LDP and the opposition parties relied on the support from similar societal groups, their policies toward these societal groups were likely to be similar. Small-scale business is one of such a societal group. See, Hiwatari, *op. cit.*, pp. 79-86, p. 205. Calder also points out the political parties' interests in small-scale business policy. Calder, *Crisis and Compensation, op. cit.*, p. 334.

[97] Mike Mochizuki, *Managing and Influencing the Japanese Legislative Process: The Role of Parties and the National Diet*, Ph. D. dissertation, Harvard University, 1982, p. 304, pp. 333-344.

[98] Zenkoku Chushokigyodantai Chuokai was founded in 1956. *Chushokigyo to Kumiai*, no. 322 (December 1971), p. 49, pp. 62-64.

the yen on the condition of labor. Revaluation of the yen, according to labor organizations, would reduce exports and slow down the domestic economy, which would decrease wages and increase unemployment.[99] Labor sectors asked for compensation for the loss which was expected to get from yen revaluation.[100]

Reflecting these domestic preferences against a further revaluation, political parties had an interest in provoking political debate regarding policy instruments for avoiding a further revaluation. The opposition parties blamed the LDP government for failing to avoid yen revaluation in August and pointed out the government's responsibility for the damage any yen revaluation would cause to the domestic economy.[101] Opposition parties called for Diet special hearings regarding the problem of the yen. In these hearings, the government's decision to keeping the exchange markets open and of let the yen float was attacked by the opposition parties. The opposition parties regarded the government's decision to shift to a floating system as a policy failure and attributed this failure to a Japanese foreign economic policy too dependent upon the United States.

The JSP, most powerful opposition party, argued that the "Nixon Shock" was the result of the LDP government's

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99 Sohyo, "Saikin no Dorumondai to Rodokumiai no Taido," (August 26, 1971).

100 Statements by labor organizations. *Rodo Chosa Jiho*, no. 613 (December 1971), pp. 19-25.

101 Statements by four opposition parties on August 27. (*Nihon Keizai Shimbun*, August 28, 1971.), JSP, "Beikoku no Shinkeizaiseisaku to Wagato no Taido," (August 26, 1977).

policy of "high economic growth" which was carried out for the interests of big business at the expense of labor and small-scale business. Thus, the JSP emphasized the importance of welfare policy in economic crisis caused by the "Nixon shock," and demanded special policy measures towards small-scale business and labor in particular.[102] The opposition parties were against a further revaluation of the yen and demanded prompt policy measures towards small-scale business and labor.

(2) Influence of Domestic Preferences on Policy Choice

(i) Domestic Preferences and Small-scale Business Policy

After the "Nixon Shock," officials of the MOF and the Bank of Japan realized that Japan had to accept a further revaluation in response to increasing payment surplus.[103] However, the policy choices of the Japanese government were restrained by domestic preferences against applying a further revaluation for payments adjustment. These domestic preferences were represented by political parties. The government therefore repeated a pledge of not accepting a further revaluation.

Between the "Nixon Shock" and the Smithsonian Agreement, the government tried to minimize the range of

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102 Nihon Shakaito, "Tomen no Keizai Josei to Wareware no Taido," October 22, 1971, *Gekkan Shakaito*, pp. 150-156.
103 Takehiro Sagami, "Sengo Keizaishi Saidai Ibento no Hiwa, chu," *Toyokeizai*, November 13, 1982, pp. 86-97. Sagami, op. cit., pp. 82-93.

revaluation of the yen, and after the Smithsonian Agreement, it tried to avoid a further revaluation. The earliest and quickest measure for avoiding revaluation was the Bank of Japan's intervention in exchange market by buying large amounts of the dollar, subsequently criticized internationally as a "dirty float," intended to control foreign exchange and minimize revaluation of the yen.[104]

The government policy after the "Nixon Shock" was influenced by the political pressure especially from the LDP politicians whose electric districts included export-oriented small-scale businesses.[105] The LDP's concern after the "Nixon Shock" was mainly over how to minimize the negative effect of change in exchange rate on the small-scale businesses, because opposition parties had also their interests in small-scale business policy from the view point of payments adjustment policy.

At the meeting of the LDP Executive Council on September 14, attended by officials from the MITI and the MOF, the discussion focused on compensation for the expected damage to small-scale businesses. MOF official expressed a preference for taking time to decide Japan's international monetary policy along with the international negotiations, while LDP politicians asked for quick measures to take care of small-scale businesses. The LDP urged the MITI to take

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104 From September to December, the amount of dollar bought was $3 billion, although it was smaller than the amount of dollar bought during 11 days after the "Nixon Shock," $4 billion.
105 Angel, *op. cit.*, p. 154.

compensatory policy toward the small-scale businesses.[106] After the MOF decided its policy of solving exchange rate problem by long-term international negotiations, the LDP strongly pressed the MOF to compensate the loss of the small-scale businesses until the exchange rate was fixed.[107]

On September 23, 1971, the government announced an emergency support policy for small-scale business. This policy, which included financial support, special tax treatment and special loan for small-scale businesses, was approved by the Diet in December.[108] According to this law, 107 industries and 83 producing districts were approved to get special measures.[109] The additional Fiscal Investment and Loan Programs were determined in three times during this period, which were mainly for measures for small-scale businesses.

(ii) Expansionary Macroeconomic Policy as an Alternative Policy Instrument

As a result of avoiding revaluation under political pressure, policy instrument applied by the government for

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106 At the LDP's Executive Council (Somukai), one member described the petition from small-scale business in his electoral district and insisted that responding to such request be the role of politics. LDP Record of Executive Council, September 14, 1971 (Ichiro Murakawa Collection of the LDP documents).

107 LDP Record of Executive Council, September 21, 1971, *ibid*.

108 Otsu, *op. cit.*

109 Tsusho Sangyosho (MITI), *Tsusho Sangyo Seisakushi*, vol. 15 (Tokyo: Tsushosangyo Chosakai, 1991), pp. 30-31.

payments adjustment heavily relied on expansionary macroeconomic policy.[110] Fiscal expansion in particular was the policy instrument which was met by domestic preferences. The demand of compensation for the damage of industries which was expected to be caused by the yen revaluation was strong among industries. Small-scale businesses in particular was at the center of political debate, in which all of political parties called for compensation for small-scale businesses.[111]

Policy choice of expansionary macroeconomic policy for adjustment of payment surplus was also apparent in the making of the 1971, 1972 and 1973 budgets. The budgets during this period were far larger compared to in the preceding period. The budget growth rate of the 1971 supplement budget was 21.5 percent over the 1970 post-supplementary budget and 17.6 percent over the 1970 supplementary budget. Spending for public works in particular was large, 232 billion yen. It was the first time since the 1960 budget to allocate expenditures for public works in the supplementary budget. Expenditures for small-scale businesses were 7.5 billion yen, an addition to the Fiscal Investment and Loan Program. The 1972 budget, which aimed at both stimulating recessionary

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[110] Yukitsugu Nakagawa, *Taikenteki Kinyu Seisaku-ron* (Tokyo: Nihonkeizai Shimbunsha, 1981), pp. 24-25.

[111] At the national meeting of small-scale businesses on October 7, 1971, the MITI Minister (Kakuei Tanaka) and representatives of political parties except for the Japan Communist Party were invited and asked to take special measures for small-scale business. All of them expressed the necessity of such measures; *Chushokigyo to Kumiai* no. 322 (December, 1971), pp. 62-69.

domestic economy and avoiding revaluation of the yen, was 21.8 percent over the 1971 budget. Public works spending increased much larger than the preceding year by 29.0 percent. This was the biggest growth rate in public works spending after World War II.

The 1972 supplementary budget and the 1973 budget were particularly expansionary affected by the formation of Tanaka Cabinet, whose political slogan of nationwide industrialization was called the "Plan for Redevelopment of the Japanese Archipelago (*Nihon Retto Kaizo-ron*)." The size of the 1972 supplementary budget amounted to 5.7 percent of the original budget, which was the largest supplement since 1967. Public works spending was 536 billion yen, which was to be financed by issuing bonds.[112]

The 1973 budget was called the "trilemma budget" because it aimed at three goals which were difficult to be achieved at the same time, that is, improving welfare, adjusting payment surplus and stabilizing price level. This budget was 24.6 percent over the 1972 budget. Public works spending was 32.2 percent and welfare expenditure was 28.8 percent over the preceding year. The budgeting process during this period was unusual because the MOF, which had adhered to the principle of a balanced-budget and refused the demands of other ministries, asked to increase public works

[112] Bond-dependence-ratio jumped to 17.0 percent in 1972 from 4.6 percent in 1971.

spending under the political pressure for expansionary policy.[113]

(iii) International Pressures for Revaluation and Domestic Preferences

After the Smithsonian Agreement, international monetary system was still unstable and payment disequilibrium among nations had not be adjusted through 1972. Japan had the largest current account surplus, while the United States was faced with the largest deficit in history. Japan's payment surplus was not reduced in 1972 partly due to the J-curve effect. The United States, facing the large balance of payment deficit, tried to carry out multilateral currency adjustment by urging Japan and European countries to readjust their currencies. In this international economic situation, domestic preferences against a further revaluation constrained the policy choice of the Japanese government.[114]

Policy choice of expansionary macroeconomic policy as a policy alternative was not reconsidered even when domestic economy turned into recovering in early 1972 and wholesale price index was rising rapidly after the summer of 1972.

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113 Comment by Vice Minister of the MOF, Iichiro Hatoyama. Hiroshi Ando, *Sekinin to Genkai: op. cit.*, pp. 110-111, Hakuo Yanagisawa, *Akaji Zaisei no Junen to Yonin no Souritachi* (Tokyo: Nihon Seisansei Honbu, 1985), p. 16.

114 With accumulating payment surplus and international pressure for a further revaluation, the Japanese government decided additional package policies for adjustment of payment surplus in May and October 1972. In these programs, however, almost same policy proposals as in the Eight Point Program in 1971 were repeated.

Political parties acquiesced to the government's policy choice of expansionary policy for payments adjustment. Opposition parties demanded the increase of welfare spending, while labor called for raising wages.

The MITI Minister, Yasuhiro Nakasone, stated at a meeting with business leaders that when he had to choose between a further revaluation and controlled inflation, he preferred controlled inflation.[115] Prime Minister, Kakuei Tanaka, also advocated expansionary policy by saying that although domestic policy had been not enough applied due to the fear of rising price level, domestic policy should be carried out [for payments adjustment] prior to further revaluation.[116] In November, Prime Minister Tanaka stated at the Diet that "the government would take every efforts to avoid a further revaluation of the yen and in case of revaluation, the government would face the responsibility for it." [117]

With international pressures for a further revaluation and domestic inflationary tendency, some business leaders and economists began to support revaluation of the yen for payments adjustment in late 1972. The Bank of Japan and MOF officials began to reconsider policy instrument for adjustment policy. As the U.S. and European pressure for further revaluation of the yen increased, the Japanese

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115 *Nihon Keizai Shimbun*, August 16, 1972.
116 *Ibid.*, October 1, 1972.
117 *Ibid.*, November 9, 1972.

government decided to let the yen float again on February 12, 1978.[118]

This shift shows that international political pressures played an important role in this decision, but also illustrates that the policy makers were also restrained by domestic preferences against further revaluation. Although the United States urged Japan to revalue the yen by 20 percent, the Japanese government resisted a formal revaluation and instead accepted a float. Since the LDP government continuously stated that it would avoid further revaluation, it wanted to avoid accepting formal revaluation, which might cause the problem of political responsibility of the LDP government.[119] Moreover, since the Diet was in session to discuss the 1973 budget bill, the government wanted to avoid realign the exchange rate for the yen which might force the LDP government to revise the budget bill by political pressure from opposition parties.[120]

(iii) The Norm of the Fixed Exchange Rate in the Case of Payment Surplus

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[118] For the details, see Takashi Hosomi, *Gekido suru Kokusai Tsuka* (Tokyo: Jijitsushin-sha, 1982), pp. 21-40; Volcker and Gyohten, *op. cit.*, pp. 105-109, pp. 129-132.

[119] Finance Minister, Kiichi Aichi, stated at the Diet that Accepting a float was not revaluation of the yen and the Japanese government did not plan to realign the exchange rate. *Nihon Keizai Shimbun*, February 14, 1973.

[120] Volcker and Gyohten, *op. cit.*, p. 130. When opposition parties at the Diet asked the Tanaka cabinet to take responsibility for *de facto* re-revaluation, Prime Minister Tanaka stated that the acceptance of a float system was a result of international pressure and hence, no responsibility of the government.

During the 1950s and the early 1960s, the Japanese government continuously chose to apply macroeconomic policy for adjustment of payment deficit in order to maintain its par value. This policy choice of tight macroeconomic policy was legitimated by the interpretation of the norm of the fixed exchange rate system by the MOF and the Bank of Japan. This interpretation of maintaining the fixed exchange rate helped counter political pressures for expansionary policy from influencing macroeconomic policy formulation.

In contrast, faced with a payment surplus in the late 1960s, a consensus of the norm of the fixed exchange rate system, which was formulated during the 1950s and maintained during the 1960s, legitimated applying expansionary macroeconomic policy as a policy alternative for payments adjustment. Not only the government but also the MOF and the Bank of Japan officials were constrained by this norm in policy choice of payments adjustment policy. As a result of this restraint, it was difficult for the MOF and the Bank of Japan to limit political pressures of political parties for expansionary policy, fiscal policy in particular, in the formulation of macroeconomic policy.

5. Summary

Japan's policy choice with respect to payments adjustment under the Bretton Woods system demonstrates that the pattern of domestic preferences regarding the exchange rate and political structure responding domestic preferences were two important factors to explaining state choice of payments adjustment policy.

During the 1950s and the early 1960s, facing payment deficit, the Japanese government chose tight macroeconomic policy instead of devaluation, unlike France in parallel economic circumstances. This policy choice was carried out through policy measures to neutralize uneven domestic distributional consequences of such policy choice. As a result of neutralizing policy, quick adjustment of payment deficit, and the norm of the fixed exchange rate system, there was little domestic preferences regarding the exchange rate and hence little political debate on payments adjustment policy in domestic political arena. Therefore, applying devaluation, although it might have encouraged export, was rarely considered as a policy instrument for payments adjustment.

In the case of payments surplus after the late 1960s, in contrast, domestic preferences against revaluation emerged. Export-oriented industries, small-scale businesses and labor strongly opposed applying revaluation to achieve payments adjustment. Policy orientations of all political parties, which responded to domestic preferences, were similar in asking for an expansionary macroeconomic policy. The period between the "Nixon Shock" and the shift to a floating exchange rate system in 1973 demonstrates how the government's choice with respect to payments adjustment was affected by domestic preferences against further revaluation and the similar responses of political parties to domestic preferences. The norm of the fixed exchange rate system contributed to reinforce domestic preferences against revaluation in the case of payment surplus, and, in contrast to the period of payment deficit, to limit the role of the MOF and the Bank of Japan in macroeconomic policy formulation.

Table 3.1

Domestic Economic Conditions in Japan:
Current Account Balance, Price Level, and Growth Rate,
1957-1964

	Current Account Balance ($ billion)	Consumer Price (percentage changes from previous year)	Economic Growth Rate (percentage changes frome previous year)
1957	-0.6	0.3	14.0
1958	0.3	-0.0	4.0
1959	0.4	1.3	12.2
1960	0.1	3.8	19.8
1961	-1.0	5.1	23.5
1962	-0.05	6.8	10.9
1963	-0.8	7.5	15.4
1964	-0.5	4.0	18.1

Sources: *Keizai Hakusho* (Tokyo: Okurasho Insatsukyoku), each year.

Table 3.2

Domestic Economic Conditions in Japan:
Current Account Balance, Price Level, and Unemployment Rate, 1968-1973

	Current Account Balance ($ billion)	Consumer Price (percentage changes from previous year)	Unemployment Rate (commonly-used definition)
1968	1.0	4.9	1.1
1969	2.1	6.4	1.1
1970	2.0	7.3	1.2
1971	5.8	5.7	1.3
1972	6.1	5.2	1.4
1973	- 0.1	16.1	1.3

Sources: *Keizai Hakusho* (Tokyo: Okurasho Insatsukyoku), each year.

Chapter Four

Payment Surplus in A Floating Rate System: Yen Appreciation or Expansionary Policy in 1977-78

1. Introduction

This chapter will deal with the case of payments adjustment problem Japan was faced with in the floating exchange rate system of the post-Bretton Woods era: the 1977-78 case. After 1976, Japan's increasing payment surplus became an urgent agenda in the international economy. In a floating exchange rate system, the nature of payments adjustment regarding policy instruments changed. Adjustment of payments imbalances was left basically to the mechanism of the exchange markets, but with increasing capital transactions across borders, macroeconomic policies were considered to exert more influence than in the fixed exchange rate system on payments adjustment.

How did this changing nature of payments adjustment affect state policy choice with respect to payments adjustment? A floating exchange rate system was designed to free policy makers from having to choose between exchange rate policy and macroeconomic policy to achieve payments adjustment. Exchange rates would move automatically in either direction to adjust payments imbalances. Macroeconomic policy, presumably, was formulated solely to achieve domestic objectives. Yet, when these presumptions appeared to be unrealistic, how did states formulate their policies and respond to external payment imbalances?

This chapter will examine how Japan's payments adjustment policy was formulated during 1977-78. During this period, the United States, Germany, and Japan conducted international negotiations over whether or not, and how states should coordinate their policies for the sake of a stable international economy. The focus here will be on under what circumstances Japan decided to choose to apply fiscal expansion policy for payments adjustment.

How did the shift to a floating exchange rate system affect Japan's policy choices? Did domestic preferences regarding the exchange rate emerge like the case of 1968-73? In Germany, after the shift to a floating exchange rate system, domestic preferences against high value of its currency was reduced. How were domestic preferences formulated with respect to payments adjustment in Japan? How did the political structure affect the formulation of payments adjustment policy? What similarities existed between the two cases of payment surpluses, 1968-73 and 1977-78? These are the empirical questions to be addressed in this chapter.

The first section of this chapter will deal with the initial period: from early 1976 to September 1977. During this time, exchange rate policies emerged on the international agenda as a policy instrument for payments adjustment. The second section will consider domestic preferences and the political structure regarding policy instruments for payments adjustment policy. The third section will examine Japan's adjustment policy in the latter period: from September 1977 to early 1978. At this time the yen/dollar exchange rate appreciated rapidly. The Japanese government, despite its austerity policy, decided to apply expansionary fiscal policy in December 1977. In this section, the emphasis will be on the relations between domestic preferences regarding the exchange rate and the choice of macroeconomic policy.

2. The International Economic Change and State Choice: 1976-September 1977

(1) The Problem of Payments Adjustment After 1973

In 1973, the international economy and the domestic economies of key nations were shaken by dramatic changes in the international economy. In March 1973, the fixed exchange rate system broke down and an international monetary system shifted to a floating exchange rate system following an unstable international monetary situation after the

Smithsonian Agreement. After this shift, most industrial countries suffered record high levels of inflation, followed by recessions. In October, a sudden increase in the price of crude oil was announced by the OPEC. The rapid rise of oil price consequently aggravated inflation and caused large balance of payments imbalances among not only industrial countries, but also among developing ones.

These changes in the international economy altered the nature of the payments adjustment problem. Between 1973 and 1976, the emphasis of payments adjustment policy was mainly on how to finance the large international payment deficits caused by the sudden rise of oil prices. Unlike the late 1960s, the majority of countries -- regardless of whether they were industrial or developing countries -- had large current account deficits. Only oil exporting countries had massive payment surpluses. In this situation, conventional policy instruments for payments adjustment were regarded as ineffective against eliminating international payment imbalances. If oil importing countries decided to cope with their payment deficits through conventional policy instruments, such as depreciating their exchange rates, deflationary macroeconomic policies and restrictions on trade and capital transactions, these policy instruments could be expected to bring about a severe world depression and protectionism. Since oil exporting countries were accumulating large foreign exchange reserves, the payments adjustment policy most supported by the IMF put emphasis on financing payment deficits of oil importing countries by recycling surpluses of the oil exporting countries.

During the period from 1974 to 1976, there were significant shifts in international payment situations brought about by a recycling of oil dollars. Current account surpluses of major oil exporting countries reduced to $41 billion in 1976 from $67 billion in 1974. By contrast, industrial countries as a whole lowered payment deficits from $22 billion in 1974 to only $1 billion. However, an uneven situation emerged with not only among developing countries but also with respect to industrial ones. Among industrial states, the United States, Germany, Japan and the Netherlands had current account surpluses, while states such as Austria, Britain, Canada, Denmark, France, Italy, Norway and Sweden suffered deficits.

The uneven situation among industrial states demonstrated that a floating exchange rate system could not solve the problem of payments adjustment automatically. Moreover, under increasing capital movements across borders, it became apparent that the macroeconomic policy of one state affected domestic economies of the other countries.

Three industrial countries - the United States, Germany and Japan - recovered from the severe cost-push inflationary pressures generated by the oil shock by applying anti-inflationary policies. Among them, Germany held the strongest current account position during this period. The surplus of Germany amounted to $6.8 billion in 1976 mainly due to the strength of its exports. Japan also successfully offset the oil-related deficit during this period through deflationary policies. Japan's current account balance recovered from substantial deficit after the oil crisis into surplus in 1976 along with the growth of its exports. The United States, although it maintained its surplus, reduced its surplus from $15 billion in 1975 to $3 billion in 1976. Other industrial states such as Britain, France and Italy still suffered from current account deficits (See Table 4.1).

[TABLE 4.1 ABOUT HERE]

The uneven current account balances among industrial states began to be recognized as a problem in the international economy. Adjustment of payment imbalances among industrial states topped the central agendas of international economic organizations such as the IMF and the OECD. At the annual meeting of the IMF in September 1976, Managing Director Johannes Witteveen stressed the importance of payments adjustment policy of each state based on the observation that the main danger in the international economy was no longer a deepening of recession but a renewal of inflation: "[T]he time has come to lay more stress on the adjustment of external positions and less emphasis on the mere financing of deficit."[1] Regarding policy instruments for payments adjustment, he pointed out the importance of both changes in exchange rate and in macroeconomic policy. Since change in exchange rates had not contributed as much to adjustment as expected, changes in exchange rates should be applied more promptly. Macroeconomic policy was also regarded as important to payments adjustment. Deficit states were expected to restrain domestic demand and shift resources to other external sectors. In surplus states, adequate recovery of domestic demand was required by applying expansionary macroeconomic policy.[2]

In reality, however, these policy instruments were not promptly applied by each state. Each state had to deal first with the domestic consequences of policy instruments for payments adjustment in unstable domestic economies after the oil crisis. The United State was most concerned over payment imbalances among three major industrial countries. At the summit meeting of industrial countries in Puerto Rico in June 1976, in which the most important agenda item was the balance of macroeconomic policies, the United States proposed that countries with large surpluses should take measures to reduce their external payment surpluses, as was happening in the United States. Since the two other surplus countries, Germany and Japan, did not respond to the U.S. proposal,

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[1] International Monetary Fund, *Summary Proceedings of the Thirty-First Annual Meeting of the Board of Governors* (Washington, D. C.: International Monetary Fund, 1976), pp. 16-17.

[2] *Ibid.*, pp. 17-18.

Puerto Rico's Summit did not produce any significant results regarding which states should apply which policy instruments for payments adjustment.[3]

The U.S. eagerness for payments adjustment was related to the concern over its changing position in external payments balance. Of the three major states which had maintained a payment surplus, the United States exhibited a large shrinkage of current account surplus between 1975 and 1976. As it became more and more apparent that its current account balance was worsening, the United States began to criticize the two other surplus countries for not taking appropriate measures to eliminate their payment surpluses.[4] The decline in the trade balance of the United States, which turned into deficit in 1976, eroded its current account position. By contrast, Germany kept a large trade surplus continuously and Japan also increased its trade and payment surpluses from 1975 (See Table 4.1). The United States therefore played a major role in setting an international agenda regarding which states should apply which policy instrument for payments adjustment.

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[3] Putnam and Bayne, *op. cit.*, p. 43.
[4] For example, Economic Report of the President in 1977 stated, "[T]he persistent Japanese surplus has complicated adjustment for other countries and has led to voluntary agreements to restrict certain trade flows." *The Economic Report of the President, 1977* (Washington, D. C.: Government Printing Office, 1977), p. 124.

(2) Exchange Rate Policy as A Policy Instrument

Exchange rate policy came to the center of international concerns regarding policy instruments for payments adjustment first among other policy instruments. The floating exchange rate system in the post Bretton Woods era proved less effective in adjusting international payment imbalances than had been expected. As for movements in the major currencies against the dollar, the Japanese yen, the English pound and the Italian lira displayed relatively little movement after the Smithsonian Agreement, compared with the Deutsche mark, the Swiss franc and the French franc. Since Japan had a large surplus like Germany, and Britain and Italy had relatively larger deficits than France, the small movements in the rates of these currencies were not enough to adjust their external payment imbalances.

(i) International Criticism of Japan's Exchange Rate Policy

Japan's current account surplus increased with the rapid rise in its exports, increasing Japan's share of the world market, and leading Japan to an early recovery from its recession. The world economy remained depressed. In this situation, Japan intervened heavily in the foreign exchange rate markets by buying dollars to stabilize the market in early 1976.[5] Given this exchange rate policy, the Japanese

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[5] As for Japan's exchange rate policy, see Ryutaro Komiya and Miyako Suda, *Gendai Kokusai Kinyuron: Rekishi, Seisaku* (Tokyo: Nihonkeizai Shimbun-sha, 1983). English translation

yen appreciated much less than the Deutsche mark of Germany, which maintained current and trade surpluses like Japan. Considering this small movement of the yen against the dollar, state intervention in the foreign exchange markets against market forces came to be recognized as problematic. In this context, criticism of Japan's exchange rate policy intensified during the summer of 1976 after the Puerto Rico Summit.

During this period, Japan's exchange rate policy was criticized for maintaining a "cheap yen," intervening in foreign exchange markets in order to keep its exports competitive -- commonly called a "dirty float." Such criticism came first from economists and the media in the United States and Europe. At the hearings of the U.S. Congress about the amendment of the Bretton Woods Agreement Act in June 1976, Fred Bergsten, a senior economist at the Brooking Institution, argued that flexible exchange rates were essential for the international economy. However, he continued, the other countries' competitive interventions in the exchange markets prevented flexible exchange rates from working properly and brought about swings in trade balances. He stated,

"Japan is likely to run the largest rate surplus in its history this year, yet it has been buying dollars massively for the last 5 months to keep the exchange rate of the yen from rising significantly, and thus hurting its competitive position. The British and Italian depreciation of their

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is Ryutaro Komiya and Miyako Suda, *Japan's Foreign Exchange Policy 1971-82* (Sydney: Allen & Unwin, 1991).

currencies almost certainly exceed the amounts justified by their underlying competitive positions, enhancing their trade balances."[6]

According to Bergsten, the other surplus countries - Germany and Japan - should be pressed "to expand their economies more vigorously, and/or let their exchange rates rise in value."[7] Based on the view that the United States had aided the recoveries of other states by moving into a temporary trade deficit, Bergstein criticized Japan for the unfair practice of keeping its exchange rate from rising, thereby worsening U.S. trade deficits.[8]

In August 1976, the American and European media's criticism of Japan's "cheap" yen exchange rate policy grew stronger.[9] U.S. officials, however, did not specifically criticize Japan's exchange rate policy officially. When Under Secretary of the Treasury for Monetary Affairs, Edwin Yeo, visited Japan to discuss U.S.-Japan economic relations, he did not comment on Japan's exchange rate policy explicitly.[10] Instead, he expressed U.S. concern over Japan's current surplus, which might provoke protectionism in Europe, and emphasized the importance of surplus countries' taking measures to adjust its payment surplus without causing

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[6] U.S. Congress, *Hearings before the Subcommittee on International trade, Investment and Monetary Policy of the Committee on Banking, Currency and Housing*, 94th, 2nd session, June 1 & 3, (Washington, D. C.: Government Printing Office, 1976), p. 98.
[7] *Ibid.*, p. 99.
[8] *Ibid.*
[9] Komiya and Suda, *op. cit.*, p. 184.
[10] *Nihon Keizai Shimbun*, August 13, 1976.

inflationary pressure domestically.[11] In response, Japan's officials explained that Japan's intervention was only to prevent violent fluctuations of the exchange rate and denied the charges of a "dirty float."[12]

More specific criticism of Japan's exchange rate policy came from U.S. Congress. Chairman of the House Banking Committee, Henry Ruess, whose electoral district included the troubled motorcycle company, Harley-Davidson, sent a letter to the Japanese Ambassador, Fumihiko Togo, accusing Japan of violating recent international understanding concerning a floating exchange rate system by "systematically depressing its currency internationally so as to increase its exports at the expense of other countries."[13] Ruess's letter made Japanese officials realize that Japan's exchange rate policy received strong political attention in the United States because of Japan's increasing current account surplus and trade surplus with the United States.

Responding to the charge of a "cheap yen," Japanese officials defended Japan's exchange rate policy. The Governor of the Bank of Japan, Teiichiro Morinaga, made a statement that Japan's exchange rate policy was only to prevent the fluctuation of exchange rates to maintain a stable market, and fit within guidelines for exchange market intervention agreed at Rambouillet Summit in 1974.[14]

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[11] *Ibid.*, August 14, 1976.
[12] *Ibid.*, August 13, 1976.
[13] *New York Times*, August 27, 1976, p. D7.
[14] *Nihon Keizai Shimbun*, August 31, 1976.

Ambassador Togo's letter responding to Ruess emphasized that Japan's intervention was simply to "smooth the market." His letter pointed out that Ruess's criticism was based only on a short-term perspective and explained that the Japanese monetary authorities also sold dollars in the latter half of 1975 on the reverse occasion in the amount far exceeding that of dollars bought in the first half of 1976.[15] Vice Minister of Ministry Finance, Michiya Matsukawa, visited the United States in September to promote a better understanding on the part of the U.S. officials of Japan's exchange rate policy.

The U.S. officials, especially the Treasury Department, expressed more understanding than the Congress and the media. At the hearing of U.S. Congress, responding to the Ruess's inquiry which singled out the relationship between exchange rates and competitive positions, Yeo answered, "I do not think that the evidence of the past 18 months suggests that the capacity exists to develop through intervention a sustainable artificial rate relationship by a major country."[16] From the autumn 1976 until the early 1977, criticism of Japan's exchange rate did not emerge from U.S. officials.[17]

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[15] *New York Times*, September 2, 1976, *Nihon Keizai Shimbun*, September 2, 1976, evening edition. A part of Togo's letter cited by Henry Ruess at a Congress hearing.(U.S. Congress, *Hearing before the Subcommittee on International Economics of the Joint Economic Committee*, 94th Congress, 2nd session, October 18, 1976 (Washington: Government Printing Office, 1977), p. 43.

[16] Hearings, *ibid.*, p. 42.

[17] Komiya and Suda, *op. cit.*, p. 177.

(ii) Change in Japan's Exchange Rate Policy

Between January and April 1976, as Japanese officials explained, Japan's exchange rate policy was to intervene to minimize the fluctuations in the exchange rate and supported a certain level of the rate to lessen the negative effects of any change in exchange rate on the domestic economy. As a result of massive interventions, fluvtuations in exchange rate were particularly small during this period between only 306 yen and 298 yen per dollar.[18] Ryutaro Komiya argues that intervention took place in a way that anybody could figure out the exchange rate level.[19] It was this massive official interventions that provoked international criticism of Japan's exchange rate policy.

The June 1974 IMF's "Guidelines for Management of Floating Exchange Rates" allowed two types of intervention: first, countering disorderly markets or erratic fluctuations and second, leaning against the wind. Leaning against the wind means resisting market tendencies in the slightly longer run than the former type of intervention. Since the "Guidelines" did not precisely define the key terms, it was difficult to determine whether state interventions were appropriate or not.[20] Although the debates over Japan's exchange rate policy concerned the appropriateness of

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[18] *Ibid.*, p. 161.
[19] *Ibid.*, p. 164.
[20] "Guideline for the Management of Floating Exchange Rates," International Monetary Fund, Decision No. 4332-(74/67), June 13, 1976, in Margaret Garritsen de Vries, *The International Monetary Fund 1972-1978*, vol. III (Washington, D. C.: International Monetary Fund, 1985), pp. 487-491.

Japanese intervention, a lack of precise criteria left no way to resolve the disputes.[21]

From April to June 1976, the exchange rate of the yen was stable and intervention hardly took place. As criticism got stronger after mid-June 1976, however, Japanese monetary authorities gradually abandoned the intervention policy which supported a stable level of yen/dollar exchange rates.[22] Partly as a result of this policy change, the yen appreciated between mid-June and mid-September twice as much as in the period between January to April.

After mid-August, government officials and cabinet members admitted more openly than before that the Japanese monetary authorities permitted yen appreciation. The Vice Minister of MITI stated that although the yen appreciation brought problems, the existing level of the yen-dollar exchange rate was appropriate.[23] Deputy Prime Minister and Director of the Economic Planning Agency, Fukuda Takeo, indicated that a gradual appreciation of the yen was desirable, because it indicated an increase of national strength and that it also had positive effects on the price

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[21] Bergsten's argument implied that Japan's exchange policy pursued inappropriate intervention.(Testimony at a hearing at the Congress; Hearings, *op. cit.*, October 18, 1976, p. 10.) Contrary, Quirk, senior economist of the IMF, argued based on the regression analysis that Japan's intervention behavior was consistent, both in direction and magnitude, with leaning against the wind. (Peter J. Quirk, "Exchange Rate Policy in Japan: Leaning Against the Wind," *IMF Staff Paper*, vol. 24, no. 3 (November 1977), pp. 642-664.

[22] Komiya and Suda, *op. cit.*, pp. 174-176.

[23] *Nihon Keizai Shimbun*, August 17, 1976.

level.[24] The MITI Minister, Toshio Kohmoto, who had opposed the yen appreciation for fear of negative effects on exports, also admitted that the existing level of the exchange rate would not cause any problem.[25] Based on the estimation that yen appreciation would not continue for long, most industries accepted the yen appreciation and agreed with the government's change in exchange rate policy into passive intervention policy, considering large payment surplus.[26]

During the period from October to December 1976, the yen depreciated against the dollar and thus, there was little intervention in the foreign exchange markets. However, from the beginning of 1977 until the end of September, the yen continuously appreciated against the dollar, although gradually. The yen appreciated particularly in response to the international criticisms of a "cheap yen." The first sharp yen appreciation in 1977 occurred after the testimony of Lawrence Klein, economics professor of the University of Pennsylvania and Carter Administration adviser. At a Congressional hearing in February, Klein emphasized the importance of the stimulative fiscal policies of the three surplus countries, arguing, "If --- Germany and Japan upvalue their currencies by 10 percent, the other OECD countries should realize GDP expansion of an extra 0.5 percent in 1977, collectively, and 0.8 percent in 1978."[27] Despite the yen's

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[24] *Ibid.*, August 17, 1976, evening edition.
[25] *Ibid.*
[26] *Ibid.* August 19, 1976.
[27] U.S. Congress, *Hearings before the Joint Economic Committee*, 95th, 1st session, Part 2, February 7,8, and 9,

appreciation after this testimony, the Japanese government kept a policy of letting the yen appreciate.[28] Business organizations such as Keidanren also supported this policy stance.[29]

There were also several reported statements by the U.S. Treasury Secretary, Michael Blumenthal, regarding the appropriateness of the exchange rate of the yen.[30] Since the yen appreciated against the dollar sharply after these statements, the media called these statements an intentional "talking down" policy by the U.S. government.[31] Partly due to the influence of U.S. officials' statements and the Japanese government's passive intervention policy, the yen appreciated by 8.6 percent during the period from January until mid-September 1977.

1977 (Washington, D.C.: Government Printing Office, 1977), pp. 184-185.

[28] Prime Minister Fukuda stated at the Diet that a gradual appreciation of the yen was desirable and that there should be no intervention when the exchange rate market was stable. Minister of Finance Hideo Boh said that monetary authorities did not intervene usually , but only in cases of market fluctuation. (*Nihon Keizai Shimbun*, February 19, 1977). MITI officials also supported this policy stance. (*Ibid.*, February 15, 1977)

[29] *Ibid.*, April 17, 1977.

[30] Stephen D. Cohen and Ronald I. Meltzer, *United States International Economic Policy in Action* (New York: Praeger, 1982), pp. 18-21, *Nihon Keizai Shimbun*, June 29, 1977.

[31] Whether "talking down" policy by the U.S. government was intentionally or not was not clear. *Ibid.*, p. 19.

(3) Macroeconomic Policy as An International Agenda

In the Carter Administration, which took office in January 1977, adjustment of international payment imbalances was regarded as one of the most important problems in its economic policy. As for policy instruments, the administration did not intend to make a specific exchange rate policy, since administration officials accepted the consensus that the exchange rates should be left to the market mechanism. A gradual depreciation of the dollar was perceived as a part of the adjustment process of payment imbalances.[32] Instead, the administration emphasized the role of the surplus countries in sharing the burden of the world's deficits by applying macroeconomic policies as policy instruments. In 1976, Germany achieved a 5.6 percent growth rate, while the United States and Japan attained about 5 percent growth. However, these three states showed different domestic conditions in price level and unemployment (see Table 4.2).

[TABLE 4.2 ABOUT HERE]

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[32] The Treasury Department of the new administration expressed confidentially dissatisfaction with Japan's exchange rate policy, though. *Ibid.*, p. 17.

(i) The Carter Administration and the "Locomotive Theory"

The principle of the Carter Administration's policy for payments adjustment was the so-called "locomotive theory," which claimed that the three surplus countries should stimulate their domestic economies in order to pull other weaker economies to recovery.[33] The Carter Administration therefore urged Germany and Japan to take more expansionary macroeconomic policies, following the United States lead. This policy initiative meant that the United States clearly set an agenda of which states should take which policy instruments for payments adjustment -- Germany and Japan should apply expansionary macroeconomic policies.[34]

This principle of the Carter Administration was conveyed to Germany and Japan by the visit of Vice President, Walter Mondale, accompanied by Under secretary of State Richard Cooper and Assistant Secretary of the Treasury Fred Bergsten, to several European countries and Japan immediately after its inauguration in January 1977. In the White House briefing before Mondale's trip to Japan, U.S policy toward Japan was revealed.[35] The briefing acknowledged that the United States faced "no acute bilateral problems with Japan" but pointed out several "potential trouble spots." The

[33] Economists from the United States, Europe and Japan proposed "locomotive theory" in 1976. See, *Economic Prospects and Policies in the Industrial Countries* (Washington, D. C.: The Brookings Institution, 1977).
[34] As for exchange rate policy, the Carter Administration did not clearly state its principle.
[35] Briefing Information for Mondale's Visit to Japan, White House Memo of January 1977, *Declassified Documents*, no. 2129, 1991.

bilateral trade deficit with Japan was at "disturbing levels," and therefore required an increase in Japan's imports from the United States. Coordination of the U.S., German, and Japanese economies also topped the agenda in the meeting with Prime Minister Takeo Fukuda. It was necessary for Japan, according to the briefing, to meet its growth target in order to contribute to the well-being of the world economy, and to international political stability. Japan's achievement of its 6.7 percent GNP growth target for 1977 was explicitly stated.[36]

(ii) Japan's Policy Response to the "Locomotive Theory"

In early 1977, the Fukuda Cabinet which had taken office in December 1976, was preoccupied with the budget making for 1977. Since opposition parties had gained seats at the expense of the LDP in the 1976 general election, the 1977 budget reflected a 430 billion yen tax cut approved under the opposition parties' pressures; they had originally proposed 1 trillion yen tax cut. This tax cut was regarded as an unexpected blow to the balanced budget restructuring plan of the MOF.[37]

Facing continuous yen appreciation and the international demand of applying stimulative fiscal policy to achieve payments adjustment, the government lowered the discount rate in March and April. The government's decision

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[36] *Ibid.*

[37] Interview with Masataka Okura, then Chief of the Tax Bureau of the MOF, in Ando, *op. cit.*, Ge, pp. 106-107.

was based on the economic forecast accepted in February by the cabinet meeting, which projected 6.7 percent economic growth and a deterioration of Japan's payment balance into a 0.7 billion yen deficit during 1977.

In contrast to German resistance to the U.S. "locomotive theory," the Japanese government engendered a cooperative attitude towards the U.S. requests.[38] At the London summit meeting in May, coordination of macroeconomic policies was the main agenda.[39] Although there were no specific goals described in the communiqué, Japan confirmed 6.7 percent growth rate as a goal and Germany 5 percent, while the United State set nearly 6 percent.[40] The communiqué said, "We commit our governments to stated economic targets." At the London Summit, Prime Minister Fukuda positively supported the target of 6.7 percent economic growth in order to demonstrate its contribution to the international economy as one of "locomotives."[41]

Although Prime Minister Fukuda stated at the Diet in April that he did not plan to make large supplementary budget in 1977, the Fukuda cabinet determined to apply some policy instruments including fiscal expansion for two purposes: achieving a 6.7 percent growth target and adjusting external

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[38] For Germany's attitude toward U.S. proposal, see Putnam and Henning, *op. cit.*, pp. 29-32, Putnam and Bayne, *op. cit.*, pp. 64-66.
[39] There was no specific reference to exchange rate policy at the London summit meeting. Masao Fujioka, "London Shunokaigi ni Zuiko-shite," *Kinyuzaisei Jijo*, May 23, 1977, p. 14.
[40] Putnam and Bayne, *op. cit.*, p. 69.
[41] Fujioka, *op. cit.*, pp. 15-16.

payment surplus. Despite the yen appreciation, the payment surplus increased continuously. The main policy instrument of the policy package determined by the cabinet on September 3 was a supplementary 2 trillion yen public work spending. According to the government, this public works spending would stimulate the domestic economy to the level of 6.7 percent growth target and bring about the decline of the payment surplus between September and March 1978. At the same time as the package announcement, the government also revised its economic forecast. In the new forecast, the 6.7 percent growth target was still regarded as attainable, but the payment balance was estimated to be about a 6.5 billion yen surplus, instead of a 0.7 billion yen deficit as indicated in the previous forecast.[42]

However, U.S. officials did not consider Japan's policy sufficient to adjust payment imbalances. When Under Secretary of State Richard Cooper and Assistant Secretary of the Treasury Bergsten visited Tokyo in mid-September, they stressed that Japan's payment surplus was increasing despite the Japanese government's forecast, and trade imbalances between the two countries were worsening. They urged the Japanese government to take further positive steps to eliminate the trade surplus with the United States and to adjust its payment surplus.[43] Responding to U.S. pressures,

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[42] *Fainansu*, no. 144 (November 1977), pp. 6-17.
[43] At the meeting, the U.S. concern was mainly on individual products which were exported massively to the U.S. such as color television sets and automobiles and which were not imported enough by Japan such as agricultural products.

on September 20, the Fukuda Cabinet offered another policy package particularly for the purpose of reducing the current account and trade surpluses.[44] The main content of this policy was the acceleration of imports of crude oil, uranium, and feed grains. Nevertheless, these policy measures continued to be perceived as insufficient and ineffective not only in the United States, but also in Japan.

3. Domestic Preferences and Political Structure

(1) Domestic Preferences

Until mid-September, although the yen appreciated against the dollar gradually, such changes in the exchange rate were considered as a necessary step to eliminating the payment surplus, not only by the government officials but also by industries and other societal groups in Japan, considering a large current account and trade surpluses. Therefore, there was little domestic representation of preferences against yen appreciation, and thus not much political debate in domestic politics about payments adjustment policy.

However, as the yen-dollar exchange rate appreciated sharply from the end of September, domestic preferences against a strong yen became more vocal in the domestic

[44] It was in 1973 when Japan was faced with the pressure of a yen appreciation that this type of package policy was proposed by the government the last time.

political arena.[45] In order to understand how domestic preferences regarding payments adjustment policy were formulated, it is helpful to know what preferences societal groups had before the yen appreciated sharply.

(i) Industries

Industries as a whole were strongly against the revaluation of the yen in the case of 1971, regardless of the types of industries. The main reason for this opposition to the yen revaluation was that a strong yen would hurt exports, thus hurting the domestic economy. In 1976, the ratio of export dependence increased to 12.0 percent, compared to 9.5 percent in 1970. The export dependence rate of the manufacturing industry as a whole was 12.1 percent, increasing from 8.0 percent in 1970. In particular, the ratio of the machine industry's export dependence increased from 13.5 percent in 1970 to 24.8 percent in 1976. Electronic products and automobile industries expanded their exports sharply.[46] By contrast, import dependence rate was stable.

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[45] Toyoo Gyohten, MOF official at that time, recalled that "The phenomenon [of yen appreciation] suddenly generated a bid debate, with strong complaints mainly from exporters, whose overseas orders were badly hurt by the strong yen. They brought politicians into their camp, ---." Volcker and Gyohten, *op. cit.*, p.153.

[46] In electronic products, the ratio was 22.4 percent in 1976 from 13.2 percent in 1970 and in automobiles, the ratio was 50.5 percent in 1976 from 22.8 percent in 1970. Ishizaki, *op. cit.*

Despite the increase of export dependence, in contrast to the 1968-73 case under the fixed exchange rate system, when the yen-dollar exchange rate was gaining strength in early 1977, industries as a whole acquiesced to the change of the government's exchange rate policy, permitting the yen to appreciate.[47] Industries did not expect that the yen appreciation would continue later than the autumn of 1977. They projected that the negative effect of the yen appreciation would be neutralized by some measures including rationalization for a short period.[48]

Instead, peak business organizations were more concerned about the consequences of the recession of 1975 and 1976 especially on the domestic economy, structurally depressed industry sectors in particular. From this perspective, peak business organizations had asked the government to take measures to stimulate the domestic economy since 1976. Keidanren set the two main agendas for 1977 in its annual economic projection at the end of 1976; the one was to achieve economic growth to contribute to the world economy, and the other was to achieve enough economic growth to revive weak industrial sectors.[49] In order to accomplish these objectives, Keidanren proposed to stimulate domestic economy with an emphasis on increased public works spending

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[47] *Nihon Keizai Shimbun,* February 15, 1977.
[48] *Ibid.*, April 10, 1977.
[49] Keidanren, "Showa 52-nendo Keizai Mitoshi, December 21, 1976," *Keidanren Geppo*, vol. 25, no. 1, 1977, pp. 30-33.

and on lowering the discount rate.[50] This proposal accepted the tenets of the "locomotive theory" and urged fiscal expansion based on the estimation that the growth rate would be lower than the government's 6.7 percent target in 1977.[51] President of Keidanren Toshio Dokoh actively lobbied for a stimulative policy. Stimulating the domestic economy which led to import increase, he argued, was the best way to achieve 6.7 percent growth and get out of the recession without causing further international conflict.[52] Stimulating fiscal policy through public works spending was also the main request by other peak business organizations.[53]

(ii) Small-Scale Business and Structurally Depressed Industries

Among industries, small-scale businesses and structurally depressed industries were regarded as most severely damaged by the revaluation of the yen in 1971. The measures for small-scale business, as described in Chapter 3, were especially hastened after the yen revaluation in 1971. According to MITI, the growth rate of total exports of small-

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[50] Business organizations opposed to the increase in corporate tax as a measure of achieving balanced budget, which, they argued, would slow the economy down.
[51] Keidanren, *op. cit*.
[52] Statement by Dokoh, *Kinyuzaisei Jijo*, August 29, 1977, pp. 12-15.
[53] These business organizations asked for a large-scale supplementary budget. Keidanren asked for 1.5 trillion yen budget, Kansai Keizaidantai Rengokai which included a large number of structurally depressed industries asked for 2 trillion yen, and Nissyo whose members were small-scale businesses requested 3 trillion yen budget.

scale business was 14.0 percent in 1971, 2.3 percent in 1972 and 7.7 percent in 1973. Considering these figures, small-scale businesses were not as damaged by the yen revaluation as originally expected. However, the yen revaluation had more negative effects on local export-oriented small-scale businesses than on other small-scale businesses. The growth rate of exports of local export-oriented small-scale businesses was -0.6 percent in 1971, -0.6 percent in 1972 and -6.5 percent in 1973.[54]

Export oriented small-scale businesses showed the same response to the yen appreciation after the beginning of 1977 as in the 1971 case. Zenkoku Chushokigyodantai Chuokai held national meetings on September 21 and passed a resolution asking the government to take special measures, among them a large supplementary budget, increase in public works spending and financial measures for small-scale business.[55]

The structurally depressed industries such as shipbuilding, textile, and aluminum industries were also damaged by the yen revaluation in 1971 more than other industries. After the first oil shock in 1973, these industries were regarded as most vulnerable to the slow down of the domestic economy. These industries projected further damage from the yen appreciation, immediately after the yen started to gain strength in early 1977.[56] Through peak

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[54] *Chushokigyo Hakusho*, 1974 (Tokyo: Okurasho Insatsukyoku, 1974), pp. 199-201.
[55] *Chushokigyo to Kumiai*, no. 455 (November 1977), pp. 38-41.
[56] According to the MITI's survey in industry's attitude toward yen appreciation, small-scale business and

business organizations, they lobbied for compensation for the projected loss from yen appreciation.

(2) Political Structure

(i) The MOF and the Bank of Japan

The MOF and the Bank of Japan were directly committed to payments adjustment policy making. After the shift to a floating exchange rate in 1973, the Bank of Japan and the MOF would be free from the obligation of maintaining the fixed exchange rate and thus they expected to concentrate on achieving the domestic goals. Nevertheless, compared with the monetary authorities of Germany and the United States, the MOF and the Bank of Japan were more concerned about maintaining a stable exchange rate and intervened frequently in foreign exchange markets for this purpose.[57] Only after the overseas criticism of Japan's exchange rate policy emerged in 1976, the Bank of Japan changed its intervention policy into more passive intervention. MOF and Bank of Japan officials who were in charge of international monetary relations recognized that severe criticism would not subside unless Japan's payment surplus declined. They expected that

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structurally depressed industries worried most about the negative effects of yen appreciation and slow domestic economy on them. *Nihon Keizai Shimbun*, April 22, 1977.

[57] After 1973, 265 yen par dollar and during the late of 1974, 300 yen par dollar were maintained by intervention. Komiya and Suda, *op. cit.*, chapter 2,3, and 4. As for Germany's exchange rate policy, see Goodman, *op. cit.*, p. 76. As for the United States, see Cohen and Meltzer, *op. cit.*

the yen appreciation would reduce current account and trade surpluses.

In macroeconomic policy making, monetary policy was applied for stimulating the domestic economy after the domestic economy began to slow down from late 1976. Taking the stable price levels into account, the Bank of Japan lowered the discount rate three times in 1977 for the purpose of stimulating the domestic economy: 0.5 percent in March, 1.0 percent in April, and 0.75 percent in September. These decisions were urged by the Fukuda cabinet, which aimed at achieving a 6.7 percent growth target for 1977. The Bank of Japan officials were cautious about the third cut of the discount rate in September, because they thought that the discount rate was low enough. However, the business organizations actively lobbied the government for a stimulative policy.[58] The level of the discount rate was as low as the level of July 1972, when expansionary policy was drastically taken after the "Nixon Shock."

In contrast to monetary policy, fiscal policy making was constrained by the MOF's concern over the increasing budget deficit after 1974. The expansionary fiscal policy following the "Nixon Shock," which led to severe inflation, was changed into a tight policy after the Oil Crisis in 1973. The budgets of 1974 and 1975 were restrained so as to stabilize price levels. In particular, public works

[58] Nihon Ginko Hyakunenshi, *op. cit.*, vol. 6, p. 460, Nakagawa, *op. cit.*, pp. 86-87.

spending, which increased by about 30 percent in 1972 and 1973, was not allowed to increase at all.

However, as the recession worsened and price level was stabilized, the principle of budget making after 1975 shifted to one of stimulating the domestic economy. Although the 1976 budget was only 14.1 percent over the preceding year, public works spending increased by 21.2 percent, while the growth rate of welfare spending was limited to 22.4 percent compared with 35.8 percent increase in the previous year.[59]

In budget making for 1976, the MOF's concern was over the rise in issuing government bonds. The dependence rate on the government bond (bond-dependence-ratio) in the 1975 budget jumped to 25.3 percent from 11.3 percent in the previous year. Despite the MOF's concern, the dependence ratio increased further in the 1976 budget to 29.4 percent and the long-term government deficit increased (See Table 4.3).

[TABLE 4.3 ABOUT HERE]

Faced with a worsening budget deficit, the MOF, which had been concerned over the soundness of the budget since the 1950s, created the principle of the 30 percent bond-

[59] The growth rate of public works spending including reserve budget for public works spending was 26.2 percent.

dependence-ratio ceiling, aiming at preventing an increase in the budget deficit. The 30 percent ceiling was not theoretically determined, but the bond-dependence-ratio in the 1976 budget, which exceeded 29 percent, made MOF officials realize the necessity of laying new restraints on budget making.[60]

The package policy proposed by the Fukuda cabinet in September included an increase in public works spending. Following this policy, the supplementary budget, whose main content was 370 billion yen public works spending, was approved in October. However, the MOF carefully limited the amount of expenditure within the 30 percent bond-dependence-ratio, 29.9 percent. Finance Minister Hideo Boh insisted that the ceiling of 30 percent bond-dependence ratio should be maintained in the 1978 budget making, too.[61]

Other ministries were not as much committed as the MOF and the Bank of Japan in the formulation of payments adjustment policy. The MITI, however, was concerned about the effect of yen appreciation on exports of industries, although a decrease in exports would lead to an improving payment balance situation. As the yen appreciated, the MITI warned that yen appreciation would damage the exports of industries, in particular small-scale businesses and

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[60] Since the Japan's dependence rate on the government loan was the highest among other industrial countries, even the 30 percent ceiling was recognized as an incredibly high rate by MOF officials. Minoru Nagaoka, *Sugao no Nihon Zaisei* (Tokyo: Kinyuzaisei Jijo Kenkyukai, 1981), pp. 35-37.
[61] Interview with Boh cited in *Nihon Keizai Shimbun*, September 8, 1977.

structurally depressed industries. They conducted surveys about the expected damage of these industries and reported to the government in order to establish special measures for small-scale business.[62]

(ii) Political Parties

The severe inflation after the oil crisis and the Lockheed Scandal damaged the popularity of the LDP. In the election of December 1976, the LDP lost large number of seats, although the LDP was still a majority party. Reflecting the result of the election, the budgeting process for 1977 was delayed and the Diet approved an income tax cut, which conflicted with the MOF's concern over the budget deficit.

Prime Minister Fukuda was well known for his adherence to the principle of the sound budget. Succeeding Kakuei Tanaka, who promoted a large-scale of public works spending which led to large budget deficit and severe inflation, Fukuda was cautious about fiscal spending, which would aggravate the budget deficit. Although the 6.7 percent growth target was proposed at the beginning of 1977, Fukuda stated that stimulative fiscal policy should be carried out within the MOF's principle of the sound budget.

On the contrary, there were supporters of expansionary fiscal policy in the LDP. The Chairman of the PARC, Toshio Kohmoto, was most vocal in proposing further expansionary

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[62] *Nihon Keizai Shimbun*, June 30, 1977.

fiscal policy from early 1977 and represented supporters of large public works spending within the LDP.[63] At a meeting with Fukuda in September, Kohmoto pressed Fukuda to agree with taking stimulative fiscal measures without considering the principle of the sound budget.[64] The LDP also constantly pressured the government and the MITI to take special measures for small-scale businesses as well as during 1971-73.

The opposition parties which gained seats in the Diet emphasized welfare policy. They criticized the LDP government for promoting big business's interest at the expense of welfare throughout high economic growth period and international monetary and oil crises. In a slowing domestic economy, they proposed government spending for welfare and public works spending for sectors which would be damaged by recession, such as small-scale business.

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[63] Kohmoto was much less reluctant to increase in issuing government bond than Fukuda; Interview with Komoto cited in *Toyokeizai*, July 2, 1977.
[64] *Nihon Keizai Shimbun*, September 3, 1977.

4. Emergence of Domestic Preferences During The Yen Appreciation: October 1977- December 1977

(1) Sharp Yen Appreciation and Exchange Rate Policy

Despite the gradual yen appreciation from the beginning of 1977, Japan's current surplus was constantly increasing. In this situation, overseas criticisms of Japan's exchange rate policy emerged again in late September. These criticisms claimed mainly that the Japanese government did not take enough measures to eliminate its payment surplus, which would harm the world economy, and that the yen was still undervalued considering the increasing payment surplus.[65]

The reemergence of these criticisms sparked the sharp yen appreciation in the foreign exchange markets after the end of September. In October and November, the yen

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[65] Morgan Guaranty Trust Company's periodical, *World Financial Market*, which had influence on the U.S. financial world, reported the two major policy alternatives to adjusting international payments imbalances. One was stimulative macroeconomic policies of Germany and Japan, and the other was selective exchange rate adjustment of the Japanese yen. This report said that since Japanese large surplus could not be eliminated without significant yen appreciation, it might be necessary for Japanese authorities to "depart from their avowed policy of leaving exchange rate determination entirely up to the market." *World Financial Market* (September 1977), pp. 10-11. At the annual meeting of the IMF in September, Britain's Chancellor of the Exchequer Dennis Healey accused Japan of distorting the international payments imbalances, stating in the official statement, "I regret only that these measures [by Germany and Japan] seem unlikely to do much for growth in 1977." International Monetary Fund, *Summary Proceedings Annual Meeting 1977* (Washington, D.C.; IMF, 1977), p.59.

appreciated rapidly by 10 percent. From September to mid-October, the yen strengthened from 266 yen to 254 yen par dollar, that is, about 5 percent increase.

With the rapid yen appreciation, the Bank of Japan changed its passive intervention policy into frequent and large intervention by buying dollars to stop the yen appreciation. However, these interventions proved not effective in preventing further yen appreciation. At a Diet special session regarding the strong yen, the intervention policy by the Bank of Japan was criticized by the opposition parties for not preventing the yen from appreciating. In response to this criticism, Governor of the Bank of Japan Morinaga stated that intervention permitted by the guideline of the IMF was not enough to stop the present yen appreciation against the strong market forces, and urged for an alternative policies to stop the yen appreciation.[66]

Until early November, the Bank of Japan and the MOF made efforts to prevent further yen appreciation. The MOF sought the possibility of coordinated intervention among nations to stop both yen appreciation and dollar depreciation. By early November, however, the MOF gave up the idea of international coordinated intervention, because the United States and Germany did not express their concerns over the yen appreciation.[67]

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[66] *Nihon Keizai Shimbun*, October 18, 1977, evening edition; November 10, 1977.
[67] *Ibid.*, November 5, 1977. In the U.S.-Germany meeting on November 4, monetary officials of both countries implied that

In mid-November, when the yen-dollar exchange rate reached to 248 yen per dollar, the Bank of Japan applied measures to restrict short-term capital inflows, which MOF officials were afraid would provoke international criticism for installing restrictions.[68] Since even this measure could not stop yen appreciation, monetary officials of the MOF and the Bank of Japan realized that preventing yen appreciation was impossible unless the payment surplus was eliminated.

(2) Policy Instrument to Halt Yen Appreciation

With rapid yen appreciation and an increasing payment surplus, the Japanese government was confronted with not only international criticism of Japan's inadequate policy for payments adjustment, but also the complaints from political parties and industries about the government's inability to stop yen appreciation. Exchange rate policy appeared ineffective in stabilizing the exchange rate and eliminating the payment surplus.

The initial government response to this situation was not focusing directly on reducing the payment surplus, but on neutralizing domestic preferences against the high yen through two policies: compensating weak industries, and preventing further yen appreciation. As for compensatory measures toward weak industries, the government was promptly

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sharp yen appreciation against the dollar was natural for Japan's large payment surplus. *Ibid.*, November 4, 1977.
[68] *Nihon Keizai Shimbun*, November 18, 1977,

to establish special measures during the high-yen period. Small-scale businesses, structurally depressed industries, peak business organizations, and political parties unanimously agreed on the necessity of compensatory measures, and thus, there was no conflict among political parties over this issue. The Small-scale Business Emergent Financing System Toward Exchange Rate Fluctuations was enforced in October. Temporary Small-scale Business Countermeasures Law for Yen Appreciation was approved unanimously by the Diet in January 1978.[69]

On the contrary, policy measures for preventing further yen appreciation provoked political debates over the choice of macroeconomic policy. Prime Minister Fukuda, who was reluctant to take further expansionary fiscal measures, initiated policy plan to increase imports in order to stop further yen appreciation. Fukuda encouraged the ministries such as the MITI and the Ministry of Agriculture to take positive measures to increase imports based on the cabinet decision of September 20.[70] Fukuda agreed with Kohmoto to set the target of import increase more than $3 billion.[71] However, the import increase plan proved difficult to be carried out, because the interests of ministries conflicted

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[69] This law included special financial loan and tax treatment for small-scale business which was damaged by yen appreciation. By June 1979, 126 industries, 25 districts, and 38 thousand firms were approved by this law to get these treatments.
[70] *Nihon Keizai Shimbun*, November 1, 1977, evening edition.
[71] *Ibid.*, November 3, 1977.

with market liberalization plan proposed by Fukuda.[72] In early November, Fukuda reluctantly admitted that increasing import more than $3 billion would unlikely happen, despite the previous government's pledge.[73]

(3) Fiscal Expansion as A Policy Alternative

Since there were no effective policies to preventing further yen appreciation, expansionary fiscal policy became the main focus of political debates in terms of a policy alternative to the high yen for payments adjustment. The central concern of political parties, industries, and government officials was over whether another supplementary budget for 1977 was necessary and how the 1978 budget should be drawn up. The argument was therefore over the size, sources of revenue and allocation of the budget.

Peak business organizations continuously advocated a large scale budget. They supported stimulative policy by increasing public works spending, not by tax cut for individuals, because, according to them, tax cut would not lead to increase in domestic consumption and thus would not work as a stimulative policy. Regarding the revenue resources to finance a large budget, they asked the government to issue bonds more than 30 percent bond-

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[72] For conflict among ministries, see *Ekonomisuto*, November 18, 1977, pp. 16-21.
[73] *Ibid.*, November 9, 1977, evening edition; *Asahi Shimbun*, November 9, 1977.

dependence-ratio. After the yen appreciated sharply, leaders of business organizations frequently met with LDP politicians and Prime Minister Fukuda to urge to draw up large budget which included the second supplementary budget for 1977.

Among political parties, the LDP had a similar policy agenda to that of industries. The LDP supported stimulative fiscal expansion through public works spending which would lead to increase in domestic demand, while it denied applying tax cut because the government's fiscal condition could not allow it. As for sources of revenue, the LDP agreed that it would be unavoidable to increase in issuing government bonds beyond the ceiling of 30 percent bond-dependence-ratio, with emphasis on the present lower level of inflation.

Although the detail was different, the underlying argument of opposition parties was also in favor of fiscal stimulative policy to avoid yen appreciation, but for stimulating the domestic economy, they supported not only further fiscal expansion but also tax cut for individuals. The opposition parties disagreed with the MOF and the LDP over the estimation that public works spending was more effective than income tax cut in stimulating domestic demand. In particular, they protested against increasing public works spending in large-scale projects and insisted upon public works spending into welfare related projects in addition to large income tax cut. However, since they could not propose an effective way to find revenue sources for the government's spending and tax reduction, the opposition parties also agreed on issuing bonds beyond the 30 percent ceiling.[74]

Despite the difference in their proposals of how to allocate the budget, all political parties supported expansionary fiscal policy as a necessary step to prevent further yen appreciation and thus, the projected recession. The choice of policy instruments with respect to payments adjustment was left to the debate between advocates of smaller government, that is, the MOF and Fukuda, and supporters of large-scale fiscal expansion such as political parties and industries.

In early November, Fukuda directed the MOF to maintain the 30 percent ceiling of bond-dependence-ratio in drawing up the 1978 budget. This action got immediate strong complaints from the LDP and industries.[75] However, he still hesitated to refer to another supplementary budget for 1977, which was a part of the demand for expansionary policy.

(4) Sharp Yen Appreciation and Policy Choice

Trade imbalances between Japan and the United States continued to worsen during the high yen period. The United States continuously pressed Japan to reduce restrictions against imports and increase imports in order to eliminate

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[74] The survey of policy proposals of political parties for high-yen and payments adjustment by Nihon Keizai Shimbun, *Nihon Keizai Shimbun*, November 24 and 25, 1977.
[75] *Asahi Shimbun*, November 12, 1977.

Japan's trade surplus. In mid-November, General Counsel of the United States Trade Representative (USTR) Richard Rivers was sent to Japan to negotiate U.S.-Japan trade imbalances. Rivers insisted that Japan should take serious measures to reduce trade surpluses with the United States.

The U.S. demands for Japan included three main targets: turning current account surplus into deficit in 1978, facilitating imports of manufacturing products in 1978 twice as much as in 1977, and liberalizing remaining import restrictions, especially on agricultural products. Moreover, the request of setting a 8 percent growth target for 1978 was the most striking U.S. demand against the Japanese government. Considering the domestic debates over expansionary fiscal policy, the specific U.S. proposal for Japan's growth target was regarded as international pressure on domestic matters.[76] The U.S. government warned the Japanese government that if Japan failed to meet the U.S. demand, it would aggravate protectionism in U.S. industries and Congress, and asked for quick response to their demands.

The meeting with the Rivers mission put political pressures on the Japanese government to take concrete measures to reduce trade surplus with the United States as well as the current account surplus. Besides international political pressures, further yen appreciation, which started

[76] Then Prime Minister Fukuda told later that he had refused to receive such a request regarding growth target, because he thought it was insulting to set other state's growth target. Interview with Fukuda in Ando, *op. cit.*, p. 80

during the U.S.-Japan negotiation in mid-November, activated domestic preferences against the high yen. When the yen appreciated as high as 240 yen par dollar in late November, the Bank of Japan intervened in the foreign exchange markets by buying massive amount of dollars to support the rate of 240 yen.[77]

This sudden appreciation of the yen to the level of 240 yen par dollar strengthened industries' criticism of the government's ineffective policies to stop yen appreciation. Finally, Fukuda admitted the necessity of a large-scale budget for 1978 including another supplementary budget for 1977, and considered expansionary fiscal policy positively.[78] He reorganized the cabinet by posting politicians who favored substantive expansionary fiscal policy to important economic ministers: Kohmoto at the MITI and Kiichi Miyazawa at the Economic Planning Agency.[79]

However, although Fukuda and the MOF agreed to draw up another 1977 supplementary budget and an expansionary 1978 budget, which covered 15 months from January 1978 to March 1979, there was still no agreement about how large the 1978 budget should be. The size of the 1978 budget depended on the growth target which the government would set. The MOF regarded a 6 percent growth target as a maximum rate, while

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[77] Komiya and Suda, *op. cit.*, p.231. This intervention was the largest intervention since the shift to a floating exchange rate system.
[78] *Nihon Keizai Shimbun*, November 26, 1977, evening edition.
[79] Fukuda also appointed Nobuhiko Ushiba, former ambassador to the United States, as a new post, Minister for External Economic Affairs to negotiate closely with the United States.

the LDP and Kohmoto insisted upon at least a 7 percent growth target.

The government determined to set a 7 percent growth target for 1978 in December during Ushiba's negotiation with U.S. officials on trade imbalances in response to Rivers mission in November. This decision was made under the political pressures from the U.S. government and domestic preferences for a large-scale expansionary fiscal policy. Peak business organizations asked for more than 6.5 percent growth target and pressed hard the government to formulate a large budget. Export-oriented industries, particularly small-scale businesses, also urged the government to take more expansionary fiscal policy.[80]

Aiming at a 7 percent growth target, both the second 1977 supplementary budget and the 1978 budget were expansionary budgets with emphasis on public works spending. As a result of formulating another supplementary budget, the bond-dependence-ratio in 1977 jumped to 34.8 percent, which was far larger than the 30 percent ceiling. The 1978 budget approved in April 1978 after long debate on tax cut between the LDP and opposition parties was 20.3 percent over the preceding year, and public works spending increased by 27.3 percent. Expenditure for government bond and public works spending showed largest growth rates in the total expenditure. The bond-dependence-ratio reached to 31.3 percent in 1978 (See Table 4.3).

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[80] *Asahi Shimbun*, December 14, 1977.

Japan acknowledged a 7 percent growth target internationally at Bonn Summit in July 1978.[81] In the domestic political arena, once expansionary fiscal policy was applied, other long-term policy measures, for instance, measures for structural change of the domestic economy, to reduce payments imbalances were rarely discussed.

5. Summary

This chapter intended to explain under what circumstances Japan chose to apply expansionary fiscal policy with respect to payments adjustment during 1977-78. This chapter demonstrates that the choice of applying fiscal policy was affected by domestic preferences against yen appreciation. Domestic preferences against yen appreciation were translated by political parties into the demand of expansionary fiscal policy. Expansionary fiscal policy, which was urged to apply by the United States, was focused by political parties as a policy instrument to prevent further yen appreciation and as compensatory measures for weak industries rather than as a policy instrument to adjust a payment surplus.

Faced with this political pressures, the MOF and Prime Minister Fukuda could not maintain the principle of the

[81] For the Bonn summit, see Putnam and Bayne, *op. cit.*, pp. 84-92; Putnam and Henning, *op. cit.*

balanced budget. This implies that a floating exchange rate system contributed through yen appreciation to weaken the role of the MOF in fiscal policy formulation, when Japan was faced with payment surplus.

The political action of industries -- business organizations and export-oriented small-scale businesses -- was similar to the period of 1968-73. They responded not to the actual impact of yen appreciation on the economy as a whole, but to the rise in the exchange rate itself and the projected loss for them caused by a high yen. Political debates and the process of the government's choice after the rapid yen appreciation revealed the sensitivity of industries and political parties to the rise in the exchange rate in itself. This explanation does not imply that international political pressure was not important in Japan's policy choice, but even the U.S. officials counted on the role of Japan's domestic sensitivity to the rise in the exchange rate itself in pressing the government to take expansionary policy.[82]

The impact of yen appreciation on the real economy was not so negative as had been expected. During the high-yen period, exports did not decrease partly because of J-curve

[82] National Security Council memo regarding strategy for the Ushiba's visit to Washington noted, "Fear of further upward pressures on the yen is the major factor driving Japanese efforts to come up with an economic package, since they want our 'blessing' in order to convince the currency market to stop exerting upward pressure on the yen." NSC Memo of December 9, 1977 *U.S. Declassified Documents*, no. 1982 (March 1991).

effects. Also the terms of trade improved in 1977 and 1978.[83] The 1978 Economic White Paper by the Economic Planning Agency noted that although the yen appreciation exerted various effects on individual industries, the yen appreciation had a beneficial effect on industries on the avarage.

Domestic preferences against yen appreciation played an important role in formulating payments adjustment policy in late 1977. However, as it became apparent that industries were not affected as badly by a high yen as had been expected, and as it became clear that the domestic economy was not thrown into recession even under the sharp yen appreciation of late 1977, there was less interest group pressures against a high yen than before, even though the yen continuously appreciated against the dollar during 1978.[84]

From mid-February, the yen started to strengthen again and in March appreciated against the dollar by 6.9 percent. This appreciation continued until autumn. In contrast to late 1977, tolerant attitudes toward yen appreciation became apparent. Indeed, the merits of yen appreciation were frequently mentioned by the MOF and the Bank of Japan officials and business leaders.[85] Merits of yen appreciation were recognized in terms of the effects on lowering the price

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[83] *Keizai Hakusho, 1978* (Tokyo: Okurasho Insatsukyoku, 1978).
[84] During 1977, the yen appreciated by 22.1 percent, and between the end of September and December by 10.6 percent. Between January and August 1978, the yen appreciated by 28.4 percent.
[85] Komiya and Suda, *op. cit.*, pp. 298-300, *Kinyuzaisei Jijo*, August 21, 1978.

of imported materials and on stabilizing the price level.

With these merits, a domestic preferences against yen appreciation became less prominent and hence less pressures from interest groups on the government to take an alternative measure to stop yen appreciation materialized. Although the supplementary 1978 budget was formulated for the purpose of achieving a 7 percent growth target, the budgeting process was less politicized than the budgeting process in late 1977, due to less pressures against yen appreciation.

Tabele 4.1

Japan's Post-Oil Crisis Recovery in Compartive Perspective: Current Account and Trade Balances among G-7 Countries, 1973-1979 ($ billion)

	1973	1974	1975	1976	1977	1978	1979
U.S.	7.15	1.96	18.13	4.21	-14.51	-15.44	-1.00
	0.95	-5.33	9.07	-9.28	-30.89	-33.78	-27.32
Japan	-0.14	-4.69	-0.68	3.68	10.92	26.54	-8.75
	3.65	1.35	4.94	9.80	17.14	25.30	1.75
Germany	5.02	10.55	4.33	3.71	4.01	8.90	-5.41
	14.80	20.72	15.92	15.18	18.41	23.31	14.41
France	1.48	-3.91	2.67	-2.92	2.46	6.20	5.90
	0.71	-4.30	1.00	-4.59	-2.70	0.71	-2.00
Britain	-2.45	-7.48	-3.33	-1.69	-0.26	1.85	-1.05
	-6.30	-12.52	-7.46	-7.01	-3.93	-3.02	-7.31
Italy	-2.53	-8.02	-0.58	-2.82	2.46	6.20	5.90
	-3.68	-8.51	-1.14	-4.24	-0.13	2.91	-1.06
Canada	0.31	-1.33	-4.55	-4.15	-4.06	-4.30	-4.15
	2.99	1.94	-0.38	1.71	2.91	3.92	3.95
OECD total Current Account	14.19	-24.79	5.68	-15.52	-21.01	12.07	-27.38

Sources: *OECD World Economic Outlook*, No. 45 (December 1989).

Table 4.2

Current Balance and Domestic Economic Conditions
of
The United States, Germany and Japan,
1976-1978

	Current Account Balance ($ billion)			Consumer Prices (percentage changes from previous year)			Unemplyment Rates (commonly-used definitions)		
	1976	1977	1978	1976	1977	1978	1976	1977	1978
U.S.	4.21	-14.51	-15.44	5.7	6.5	7.6	7.7	7.0	6.1
Germany	3.71	4.01	8.90	4.5	3.7	2.7	4.0	3.9	3.7
Japan	3.68	10.92	16.54	9.4	8.2	4.2	2.0	2.0	2.2

	Growth of Real GNP (percentage changes from previous year)				Exchange Rate (average of daily rates)		
	1976	1977	1978		1976	1977	1978
U.S.	4.9	4.7	5.3	dollar	1.000	1.000	1.000
Germany	5.6	2.7	3.3	D-Mark	2.519	2.322	2.009
Japan	4.8	5.3	5.2	yen	296.5	268.5	210.4

Sources: *OECD Economic Outlook*, No. 46 (December 1989)

Table 4.3

Budget Deficits of the United States, Germany, and Japan

1. Bond-Dependence-Ratio (Percentage of Government Bond to Annual Expenditure)

	1974	1975	1976	1977	1978	1979
U.S.	2.3	16.0	19.8	13.1	12.9	8.0
Germany	7.7	21.1	15.9	12.9	13.9	12.8
Japan	11.3	25.3	29.4	32.9	31.3	34.7

2. Accumulated Long-term Government Deficit as a Percentage of GNP

	1974	1975	1976	1977	1978	1979
U.S.	26.1	26.6	27.0	28.0	28.1	27.1
Germany	6.6	9.4	10.5	11.7	13.1	14.1
Japan	8.6	12.3	16.1	20.4	24.8	30.0

Sources: *Nihon no Zaisei*, 1986 (Tokyo: Toyokeizai Shimpo-sha, 1986)

Chapter Five

The Choice of The High Yen: Impact on Policy Choice in 1985-87

1. Introduction

This chapter will deal with another case of Japan's payments adjustment policy in the post-Bretton Woods floating exchange rate system: the 1985-87 case. We will examine under what circumstances Japan chose to apply substantive fiscal measures with respect to payments adjustment. During 1985-87, the problem of payments adjustment again became one of the most urgent issues confronting the international economy. Thus, international negotiations continuously took place regarding which states should choose which policy instruments.

The obvious difference between state choices during 1985-87 and the previous cases was that industrial countries first agreed to apply exchange rate policy in a coordinated way for the purpose of adjusting current account imbalances. Following this agreement, Japan deliberately chose a high yen policy for the purpose of reducing its current account and trade surpluses.

Regarding macroeconomic policy, Japan, as well as Germany, was reluctant to subordinate it to payments adjustment as in the 1977-78 case. However, despite its firm commitment to reduce its budget deficit, Japan made a decision to apply expansionary fiscal policy, which actually suspended fiscal reform of the Nakasone cabinet, in May 1987. In contrast, Germany, in parallel balance of payment position to that of Japan, changed modestly its existing fiscal policy.

International negotiations among the United States, Germany and Japan in the period from the Plaza Accord in September 1985 to the Louvre meeting in February 1987 have been previously explored.[1] In contrast to these studies, this chapter will focus on domestic-level factors: domestic preferences regarding the exchange rate, and the political structure which responds to such domestic preferences.

Did similar domestic preferences against the yen appreciation emerge? What kinds of policy orientations did political parties have regarding payments adjustment? How did political structure affect the choice of macroeconomic policy? These are empirical questions addressed in this chapter.

To illuminate the pattern of domestic preferences regarding the exchange rate, this chapter will be organized

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[1] Funabashi's work was the most extensive study. Funabashi, *op. cit.* Volcker and Gyohten, *op. cit.*, Chapter 8 and 9, Henning, *op. cit.*, Iida, *op. cit.*, Chapter 7 and 8. For the U.S. exchange rate policy making, see Destler and Henning, *op. cit.*

chronologically in terms of the level of the yen/dollar exchange rate. This chapter is divided into three sections: September 1985 to early 1986, February to late 1986, and January to May 1987. The yen started to appreciate after the Plaza Accord (September 1985) and continuously gained strength sharply until 1988 by about 70 percent against the dollar.

2. Reemergence of the Payments Adjustment Problem

(1) Current Account Imbalances and Policy Instruments

The second oil crisis in 1978, which again increased sharply the price of crude oil, was the starting point of another period of large international payments imbalances. Industrial countries suffered a renewal of inflation due to the sharp rise in the price of imported oil, while for non-oil-exporting developing countries, the second oil crisis created another difficulty in eliminating their oil-related debts from the first oil crisis. Current account balances of the OECD countries as a whole turned into a $27 billion deficit in 1979 and a $67 billion deficit in 1980, compared to a $12 billion surplus in 1978 (See Table 2.2).

The aggregated current account deficits of the OECD countries as a whole were reduced in 1981, but again increased to $61 billion in 1984. Payments imbalances among industrial countries became prominent, particularly the large current account deficit of the United States and the increasing surpluses of Japan and Germany. In 1984, the U.S. current account deficit amounted to about $100 billion, which was about double the amount of 1983, while Japan's surplus reached $35 billion and Germany's surplus was about $10 billion (See Table 5.1).

[TABLE 5.1 ABOUT HERE]

The uneven current account positions among industrial states began to be regarded as problematic in the international economy, because not only did it lead to an economic instability in an individual state, but also it caused protectionist pressures across borders.

The attitudes of industrial countries toward payments adjustment were different. In terms of policy instruments, both exchange rates and macroeconomic policies of major industrial countries were not working to adjust payment imbalances. Exchange rates for major currencies moved widely in the early 1980s, particularly between the U.S. dollar on the one hand, and the Japanese yen and the Deutsche mark on the other. From October 1980, the U.S. dollar began to appreciate gradually until 1985, while the yen and the Deutsche mark depreciated during the same period, despite their increasing surpluses. The U.S. dollar appreciated by 67 percent from 1980 to early 1985 by the IMF's measure.[2] These movements tended to aggravate payment imbalances among countries. In this situation, the United States maintained policy of non-intervention in the foreign exchange market, while G-10 governments intervened to prevent their currencies from depreciating further against the dollar.[3]

Macroeconomic policy was also not appropriately applied in terms of payments adjustment in the United States, Germany and Japan. In the United States, despite its large payment deficit, tight monetary policy was applied for the sake of attracting capital inflows to finance its increasing budget deficit, and expansionary fiscal policy was maintained. In Germany, in order to subsidize inflation and reduce its budget deficit, tighter fiscal policy was maintained, despite a payment surplus. In Japan, with a large payment surplus, fiscal policy was tightened to reduce its accumulating budget deficit. Monetary policy was mainly applied to stimulate the domestic economy and thus the lower discount rate was maintained in the early 1980s.

As it became apparent that exchange rate movements for major currencies were in the direction to widen payments imbalances instead of eliminating imbalances, a high dollar

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[2] Destler and Henning, *Ibid.*, pp. 22-23.

[3] *Ibid.*, p. 23. Former Governor of the Bank of Japan Sumita told that Japan did not intervene so often despite its complaint about a weak yen. Satoshi Sumita, *Wasuregataki Hibi 75nen: Sumita Satoshi Kaisoroku* (Tokyo: Kinzai, 1992), p. 104.

and U.S. high interest rates provoked political debates over the appropriateness of U.S. macroeconomic policy and exchange rate policy in terms of payments adjustment.

Internationally, U.S. interest rates and a high dollar were one of the main agendas of the summit meetings of Group of Seven in the early 1980s. Until 1985, the other countries complained unanimously about U.S. high interest rates, its large budget deficit, and a high dollar.[4] However, there was no explicit agreement of which states should apply which policy instruments for payments adjustment at these summit meetings.

(2) The Plaza Accord

Facing the sharp appreciation of the dollar, despite its current account and trade deficits, the Reagan administration continued to take its non-intervention posture in exchange rate policy. The underlying argument of the U.S. Treasury was that "exchange rates could be misaligned only when the market was imperfect."[5] The Treasury disagreed on the notion of overvalued dollar, claiming that U.S. high interest rates had not been a major determinant of exchange rate movements.[6]

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[4] Putnam and Bayne, *op. cit.*, p. 127.
[5] Volcker and Gyohten, *op. cit.*, p. 249.
[6] For example, see the testimony of Under Secretary of the Treasury, Beryl Sprinkel. U.S. Congress, *Joint Hearings before the Subcommittee on International Trade, Investment and Monetary Policy, and Subcommittee on Domestic Monetary Policy, Committee on Banking, Finance and Urban Affairs,*

The dollar-yen relationship was regarded as the most seriously misaligned exchange rate, considering the increasing trade imbalances between the United States and Japan. In contrast to the 1976-77 period, there was little criticism of Japan's exchange rate policy per se. Instead, the Reagan administration attributed the misaligned dollar-yen exchange rate to the limited international role of the yen. The Treasury claimed that Japan's segmented, highly regulated domestic capital market prevent foreigners from using the yen.[7] In this context, the Yen-Dollar Agreement was concluded between the two countries in May 1984, aiming at liberalizing Japan's financial market.[8] The Treasury expected the yen to be stronger by liberalizing Japan's financial market.[9] However, in reality, the dollar kept appreciating, while U.S. current account and trade deficits were increasing during 1985.[10]

98th, 2nd session, October 27, 1983 (Washington, D. C.: Government Printing Office, 1984), pp. 72-78.

[7] The testimony of Sprinkel at Congress. U.S. Congress, *Hearings before Subcommittees on Trade, House Ways and Means Committee,* House, 98th, 2nd session, April 21, 1983 (Washington, D. C.: Government Printing Office, 1983), p. 406.

[8] For the details, see Jeffrey A. Frankel, *The Yen/Dollar Agreement: Liberalizing Japanese Capital Markets* (Washington, D. C.: Institute for International Economics, 1984), Frances McCall Rosenbluth, *Financial Politics in Contemporary Japan* (Ithaca: Cornell University Press, 1989), chapter 3.

[9] Testimony of R. T. McNamar, Deputy Secretary of the Treasury; *Hearings before the Subcommittees on International Finance and Monetary Policy of the Committee on Banking, Housing, and Urban Affairs*, Senate, 98th, 2nd session, June 6, 1984 (Washington, D. C.: Government Printing Office, 1984), pp. 19-21.

[10] The effect of the Yen/Dollar Agreement on the value of the yen was doubtful, because liberalization of Japan's financial

The Plaza Accord among the Group of Five countries was formulated, mainly due to the change in the U.S. non-intervention policy. The Reagan administration finally acknowledged the relations between U.S. high interest rates and a high dollar and the relations between the exchange rates and international imbalances.[11] The other industrial countries had criticized the high dollar in terms of payments adjustment. Therefore, once the United States expressed its interest in realigning exchange rates, the Plaza Accord, which focused mainly on realignment of exchange rates, was agreed. On macroeconomic policy, in the Plaza Accord, the participants agreed to make macroeconomic commitments, but their commitments were not explicitly stated.[12]

3. The Expected Yen Appreciation; September 1985-January 1987

The Japanese government was willing to agree on exchange rate realignment for payments adjustment at the Plaza meeting. As a result of this policy choice, the yen started to appreciate sharply after the Plaza Accord. Between September 1985 and January 1986, the yen gained strength by about 20 percent.

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market encouraged capital outflows from Japan, which would further reduce the value of the yen. For example, see the testimony of Fred Bergsten. *Ibid.*, p. 128.

[11] For the details of U.S. policy change, see Destler and Henning, *op. cit.*, chapter 3.

[12] Funabashi, *op. cit.*, chapter 1.

Long before the Plaza Accord was agreed, Japan was already confronted with the problem of payments adjustment. Faced with an increasing trade surplus with the United States, the Japanese government realized the necessity to eliminate its surplus as quickly as possible, because international criticism of Japan's economic policy was intensifying and protectionism pressures were increasing, particularly from U.S. Congress. Also in the U.S. administration, trade deficit with Japan came to the serious attention. In April 1985, State Secretary, George Shultz, claimed that Japan should stimulate the domestic economy for payments adjustment.

Regarding policy choice to reduce external surplus, the stimulation of the domestic economy was focused in domestic politics as a useful way to reduce external payments imbalances, because a growth of the domestic economy would increase imports. What kinds of policy instruments for payments adjustment were discussed before the Plaza Accord? How was the government choice of the high yen perceived domestically?

(1) Domestic Preferences Regarding A High Yen

(i) Industries

When the yen started to gain strength in September, industries in general regarded the government's decision as acceptable amid increasing trade surplus, despite the rise in export dependence. After the second oil shock, the Japanese economy recovered mainly through increasing export. In 1984, the Japan's export dependence ratio increased to 13.5 percent, compared to 12.0 percent in 1976 (See Table 2.1). The export dependence ratio of manufacturers as a whole was 14.2 percent and the machine industries in particular increased its export dependence ratio to 27.5 percent in 1984 from 24.8 percent in 1976. The import dependence ratio in 1984, by contrast, was as low as that of 1976, about 10 percent. The import dependence ratio of manufacturing industry slightly increased to 5.8 percent in 1984 from 4.7 percent in 1976.[13]

In terms of trade with the United States, export dependence ratio increased to 41 percent in 1984 from 25 percent in 1977, while import dependence ratio slightly increased to 20 percent in 1984 from 18 percent in 1977.[14] As for denomination ratio of Japan's trade, 36 percent of exports and 10 percent of imports were denominated in the yen. More precisely speaking of manufactures and trading firms, 51 percent of exports and 26 percent of imports of larger firms were denominated in the yen.[15]

Export-oriented industries which benefited from the undervalued yen during the early 1980s were expected to cope with a higher yen without worsening their profitability.

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[13] Ishizaki, *op. cit.*
[14] *Tsusho Hakusho, 1987* (Tokyo: Okurasho Insatsukyoku, 1987), pp. 812-815.
[15] Keizai Kikakucho, *Kigyo no Ishiki to Kodo, 1986* (Tokyo: Okurasyo Insatsukyoku, 1986), pp. 15-19.

Most of industries set the range of the yen-dollar exchange rate which they could cope with around 200 yen against the dollar.[16]

The concern of peak business organizations during 1985 was over the trade conflict with the United States rather than over the level of the exchange rate for the yen in itself. From early 1985, protectionism against Japan's exports intensified in U.S. Congress. Reflecting these protectionism pressures, the U.S. government started the negotiation with Japan on market liberalization known as the MOSS (Market Oriented Sector Selective) Talks in early 1985. From the consideration of reducing the tension with the United States, peak business organizations were concerned about measures to eliminate trade surplus.

Major four peak business organizations sought to reduce payments imbalances and trade conflict, but there was the difference among the proposals of these organizations. The leaders of Keizaidoyukai and Nissho proposed that domestic economic expansion through vitalizing private sectors should encourage imports to reduce current account surplus, while the leaders of Keidanren and Nikkeiren disagreed on the idea that domestic economic expansion would help to eliminate payments imbalances. Regarding trade surplus, the leaders of

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[16] According to the survey of larger firms in Tokyo, Osaka and Nagoya by the Economic Planning Agency in February 1986, the exchange rate which could be coped with was 207.2 yen against the dollar on average, but the rates varied from ¥195.4 in precision machine industry to ¥226.7 in shipbuilding industry. *Ibid.*, pp. 19-20.

Keidanren and Nissho referred to regulations on exports, aiming at reducing trade surplus, while the leaders of Keizaidoyukai and Nikkeiren opposed such controlled measures on exports.[17]

In contrast to the period of 1977-78, applying expansionary fiscal policy with respect to payments adjustment was not unanimously advocated by these peak business organizations until 1987, despite the sharp yen appreciation during 1986. Main reason was that the leaders of these peak business organizations had been firmly committed to the Nakasone cabinet's fiscal reform. Business leaders were afraid that increasing budget deficit might lead to the raise in corporate tax. In order to avoid such tax increase for industries and businesses, they urged the government to take a positive step to reduce its budget deficit by reducing government expenditure and reforming the bureaucratic system, instead of increasing tax.

Their initiatives in 1981 were translated into the political slogan of the Nakasone cabinet's fiscal policy; "fiscal reform without enlarging tax bases."[18] Keidanren, which represented most industries, was the most powerful supporter of the Nakasone cabinet's fiscal reform.[19] In the

[17] *Nihon Keizai Shimbun*, November 21, December 25, 1985, May 29, 1986. Export-oriented industries criticized the idea of export regulations.
[18] *Asahi Shimbun*, April 2, evening edition.
[19] Former President of Keidanren Dokoh was asked by Nakasone to chair the Second Reform Council, which was established to achieve administrative and fiscal reform. Although Dokoh strongly urged the government to take fiscal expansionary measures in 1977, he directed fiscal reform this time.

proposal for the budget making for 1986 submitted to the government and the LDP, Keidanren emphasized the necessity of pursuing the principle of no growth of the size of budget, reducing the Loan and Investment Program, and reforming bureaucratic system.[20],

When the business organizations started to express their uneasiness about the level of the yen publicly was January 1986. At this time, the yen-dollar exchange rate reached beyond the rate of 200 yen against the dollar, which most industries regarded as the highest rate they could cope with. However, the attitudes of business leaders were ambiguous about which policy instruments the government should take, because of their conflicting preferences regarding policy instruments. .

(ii) Small-Scale Business

Manufacturing small-scale businesses were again hit severely by the yen appreciation during 1985-88. Exports of small-scale business declined in 1986 by 7.8 percent from the previous year, while exports of large industries dropped by only 0.7 percent. Export-oriented small-scale businesses particularly lost their profitability because of the decline of exports. Local export-oriented small-scale businesses were most damaged by a high yen. The number of manufacturing regions, which consisted of mainly small-scale businesses and which exported more than 20 percent of their products,

[20] *Keidanren Geppo*, August 1985, pp. 27-29.

dropped to 66 in 1986 from 79 in 1985. They also decreased exports by 20.4 percent.[21]

As the yen appreciated, the negative effect of a high yen on small-scale business became evident. In October 1985, about 40 percent of small-scale businesses claimed that they could manage to cope with a high yen, but in January 1986, when the increase in imports of import-competing products was apparent, most of small-scale businesses explicitly opposed further yen appreciation.[22]

In response to the sharp yen appreciation, they lobbied politicians and the MITI, which supervised small-scale business policy.[23] Zenkoku Chushokigyodantai Chuokai made the resolution which urged the government to increase expenditures for small-scale business in the 1986 budget to stimulate the domestic economy. This resolution also emphasized compensatory measures for the projected loss of small-scale business in the process of market liberalization, which the government tried to carry out.[24] Because of the MOF's tight budget principle, budget allocation for small-scale business had not increased since 1981 and even slightly

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[21] *Chushokigyo Hakusho*, 1987 (Tokyo: Okurasho Insatsukyoku, 1987).

[22] Mitsugu Yamamoto, "Ensoba Kotoka ni okeru Chushokigyo no Genjo," *Chushokigyo to Kumiai*, no. 496 (June 1986), pp. 40-49.

[23] Noboru Takeshita, *Shogen Hoshuseiken* (Tokyo: Yomiuri Shimbunsha, 1992), p. 158, *Shugiin Kaigiroku, Yosan-iinkai*, no. 4, February 6, 1986.

[24] *Chushokigyo to Kumiai, op. cit.*, no. 489 (November 1985), pp. 46-52.

decreased the ratio in the general account.[25] The amount of the Loan and Investment Program for small-scale business had been also restrained since 1982.

(2) Political Structure

(i) The Nakasone Cabinet

The main political slogan of the Nakasone cabinet which started in 1982 was administrative and fiscal reform, aiming at a "small government." Nakasone's commitment to fiscal austerity principle was backed by business leaders and welcomed by the MOF. Commitment to fiscal austerity policy, however, constrained the choice of policy instruments for payments adjustment. How to stimulate the domestic economy was the main concern of the government in terms of eliminating external imbalances. In order to avoid fiscal expansion, the choice was restricted to vitalizing private sector's economic activities, not through government expenditure. This choice was apparent in the package policy for increasing domestic demand in October 1985, which was determined mainly from the viewpoint of reducing the tension with the United States.[26] The main content of this package policy was stimulating private sector's activities in housing and urban development projects. Fiscal expansion was

[25] The ratio of measures for small-scale business in the general account was 0.4 percent in 1985.
[26] *Nihon Keizai Shimbun*, October 1, evening edition.

carefully avoided from this package even during the high-yen period.[27]

In response to the high yen after the Plaza Accord, the immediate focus of the government was on measures for small-scale businesses. The MITI and political parties, responding to the demand from small-scale businesses, hastened to formulate special measures for small-scale business. Due to the tight budget, expenditures for small-scale business actually declined by 5.2 percent in the 1986 budget, but the government decided to introduce the special loan program with low interest for small-scale business as early as in October 1985 and continuously focused on small-scale business policy through the high yen period.[28]

(ii) The MOF and the Bank of Japan

The MOF and the Bank of Japan preferred realignment in exchange rates for payments adjustment to expansionary macroeconomic policy. The choice of the Nakasone cabinet to take a high yen policy after the Plaza Accord was therefore welcomed by the MOF and the Bank of Japan.[29] They intervened

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[27] Nakasone asked the group headed by former governor of the Bank of Japan, Haruo Maekawa, to make a proposal to solve the present economic problems. Later, the proposal called Maekawa Report, which put emphasis on the importance of structural change of Japanese economy was submitted to Nakasone in June 1986.
[28] These measures were later criticized by the U.S. government which regarded this loan program as subsidies for exporters. The Japanese government explained that the measures were designed to assist small-scale businesses facing bankruptcies and to enable their smooth adjustment to the high yen.
[29] Funabashi, *op. cit.*, p.95.

the foreign exchange market by selling heavily dollars to raise the exchange rate for the yen and expected the yen to appreciate by about 20 percent.[30]

Until the yen hit the rate of 190 yen against the dollar in early 1986, more than 20 percent appreciation, MOF and Bank of Japan officials repeatedly stated that the yen had not appreciated enough, leading to a higher yen.[31] Governor of the Bank of Japan, Satoshi Sumita, stated that although a high yen would put a negative effect on export-oriented industries, yen appreciation would be desirable, considering Japan's large external surplus. Sumita even referred to raising the discount rate in case the yen get weak.[32] Only in February 1986, when the yen approached beyond the rate of 190 yen against the dollar, Sumita announced that the stable yen would be desirable than further yen appreciation.[33]

Regarding macroeconomic policy, fiscal policy had been constrained by fiscal austerity policy supported by the MOF and the Nakasone cabinet since the early 1980s. Because of the expansionary fiscal policy in the late 1970s in response to payments adjustment problem, budget deficit worsened in the early 1980s (See Table 5.3).

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[30] Toshimitsu Oba (former Vice Minister for international affairs of the MOF),"Dorudaka no Zesei wa mada Daiichidankai ni Suginai," *Kinyuzaiseijijo*, November 4, 1985, pp. 8-11.
[31] *Nihon Keizai Shimbun*, November 8, November 9, 1985.
[32] This statement was regarded as an unusual comment by the governor of the Bank of Japan. *Kinyuzaiseijijo*, October 14, 1985, pp. 12- 13.
[33] *Nihon Keizai Shimbun*., February 4, 1986.

[TABLE 5.3 ABOUT HERE]

From the 1975 budget, deficit bond was continuously issued to finance budget deficit. In 1981, the MOF established the principle of budget making, that is, no growth of the general account, although the MOF was reluctant to accept the part of the slogan of the Nakasone cabinet's fiscal reform: "without enlarging tax bases." In 1984, as a goal of fiscal reform, the Nakasone cabinet also made a pledge to issue no deficit bond in the 1990 budget. In order to achieve this goal, the total size of the budget was restrained from increasing and the amount of issuing deficit bond was also limited.

Due to these principles, a large expenditure cut was legitimated in the name of fiscal reform. One of most specific principles of fiscal reform was restricting public works spending to the same level of the preceding year, because public works spending was usually financed through a new issue of government bonds, which would aggravate budget deficit.[34]

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[34] There are several kinds of the government bond in Japan. The bond issued on the basis of Article 4 of the Financial Law is called construction bond, because it is limited to finance public works spending. Issuing construction bond requires the approval of the Diet. In order to finance other expenses than public works spending, another type of bond is

In the budget making for 1986, which was conducted in the midst of the yen appreciation after the Plaza Accord, the fiscal austerity policy was maintained.[35] The growth rate of the general account was zero and the amount of new bonds dropped compared to the previous year. This reduction of new bonds was expected to decrease the bond-dependence-ratio to 20.2 percent.[36]

(iii) Political Parities

Increasing domestic demand was a major agenda for all political parties in face of severe international criticism of Japan's current account and trade surpluses. The LDP initially agreed on the desirability of the yen appreciation after the Plaza meeting. In 1985, the LDP put its focus on small-scale business policy and on increase of public works spending through the increase of the Loan and Investment Program to avoid increasing budget deficit. In the budget making for 1986, the LDP agreed with the government about no issue of construction bonds. However, within the LDP, the supporters of expansionary fiscal policy took an active part in calling for a new issue of construction bonds.

The opposition parties also placed priority on the necessity of increasing domestic demand long before the Plaza

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issued based on special legislation. This type of bond is called deficit bond.

[35] Minister of the MOF, Noboru Takeshita, stated that the MOF would aim at the goal of issuing no government bond in 1990; *Ibid.*, December 29, 1985.

[36] *Nihon no Zaisei, 1986* (Tokyo: Toyokeizai Shimpo-sha, 1986), p. 135.

Accord. As the yen appreciated after the Plaza meeting, they emphasized policy measures for neutralizing distributional uneven consequences of a high yen policy. In this context, their focuses were on measures for small-scale business, returning the profits of industries which benefited by a high yen to consumers, and fiscal stimulative measures.[37]

Regarding expansionary fiscal policy, in the 1986 budget making, policy preferences of the opposition parties were almost similar. They objected to fiscal reform led by Nakasone, because they disagreed over the allocation of budget. Within the austerity policy, defense expenses were excluded from the zero growth principle as well as spending for aid in budget making. Instead, increase in welfare and educational spending supported by the opposition parties were restrained in the name of fiscal austerity principle. As a way to expand the domestic economy, the opposition parties therefore proposed expansionary fiscal policy including a large income tax cut and increase in public works spending for improving a standard of living.[38] As revenue sources for fiscal expansion, they agreed on the necessity of a new issue of construction bonds.[39]

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[37] See the discussion at the Diet, *Syugiin Kaigiroku, op. cit.*

[38] *Nihon Keizai Shimbun*, December 29, 1985.

[39] For instance, the JSP proposed beyond 2 trillion yen income tax cut. Nihon Shakaito, "1986-nendo Yosanhensei ni tusiteno Taido," *Gekkan Shakaito*, no. 359 (February 1986), pp. 199-201.

4. Policy Choice in the Sharp Yen Appreciation: February-December 1986

During the period from February to December 1986, the appreciation of the yen continued until October, while trade and payment surpluses did not decrease. The yen appreciated from 180 yen to 155 yen against the dollar, the highest rate in the postwar period at that time. During this period, Japan's policy choice was restrained by both international pressures to reduce external surplus and domestic pressures to stop the yen appreciation. Both in the international negotiations and in domestic politics, expansionary macroeconomic policy came to be focused as a policy alternative for resolving the problems of payments adjustment and a higher yen.

(1) Response to Higher Yen

Monetary policy was first applied for payments adjustment. The Bank of Japan lowered the discount rate by 0.5 percent three times: in January, March, and April.[40] During 1986, the government's choice was to avoid applying expansionary fiscal policy in regard to payments adjustment. Although the Nakasone cabinet did admit that the yen appreciated too sharply in a short period, it was reluctant

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[40] In March, there was coordinated cut among G-5 and in April, coordinated cut between the U.S. and Japan.

to apply expansionary fiscal policy, because of its firm commitment to fiscal reform.

When the yen appreciation was regarded problematic after February, the initial response of the Nakasone cabinet was to halt the yen appreciation through market intervention and to emphasize the positive effect of a higher yen towards the consumers. In mid-March, the Bank of Japan intervened in the exchange markets for the first time after the Plaza meeting by buying the dollars to stabilize the exchange rates. This intervention was initiated by the Japanese government's concern over a higher yen, but turned out to be little effective in stabilizing the yen.[41]

The comprehensive economic policy package of April 1986 regarding the yen appreciation focused on the return of profits caused by the high yen to consumers. Following this policy package, electric power companies and gas companies, which enjoyed the merit of cheaper crude oil, were urged to lower their rates.[42] The Economic Planning Agency also started to stress the contributions of yen appreciation to adjustment of payment and trade surpluses, stabilization of price level, and expansion of domestic economy.[43]

Industries, which were sensitive to the rise in exchange rate during 1971-73 and 1977-78, generally recognized the negative effects of a high yen on their

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[41] *Kinyuzaiseijijo*, March 31, 1986, pp. 12-13.
[42] *Nihon Keizai Shimbun*, April 4 and 8, 1986.
[43] *Ibid.*, April 6, 1986, *Keizai Hakusho*, 1986 (Tokyo: Okurasho Insatsukyoku, 1986).

profitability. According to the polls of 399 companies conducted by Keidanren in September 1986, 74 percent recognized the deflationary effect on them and 79 percent said that further yen appreciation would hurt them.[44] On policy request for the government, 65 percent favored fiscal policy and 30 percent asked for stabilizing the exchange rate.

When the yen appreciated beyond the rate of 180 yen against the dollar, leaders of export-oriented industries came to stress unanimously the risk of recession and the importance of stimulating the domestic economy. However, as far as business leaders were concerned, they could not unite their policy proposals on specific measures until the spring of 1987. Thus, there was not much effective lobbing in pressing the government to take a further fiscal policy, besides privatization and deregulation.[45]

There was the diffused opinions among business leaders particularly on how to apply expansionary fiscal policy. The leaders of Keidanren and Nikkeiren continued to oppose a new issue of construction bonds, which would aggravate the budget deficit, and favored vitalization of private sector without putting burden on the budget.[46] Nissyo, by contrast, supported a new issue of construction bonds to stimulate the

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[44] Keidanren, "Endaka Anketo Chosakekka no Gaiyo ni tsuite," *Keidanren Geppo*, November 1986, pp. 89-94.
[45] Former Vice Minister for international affairs of the MOF, Toyoo Gyohten recalled that "the business and the public were not really worried about the yen." Volcker and Gyohten, *op. cit.*, p. 237.
[46] *Nihon Keizai Shimbun*, May 29, 1986.

domestic economy. Keizaidoyukai was not for a new issue of construction bonds until the summer of 1986.

Differences of business leaders' opinions were attributable to uneven distributive consequences of a high yen policy. There was the different effects of the yen appreciation on the profitability among industries. Export-oriented manufactures lost their profitability, while domestic-oriented non-manufactures improved their profitability, due to the decline of the cost of imports.[47] Among export-oriented industries, the effect of a high yen was different among industries. Export-oriented small-scale businesses were most severely damaged by the yen appreciation than larger industries.[48] Nissho's favor for expansionary fiscal policy reflected the interests of its rather concentrated members, that is, small-scale businesses, who asked for fiscal expansion.

On the contrary, all political parties responded to the sharp yen appreciation in a similar way. As the yen strengthened, political parties, regardless of the LDP or the opposition parties, gave priority on urging the government to take policy measures to halt the yen appreciation, emphasizing its deflationary effect on the domestic economy, especially small-scale business. Political parties focused on expansionary fiscal policy as a policy instrument not only

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[47] *Keizai Hakusho, 1987* (Tokyo: Okurasho Insatsukyoku, 1987), pp. 146-160.
[48] *Chushokigyo Hakusho*, 1987 (Tokyo: Okurasho Insatsukyoku, 1987), pp.

to avoid further yen appreciation, but also to neutralize the uneven domestic consequences of the government's choice of a high yen.

Within the LDP, the leaders of anti-Nakasone factions such as Kiichi Miyazawa and Toshio Kohmoto proposed to take expansionary fiscal measures financed through a new issue of construction bonds. The JSP demanded to postpone the government's fiscal reform plan for five to ten years.[49]

(2) Maintaining Fiscal Austerity in the Midst of Yen Appreciation

After Tokyo summit in May 1986, when it turned out to produce no agreement among nations on stabilizing the exchange rates, the yen gained its strength against the dollar again. The result of Tokyo summit sparked the dispute over the government's policy among political parties, criticizing the government for failing to stop the yen appreciation.[50]. This dispute continued to intensify until the summer of 1986, because the opposition parties intended to set the problem of the high yen as a major campaign issue for the general election in July.[51]

However, outlined policy orientations of all political parties were so similar that the high yen problem could not

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49 *Kinyuzaiseijijo*, April 7, 1986, pp. 30-31.
50 *Nihon Keizai Shimbun*, May 7, 1986.
51 Gyohten recalls that Prime Minister Nakasone asked him to restore the yen-dollar exchange rate to 170 yen before the election; Volcker and Gyohten, *op. cit.*, p.257.

become the main election issue among parties.[52] All political parties pressed the government to take both expansionary fiscal policy and compensatory policy for sectors damaged by the yen appreciation such as small-scale business. Even politicians in Nakasone faction did not dare to discuss fiscal reform during the campaign. Since the LDP won the landslide victory in the election, Nakasone was allowed to continue his premiership, but this did not mean that the Nakasone cabinet was not pressed to take expansionary fiscal policy any longer.

Instead, after the election, with further yen appreciation, the demand for making a large supplementary budget increased within the LDP as well as among the opposition parties. The LDP politicians, who promised to take an expansionary fiscal policy in the election campaign, used the victory of the election as leverage to put pressure on the MOF and Nakasone. Particularly after the Economic Planning Agency announced the slowdown of economic growth officially in late August, expansionary fiscal policy came to be much more emphasized than before in terms of not only counter-high-yen measures, but also counter-recession measures.

In international negotiations, the Japanese government repeatedly got a message from U.S. Treasury Secretary, James Baker, that in order to get an agreement of stabilizing the

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[52] Masao Soma, ed., *Nihon no Sosenkyo 1986 nen* (Fukuoka: Kyushudaigaku Syuppankai, 1987), pp. 60-69.

exchange rates by international coordination, Japan should stimulate the domestic economy to reduce current account surplus. The domestic demand of applying macroeconomic policy with respect to payments adjustment increased after the Baker-Miyazawa agreement in October. In this agreement, the United States acknowledged the importance of stabilizing the exchange rates, while the Japanese government agreed with the necessity of applying expansionary macroeconomic policy.[53] As a result of this agreement, the Bank of Japan lowered the discount rate from 3.5 percent to 3.0 percent.

On fiscal policy, the 1986 supplementary budget was a response to the demand of fiscal expansion, but it was also a product of a compromise between the demand of fiscal expansion and the principle of fiscal austerity. Supporters of fiscal expansion called for increasing public works spending, with emphasis on both the deflationary effect on the domestic economy caused by the yen appreciation, and the necessity of responding to international pressures for domestic economic expansion. The MOF and the Economic Planning Agency, by contrast, offered a theoretical counterargument that fiscal expansion would have little effect on stimulating the domestic economy and thus, was not useful to reduce current account surplus.[54]

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[53] Funabashi, *op. cit.*, pp. 159-161.
[54] MOF official stated that fiscal expansionary policy was not appropriate for adjusting payments imbalances. *Nihon no Zaisei, 1987* (Tokyo: Toyokeizaishimposha, 1987), pp. 52-54.

The 1986 supplementary budget was a 3.6 trillion yen ($ 23.2 billion) budget and the largest supplementary budget in the postwar period, most of which was allocated to public works spending. This expenditure planed to be financed through a new issue of construction bonds. Issuing new bonds meant the erosion of the MOF's fiscal austerity policy, but this supplementary budget was cosmetic, because there was not much real increase in the government expenditure.[55] Since then, the U.S. government, the IMF and the OECD had specifically asked the Japanese government to increase real budget expenditure.

In the 1987 budget making, which was already started before summer, the principle of the tight budget was also maintained, because the size of the general account was restricted to that of the 1986 budget. The MOF explained that the emphasis was put on public works spending within the fiscal austerity principle. Indeed, the whole scale of public works spending was determined aiming at 5.2 percent growth rate for 1987, which was higher than the government projection, 4.6 percent. However, because the announced public works spending included also local government expenditure and the Loan and Investment Program, public works spending in the general account even declined by 2.3 percent

[55] Hiroshi Miyazima, *Zaisei Saiken no Kenkyu* (Tokyo: Yuhikaku, 1989), p. 191. The real increase was 133 billion yen.

from the preceding year.[56] This implies that not much real money was planned to spend for public works.

5. The Choice of Expansionary Fiscal Policy in 1987

From October 1986 to early January 1987, there was little move in the yen-dollar exchange rate, and hence, not much political activities in regard to payments adjustment in Japan. However, from January 1987, the yen started to gain strength again and reached beyond the rate of 145 yen against the dollar in April.

(1) Macroeconomic Policy to Stop Yen Appreciation

The rapid yen appreciation after late January sparked again domestic criticism of the Nakasone cabinet's failing to stabilize the exchange rate for the yen, despite the Baker-Miyazawa agreement in September. After the yen started to appreciate again in January, the debate converged on policy measures to stop the yen appreciation. Expansionary fiscal policy was focused again in terms of policy instrument to stop the yen appreciation and stimulate the domestic economy, which was regarded as suffering deflationary effect by a high yen.

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[56] Syun'ichi Nagata, "62-nendo Yosan no Tokusyoku to Jutenshisaku," *Kinyuzaiseijijo*, January 26, 1987, pp. 48-50.

Finance Minister Miyazawa tried to introduce expansionary fiscal measures for the sake of stabilization of the exchange rate for the yen.[57] However, as Funabashi argues, it was not easy task for him, because of the difficult process of 1987 budget making in the Diet and the MOF's strong fiscal austerity policy backed by Nakasone and some business leaders.[58] The approval of the 1987 budget by the Diet was delayed, because tax reform plan pursuing budget revenues expansion proposed by the Nakasone cabinet was confronted with the fierce opposition to sales tax from the opposition parties. Due to this delay, new expansionary fiscal plan was difficult to be introduced without risking a budget making.

At the G-5 Louvre meeting of February 21, two policy instruments for payments adjustment: changes in exchange rates and macroeconomic policy, were discussed extensively among countries. Regarding exchange rates, there was broad recognition that further substantial exchange rate shifts could damage growth and adjustment prospects, and the desirability of stabilizing the exchange rates around present levels was acknowledged. In the Louvre agreement, according to Funabashi, Miyazawa insisted that "the yen-dollar range should be established at between 150 and 170," but the final agreed range was the range plus or minus 2.5 percent of the

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[57] Miyazawa, in response to the sharp yen appreciation, flew to Washington to discuss the exchange rate problem with Baker in January 21.
[58] Funabashi, *op. cit.*, p. 193

rate of 153.50 yen against the dollar as a defense line for mutual intervention.[59]

Besides stabilizing exchange rates, the participants admitted that exchange rates should not be relied on as the sole policy instrument of correcting current account and trade imbalances.[60] The surplus countries committed themselves to stimulate the domestic economy, while the deficit countries agreed to reduce their domestic imbalances. Before the Louvre meeting, the Bank of Japan lowered the discount rate again by 0.5 percent to the lowest level in the postwar period, 2.5 percent, mainly aiming at stabilizing the exchange rate for the yen.[61] The Bank of Japan publicly stated that since the discount rate would not be further lowered, fiscal measures should be responsible for stimulative measures.[62]

(2) After the Louvre Meeting

Since the 1987 budget had not been approved by the Diet, the Nakasone cabinet hesitated to formulate

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[59] *Ibid.*, pp. 185-186.
[60] See the testimony of U.S. Assistant Secretary of Treasury, David Malford, U.S. Congress, *Hearings before the Subcommittees on Asian and Pacific Affairs and on International Economic Policy and Trade of the Committee on foreign Affairs*, House, 100th, 1st session, April 23, 1987 (Washington, D. C.: Government Printing Offices, 1988), pp. 11-12.
[61] Nobuo Inaba (Bank of Japan official), "Koteibuai Hikisage no Shushi to Haikei," *Kinyuzaiseijijo*, March 2, 1987, pp. 18-21.
[62] *Nihon Keizai Shimbun*, February 21, 1987.

expansionary fiscal measures even after the Louvre meeting. On the contrary, with the Louvre Accord as a trigger, among industries, the LDP politicians, the opposition parties, and other ministries such as the MITI, the demand for fiscal stimulus was growing. These demands got stronger after the yen appreciated beyond the rate of 145 yen against the dollar in late March and the rate of 140 yen in late April. The massive intervention by the Bank of Japan and G-7 meeting in Washington, which confirmed coordinated intervention to stabilize the exchange rates did not stop the yen appreciation.[63].

Among business leaders, three peak business organizations proposed to the government to shelve its fiscal reform, to which they had firmly committed themselves. Keidanren, which had supported fiscal austerity policy, asked for more than 5 trillion yen ($34 billion) fiscal stimulative measures, financed through a new issue of construction bonds.[64] Only leader of Nikkeiren, Bunpei Otsuki, was still opposed a large-scale of fiscal expansion accompanied with a new issue of construction bonds.[65] However, due to the persuasion of other peak organizations, Otsuki also agreed on substantive fiscal measures financed through construction bonds.[66]

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63 *Ibid.*, March 30, and April 10, 1987.
64 *Ibid.*, April 2 , April 7, 1987.
65 *Ibid.*, April 17, 1987.
66 *Ibid.*, April 28, 1987.

After late April, in contrast to their different attitudes during 1986, peak business organizations united in pressing the government to take large scale of fiscal stimulative measures.[67] The opposition parties also pressed the government to take fiscal stimulative measures such as income tax cut, increase in welfare spending and public works spending, emphasizing the deflationary effect of the high yen on local small-scale business and the rise in unemployment rate.[68]

Within the LDP, supporters of fiscal expansion had gained ground because of the sharp yen appreciation, the Louvre Accord, and growing domestic preferences for applying fiscal policy. The LDP determined to revise fiscal reform plan and to take substantive expansionary fiscal measures.[69] This decision implied that the Nakasone cabinet's fiscal reform supported by the MOF had to give way to fiscal stimulative measures supported by the LDP, the opposition parties, and the other ministries such as the MITI, the Foreign Ministry and the Ministry of Construction.[70]

The government finally decided its comprehensive fiscal expansion program of 6 trillion yen ($ 42 billion) in late

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67 "Nakasone Souri eno Moushiire," April 27, 1987; "Tomen no Kinkyukadai ni tsuiteno Yobo," May 12, 1987; *Keidanren Geppo*, June 1987, pp. 92-93.
68 For example, see JSP's proposal of January 8, 1987, Nihon Shakaito Seisaku Shingikai, ed., *Nihon Shakaito Seisaku Shiryoshu* (Tokyo: Nihon Shakaito Chuohonbu Kikanshikyoku, 1990), pp. 942-945.
69 *Nihon Keizai Shimbun*, April 7, 1987.
70 For the aggressive pro-expansion attitude of Construction Minister, see Takeo Taguchi, *Amano Kensetsu Gyosei 474 nichi: Naiju Kakudai no Kiseki* (Tokyo: Gyosei Kenkyujo, 1988).

May, which turned out to be larger than the original plan of 5 trillion yen, equivalent to 1.8 percent in GNP.[71] This program planned to be financed mainly through construction bonds (¥1.3 trillion, $9 billion) and gains from selling NTT stock (¥450 billion, $3 billion).[72] This decision eventually shelved Nakasone cabinet's fiscal reform, and the MOF's fiscal austerity policy was suspended.[73] The 1987 supplementary budget, which was based on this program, was approved by the Diet in June 1987, although the opposition parties criticized it for including not enough income tax cut and concentrating public works spending in large and urban-centered projects.

6. Summary

This chapter aimed at explaining how Japan chose to apply expansionary fiscal policy with respect to payments adjustment during 1985-1987. There were two obvious differences from the previous cases. First, during this period, the Japanese government first deliberately chose to apply exchange rate realignment to keep a high yen for adjusting external payment surplus. Financial officials and

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[71] *Asahi Shimbun*, May 30, 1987, "Kinkyu Keizaitaisaku ni Tsuite," *Fainansu*, no. 260 (July 1987), pp. 18-22.
[72] NTT was one of public corporations which was privatized as a part of the Nakasone cabinet's privatization plan.
[73] Finance Minister Miyazawa stated that fiscal austerity policy was changed and fiscal stimulative measures would be put priority. *Asahi Shimbun*, May 30, 1987.

the Nakasone cabinet initially maintained a high yen to correct external imbalances. Second, the government did not apply substantive fiscal measures for twenty months after the yen started to appreciate. As for macroeconomic policy, monetary policy was the main policy instrument with regard to payments adjustment. Since the Nakasone cabinet was firmly committed to a fiscal austerity policy supported by the MOF and business leaders, it tried to avoid applying fiscal expansion, even while economic slow down was apparent. Moreover, the divergent view of business leaders over a further fiscal policy helped the government to pursue policy measures of stimulating the economy through privatization and deregulation.

Then, under what conditions, did the government choose to apply fiscal policy, which changed the principle of existing fiscal policy, with respect to payments adjustment? This chapter demonstrates that the choice of applying substantive fiscal stimulative measures in May 1987 was affected by increasing domestic preferences against the rapid yen appreciation after January 1987. Facing the higher yen after late March, industries and business leaders unanimously urged the government to apply fiscal stimulative measures.

Policy orientations of the LDP (anti-Nakasone factions) and the opposition parties were similar with regard to macroeconomic policy. Against the MOF's fiscal austerity policy, they made political debate over the deflationary effect of the high yen on the domestic economy. They therefore focused on measures to stop a higher yen and to compensate small-scale business hit by the high yen, taking the rise in unemployment rate seriously. Expansionary fiscal policy, which was urged by the U.S. government for payments adjustment, was emphasized in domestic politics as a measure to halt the yen appreciation and to stimulate the domestic economy, rather than as a measure to correct payment imbalances.

This chapter also shows that due to the domestic sensitivity within Japan to a rise in the yen's value, international pressures for expansionary fiscal measures could have an influence on Japan's choice of expansionary fiscal policy. In the negotiations with the United States, the necessity of exchange rate stability was accepted by the U.S. government in exchange for Japan's commitment to expansionary macroeconomic policy.

The yen appreciation actually had negative effects on the domestic economy such as lowering growth rates and increasing unemployment rate. But around May 1987, the domestic economy was already in the process of recovering. From the view point of domestic economy, the decision in May 1987 was too late. However, since the yen continuously gained strength, the fear of recession was still strong among export-oriented industries. On the contrary, there was little representation within Japan of domestic preferences for a high yen, although the government tried to emphasize the positive effects of such an eventuality.

Table 5.1

Current Account and Trade Balances of G-7 Countries, 1984-1990
($ billion)

	1984	1985	1986	1987	1988	1989	1990
U.S.	-99.01	-122.34	-145.39	-160.20	-126.24	-106.31	-92.13
	-122.38	-133.64	-155.14	-170.32	-137.11	-128.93	-123.40
Japan	34.99	49.15	85.83	87.00	79.64	57.16	35.42
	44.26	55.99	92.82	96.42	95.00	77.11	63.58
Germany	9.82	16.42	39.50	45.88	50.54	57.24	47.92
	22.29	28.51	55.74	69.88	79.41	76.71	71.87
France	-1.16	-0.22	1.95	-4.93	-4.71	-5.53	-13.56
	1.49	0.88	1.64	1.38	1.13	-0.25	-13.95
Britain	2.44	3.51	-0.10	-7.07	-27.37	-32.46	-24.51
	-6.11	-2.65	-12.80	-17.93	-36.98	-37.96	-31.13
Italy	-2.31	-3.58	2.44	-1.07	-5.78	-10.62	-14.45
	-5.82	-6.08	4.53	-0.07	-0.77	-2.17	-----
Canada	2.08	-2.27	-8.20	-8.75	-11.27	-17.50	-18.88
	15.97	12.57	7.57	9.06	8.88	5.05	9.82
OECD total	-56.39	-63.26	-28.65	-57.55	-52.62	-81.14	-101.65

Sources: *OECD Economic Outlook*, No. 50 (December 1991).
IMF International Financial Statistics Yearbook 1991.

Table 5.2

Economic Conditions in Comparison, 1984-1988:
The United States, Germany and Japan

	Growth of Real GNP (percentage changes from previous year)			Consumer Prices (percentage changes from previous year)			Unemployment Rates (commonly-used definition)		
	U.S.	Germany	Japan	U.S.	Germany	Japan	U.S.	Germany	Japa
1984	6.8	3.3	5.1	4.3	2.4	2.3	7.5	8.2	2.7
1985	3.4	1.9	4.9	3.5	2.2	2.0	7.2	8.3	2.6
1986	2.7	2.3	2.5	1.9	-0.2	0.6	7.0	7.9	2.8
1987	3.7	1.7	4.5	3.7	0.2	0.1	6.2	7.9	2.8
1988	4.4	3.6	5.7	4.1	1.2	0.7	5.5	7.9	2.5

	Current Account Balance ($ billion)			Exchange Rate (average of daily rates)		
	U.S.	Germany	Japan	U.S. dollar	Germany mark	Japan yen
1984	-104.19	9.82	35.00	1.000	2.846	237.6
1985	-112.69	16.41	49.16	1.000	2.944	238.6
1986	-133.25	39.20	85.85	1.000	2.172	168.5
1987	-143.69	45.17	87.02	1.000	1.797	144.6
1988	-126.55	48.51	79.63	1.000	1.756	128.2

Sources: *OECD Economic Outlook*, No. 46 (December 1989).

Table 5.3

Budget Deficits of the United States, Germany and Japan, 1984-1989

1. Bond-Dependence-Ratio (Percentage of Government Bond to Annual Expenditure)

	1984	1985	1986	1987	1988	1989
U.S.	21.8	22.4	22.3	14.9	14.6	13.4
Germany	11.4	8.8	10.4	13.1	6.9	12.5
Japan	24.8	23.2	21.0	16.3	11.6	10.1

2. Accumulated Long-Term Government Deficit as a Percentage of GNP

	1984	1985	1986	1987	1988	1989
U.S.	33.0	36.4	40.9	44.5	46.0	47.7
Germany	20.1	20.8	20.9	21.7	22.3	21.3
Japan	45.9	47.1	50.1	50.4	49.0	47.1

Source: *Nihon no Zaisei 1990* (Tokyo: Toyokeizai Shimpo-sha).

Chapter Six

Conclusion:

Payments Adjustment, International Economy and Domestic Factors

1. Introduction

This chapter will review the answers to the main question posed by this thesis and examine some broader issues related to international political economy and Japanese foreign economic policy.

This chapter is arranged in four sections. First, the argument of this thesis on payments adjustment policy will be reviewed. In this section, the relationship between the international economy and state policy choices will be discussed in relation to existing approaches in international political economy. Second, the comparison among state choices of payments adjustment policy will be summarized in terms of the argument of this thesis. Japan's choices will be compared with those of Germany and the United States. Third, the question of whether or not and how Japan's payments adjustment policy was formulated and changed over time will be examined in light of the three cases of this thesis. Both similarities and differences in the formulation of payments adjustment policy will be highlighted. Fourth, the effects of domestic-level factors on international trends will be reviewed and the empirical and theoretical implications of international macroeconomic policy coordination will also be discussed.

2. The Payments Adjustment Problem and State Policy Choice

This thesis has sought to explain under what circumstances a state chooses macroeconomic or fiscal policy in order to adjust external imbalances, and the role domestic politics plays in this process -- be it supportive, or critical or a combination. Japan's payments adjustment policy was examined, because post-World War II Japan has chosen to apply macroeconomic policy, fiscal policy in particular, for payments adjustment, when adjusting international payments imbalances became one of the serious agendas among nations. Indeed, Japan's selected path has diverged from those of other industrial countries in parallel balance of payment circumstances.

We have examined three cases of Japan's payments adjustment policy: (1)1968-73 (2)1977-78 and (3)1985-87. In each case, the adjustment of external imbalances was one of urgent problems in the international economy. In other words, the United States suffering a large payment deficit consistently pressed surplus countries to take measures to eliminate their payments imbalances. Why and under what circumstances did Japan choose to apply macroeconomic policy with respect to payments adjustment?

This thesis has argued that two domestic factors are essential to explaining state choice of policy instruments for payments adjustment in an interdependent international economy. The first is domestic preferences regarding changes in exchange rates, and the second is the policy orientations of political parties regarding payments adjustment. Domestic preferences regarding the exchange rate shaped the state's choice of macroeconomic policy with respect to payments adjustment, and were transmitted through political parties.

As the cases demonstrate, in Japan, facing a payment surplus, there was overrepresentation of domestic preferences against revaluation (appreciation) of the yen. Export-oriented industries, small-scale business were especially sensitive to exchange rate levels and pressed the government to stop a high yen when it had began to accelerate. These preferences of export-oriented industries were translated into policy choice of macroeconomic policy through political parties. All political parties were sensitive to such domestic exchange rate preferences, because export-oriented, small-scale businesses, which all political parties relied on as electoral supporters, were hit hardest by the yen appreciation.

In this context, as the yen appreciated further, expansionary fiscal policy came to be focused as counter-high yen and counter-recession measures in domestic politics. Because of the existence of these domestic political biases, international political pressures to stimulate the domestic economy and adjust external imbalances could put influence on Japan's choices of policy instrument for payments adjustment. The result was expansionary macroeconomic policy.

This argument leads us to consider one of the important questions in international political economy: How do international factors affect state policy choice? This thesis demonstrates the importance of opening the "black box" in order to understand the relationship between international factors and state policy outcomes.

In Japan's payments adjustment policy, international political pressures, especially from the United States, played an important role in urging Japan to take an expansionary fiscal policy. U.S. threat of protectionism made Japan consider the payments adjustment problem a most urgent problem in foreign economic policy, because of Japan's large trade dependence on the United States. However, as the three cases illustrate, without domestic conditions in favor of expansionary macroeconomic policy, international political pressures alone could not generate much influence in changing the principle of the existing domestic policy.

Moreover, this domestic bias toward expansionary fiscal policy was not a fixed one, but was formulated in response to the level of the exchange rate. There is no doubt that in an increasingly interdependent international economy, state economic policy is affected by the international economy. Most studies of international coordination of domestic policies assume that the state is a unitary actor and explain state policy outcomes in the context of optimal national economic policy.[1] However, we have to notice that the international economy affects domestic actors differently in various ways.[2]

One example is through the exchange rate. The international economy influences exchange rate levels and fluctuations, and changes in exchange rates affect not only the domestic economy as a whole, but also economic conditions of societal actors by altering international economic transactions.[3] Therefore, exchange rate realignment entails the domestic distributional effect. Most examinations of international coordination of domestic policies refer to the effect of the international economy on the domestic economy as a whole, but do not pay much attention to the economic impact of exchange rate policy on societal actors.[4] As the

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[1] For example, Cooper, *The Economics of Interdependence, op. cit.*, Keohane and Nye, *Power and Interdependence, op. cit.*, Oye, ed., *op. cit.* See, Chapter 1, footnote 38.
[2] Gourevitch, *Politics in Hard Times, op. cit.*, Peter J. Katzenstein, *Small States in World Markets: Industrial Policy in Europe* (Ithaca: Cornell University Press, 1985).
[3] For the mechanism of the exchange rate system, see John Williamson, *The Exchange Rate System* (Washington, D. C.: Institute for International Economics, June 1985), John F. O. Bilson and Richard C. Marston, eds., *Exchange Rate Theory and Practice* (Chicago: University of Chicago Press, 1984.)
[4] For the literature, see Chapter 2, footnote 2,3, and 4.

cases of Japan reveal, both under the Bretton Woods system and in a floating exchange rate system, domestic preferences against a high yen constrained state policy choice for payments adjustment. In the floating exchange rate system of the 1970s and the 1980s, exchange rate movements triggered by state choice of exchange rate realignment provoked domestic preferences against the level of the exchange rate, and such preferences affected the choice of macroeconomic policy. In the three cases, severe recession was expected because of the high value of the yen, but in reality the domestic economy was not thrown into recession. Moreover, the positive effects of a high yen were revealed.

It is important to understand how and why the international economy affects state foreign economic policy. This thesis points out the importance of focusing on domestic societal actors and political structure instead of some unitary, rational state, in understanding payments adjustment policy.

3. Comparative Perspectives on Policy Choice for Payments Adjustment

This thesis also provides a comparative perspective on state choice of payments adjustment policy, by analyzing major industrial countries' responses to parallel balance of payment situations.

Under the fixed exchange rate system of the Bretton Woods system, Japan always applied macroeconomic policy for adjusting external imbalances, instead of changing the exchange rate. In contrast, France often chose to devalue when faced with a payment deficit, and Germany applied revaluation instead of expansionary macroeconomic policy in the face of a payment surplus. Under the floating exchange rate system in the post-Bretton Woods era, although industrial countries including Japan first chose to realign their exchange rates, Japan finally applied macroeconomic policy, fiscal policy in particular, in a much more responsive fashion than did Germany to the problem of payments adjustment.

What accounts for the difference in state choices between Japan and other industrial countries such as Germany? This thesis argued that the most crucial factor to explain this difference was domestic preferences regarding the exchange rate. Under the fixed exchange rate system, if domestic preferences against change in the exchange rate were strong, it was difficult for a state to choose either revaluation or devaluation for the purpose of adjusting external imbalances. Moreover, since maintaining par value was one of the principles of the Bretton Woods system, it was hard for a state to justify or make such changes in par value. When Japan experienced a payment deficit, the absence of domestic preferences regarding the exchange rate and a firm domestic consensus on maintaining par value contributed to state choice of applying deflationary policy. In contrast, when faced with a payment surplus, strong domestic preferences against revaluation facilitated the Japanese government in applying expansionary macroeconomic policy during 1968-73. As Chapter Two revealed, conflicting domestic preferences in Germany in 1960s offered the German government latitude to choose revaluation, instead of inflationary macroeconomic policy.

Under a floating exchange rate system, when there are strong domestic preferences against the existing level of the exchange rate (a high or low currency), states would be asked to take measures to adjust the level of the exchange rate. However, in a floating exchange rate system, stabilizing exchange rates through a single country's exchange rate policy proves difficult. Very often, states with a payment surplus would feel strong domestic preferences against a high currency, thus leading to expansionary macroeconomic policy.[5]

A comparison between Japan and Germany during 1977-78 and during 1985-87 may clarify this argument. During both periods, the yen and the Deutsche mark appreciated against the dollar. In Japan, as the yen appreciated, export-oriented industries, export-oriented and local small-scale businesses in particular led a drastic rally against a high yen. These strong preferences influenced the choice of macroeconomic policy. In Germany, since there was little

[5] In the case of payment deficit, strong domestic preference against a weak currency might lead to deflationary macroeconomic policy.

domestic preference against a high Deutsche mark, the choice of macroeconomic policy was not focused in the context of counter-high currency.

This argument challenges the conventional understanding of exchange rate policy; there is little domestic preferences or little activities of interest groups regarding the exchange rate, due to the nature of monetary policy.[6] As the cases of Japan and Germany during the 1960s demonstrate, however, the conventional understanding based on a single country case of U.S. exchange rate policy may not be relevant to other industrial states. Differences between monetary policy and other issue areas such as trade policy show us a different degree of interactions between state officials and interest groups in different issue-areas.[7] As the cases of Japan and Germany in the 1960s showed, however, the degrees of representation of domestic preferences in exchange rate policy cannot be attributable solely to the nature of monetary policy.

Domestic economic structures such as trade dependence with the United States and the ratio of denomination of exports in dollars might be important variables in explaining the different degrees of representation of domestic exchange rate preferences. In a country where trade dependence with the United States and the denomination ratio of exports in

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[6] See, Krasner, "United States Commercial and Monetary Policy," *op. cit.*, Odell, *U.S. International Monetary Policy, op. cit.*, Gowa, "Public goods and Political Institutions," *op. cit.*

[7] Krasner, *op. cit.*

dollars are high, a high value of its currency against the dollar could make most of its exports more expensive in the United States. Japan is regarded as this type of country, compared to Germany. However, a high value of currency can also have positive effects on other industries and on the domestic economy as a whole such as stabilizing price levels.[8] The question here is why there was little domestic representation of preferences for a high yen in Japan. In other words, why were negative effects of a high yen emphasized compared to positive effects in Japan?

In order to answer this question, we need to examine the political structure. In Japan, a high yen hit local export-oriented small-scale businesses and structurally-weak industries most severely. Since small-scale business policy is an important issue areas for political parties -- with low partisan conflict -- both the LDP and the opposition parties alike have tended to emphasize the negative effects of a high yen since the Bretton Woods period. In Germany and the United States, in terms of domestic politics, no equivalent sectors existed with regard to exchange rates like Japanese small-scale business. Without knowing this political structure, even though there are domestic preferences against a high yen, it would be difficult to understand why such preferences would be translated into political debates over the choice of macroeconomic policy in Japan.

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[8] *Keizai Hakusho, 1986, op. cit.*

4. Policy Formulation Over Time

A third point in this chapter is related to Japanese foreign economic policy. There are few studies on Japanese politics which analyze foreign economic policy formulation in the same issue-area at two or more points in time.[9] This thesis contributes to the literature by looking at Japan's payments adjustment policy at several points in time. In this thesis, payments adjustment policy has been considered in three separate cases at different periods. What are the similarities and differences among cases? What constant factors existed in the formulation of Japan's payments adjustment policy? These are important questions to understand the relationship between a changing international economy and Japan's foreign economic policy.

From the late 1960s to the 1980s, not only did the structure of the international economy change, but also Japan's position in the international economy.[10] During this period, Japan's GNP and exports increased sharply, making Japan the dominant creditor nation by 1985. Japan's current account and trade surpluses constantly expanded after the early 1980s. In particular, trade imbalances with the United States were getting wider after the mid-1970s. Export dependence ratio on the United States also increased, and for

[9] As for Japanese foreign economic policy, there are many case studies in trade policy, but in other issue-areas related to foreign economic policy, there were a few studies.
[10] Gilpin, *The Political Economy of International Relations, op. cit.*, chapter 9.

Japan, the United States was the biggest trade partner, and vice versa.

In changing international and domestic economies, Japan's initial attitude towards payments adjustment changed. During 1968-73, partly due to the uncertainty of a new international monetary system, Japan tried to avoid applying changes in exchange rate for payments adjustment. On the contrary, during 1977-78, Japan first changed its exchange rate policy with respect to payments adjustment, and during 1985-87, Japan deliberately took a high yen policy for the purpose of correcting external imbalances. This change in Japan's initial attitude toward payments adjustment was not only related to the international consensus on the role of the exchange rate in adjusting external imbalances in a floating exchange rate system, but also attributable to the change in Japanese financial officials' preferences of a high yen to expansionary macroeconomic policy, facing accumulating external surplus. Financial officials' preferences of a high yen was also related to their domestic concern about a budget deficit. The rising budget deficit prevented the MOF from changing its fiscal austerity policy for the sake of payments adjustment.

There was also a change with regard to the concern of political leaders for the domestic economy. In contrast to Prime Minister Tanaka's preferences for fiscal expansion during 1971-73, when Japan was at the last stage of high economic growth, Prime Ministers Fukuda during 1977-78 and

Nakasone during 1985-87 supported the MOF's fiscal austerity policy concerning budget deficit, and they, therefore, supported to apply change in exchange rate as an initial response to payments adjustment. Fukuda and Nakasone acknowledged that accumulating a trade surplus sparked economic friction with the United States, and that considering increasing Japan's position in the international economy, Japan should play an important role in the international payments adjustment process. However, they hesitated to apply expansionary fiscal policy, and instead tried to correct payments imbalances through, first, a high yen and other measures such as introducing an urgent import program, and stimulating the economy through deregulation and privatization.

Business leaders' preferences regarding policy instruments of payments adjustment policy also changed. As the cases revealed, during 1968-73 and during 1977-78, the leaders of four peak business organizations urged the government to take expansionary fiscal policy in order to avoid revaluation or appreciation of the yen immediately after the yen started to appreciate. During 1985-87, however, business leaders were not as active initially in pressing the government to take expansionary fiscal policy, partly due to their firm commitments to fiscal reform, and partly due to the diffusion of industries' attitudes toward a high yen.

The effect of a high yen became clearly varied by industry. There was little effect of a high yen on domestic market-oriented industries and technologically advanced industries such as electrical products, precision machine, chemical, and food industries. However, export-oriented industries and heavy industries such as steel, automobile, textile industries lost profitability because of a high yen. The dual structure in earnings during the high yen period became apparent in 1985-87. For business leaders, it became increasingly difficult to represent a diffused set of preferences towards a high yen.[11] Their initial reluctance to support expansionary fiscal measures subsequently helped the government to postpone applying substantive fiscal stimulative measures.

Despite these differences, there were also similarities in the three cases. First, there were always international pressures on Japan to correct its external surplus. In particular, the United States, with its large trade deficit with Japan, persistently urged Japan to reduce its trade surplus with the United States. The United States negotiated with Japan by emphasizing trade-off between exchange rate stability and expansionary macroeconomic policy in terms of payments adjustment.

Second, the preference of export-oriented, small-scale businesses against a high yen was also a constant. A high yen (the result of revaluation or appreciation) negatively

[11] Interview with a staff of Keidanren.

affected export-oriented industries, because a higher yen made their products more expensive in the United States and lowered the price of imported goods in Japanese market. Within this group, local export-oriented and import-competing small-scale businesses were damaged most severely by a high yen, because for most small-scale business, there became little room left for rationalization. Thus, small-scale manufactures were active in lobbying the Japanese government to stop yen appreciation and undertake compensatory measures.

Third, policy orientations of political parties did not change in the three cases. The governing LDP was sensitive to policy preferences of not only large businesses, but also small-scale businesses; because both groups comprised important LDP electoral bases. The LDP hastened to take compensatory measures for small-scale businesses during the high yen period. When the yen started to appreciate, supporters of fiscal spending in public works such as roads, bridges and railroads within the LDP gained ground and asked for fiscal stimulative measures to counter a projected deflationary domestic economy and to stop a high yen.

The underlying policy orientations of the opposition parties regarding payments adjustment also did not change. The opposition parties saw the rapidly rising yen as a failure of the LDP government's foreign economic policy, and demanded that the government take steps to remedy the uneven distributional effects of a high yen. Although they touched on the necessity of distributing the profits caused by a high yen to consumers by changing domestic economic structure, their main emphasis was on small-scale business policy and counter-recession policy through expansionary policy. Therefore, although there was the different policy preferences on the allocation of budget and the sources of revenue between the LDP and the opposition parties, the opposition parties also supported expansionary fiscal policy through three cases.

This study shows that when faced with the problem of payment surplus, the MOF's sound budget principle gave way to political demands for expansionary policy in both the Bretton Woods fixed exchange rate system and a floating exchange rate system. However, studies focusing only on the relations between the LDP and bureaucrats do not fully explain why the LDP was influential in the formulation of payments adjustment policy. We need to know why the LDP's policy orientation gained ground by examining the relations between societal actors and political parties including the opposition parties.

Due to changes in domestic conditions, Japan's choice of payments adjustment policy showed a gradual change. However, the similar factors which originated in the 1960s under the Bretton Woods system still put more crucial influence on the formulation of Japan's payments adjustment policy. Thus, Japan finally decided to apply expansionary fiscal policy with respect to payments adjustment in 1977 and in 1987.

Then, will Japan's adjustment policy change in future? If so, how? These questions will be discussed with regard to the problem of international policy coordination in the next section.

5. Domestic Sources of International Policy Coordination

International macroeconomic policy coordination is one of the important topics in international political economy. The economic literature has examined international policy coordination in the context of optimal economic policy. Most literature focusing on the political aspects of international policy coordination have argued that it is difficult to coordinate individual country's macroeconomic policy, mainly because of domestic constraints on macroeconomic policy such as economic structures and political pressures.[12] In particular, fiscal policy is regarded as most difficult to change for international macroeconomic policy coordination.

The cases of this thesis confirm that fiscal policy is more difficult to change with respect to payments adjustment than exchange rate policy in a floating exchange rate system. Germany and Japan hesitated to take expansionary policy facing payments surpluses, while in the face of payment

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[12] For example, Thomas D. Willett, "National Macroeconomic Policy Preferences and International Coordination Issues," *Journal of Public Policy*, vol. 8, part. 3/4, (July-December 1988), pp. 235-263.

deficit, the United States could not take measures to reduce its budget deficit.

However, this thesis also reveals that domestic factors could facilitate state coordinated behavior in a floating exchange rate system. The existence of domestic preferences regarding policy instruments for payments adjustment may prompt a state to take other policy instrument, which was internationally requested for payments adjustment.

Under the floating exchange rate system in the 1970s and 1980s, in Japan, domestic preferences against a high yen contributed to press the government to change its fiscal policy into expansionary macroeconomic policy, which was regarded internationally as a desirable policy to achieve adjustment of payments imbalances among nations.

This aspect can also be found in U.S. policy with respect to payments adjustment. In the United States during the high dollar period of the early 1980s, according to the study of Destler and Henning, leaders of industries which were affected by the increase of import urged the government and Congress to lower the high value of the dollar and to cut the budget deficit, which was considered by industries as the major cause of a high dollar.[13] U.S. reduction of its budget deficit was regarded as an appropriate measure to correct its external deficit in the international negotiations on payments adjustment, but the U.S. government avoided its

[13] Destler and Henning, *Dollar Politics, op. cit.*, pp. 127-128.

commitment to budget deficit cut. On the contrary, when the dollar started to depreciate after the Plaza Accord and import competition reduced, "the energy behind business's push for budget deficit reduction dissipated."[14] This whole episode implies that preferences against a high dollar motivated industries to press the government to take policy measures to change its fiscal policy, but without domestic exchange rate preferences, there was not much representation of preferences on the choice of macroeconomic policy, either.

In Germany, there was little preferences against the level of the exchange rate in itself, unlike Japan. According to the survey of German and Japanese industries during the period of the high values of their currencies, most German industries did not favor the realignment of the exchange rate, while most of Japanese industries preferred stopping a high yen.[15] In Germany, the choice of macroeconomic policy was discussed largely from the view point of domestic economic objectives, hardly in the context of stopping the appreciation of the Deutsche mark. The delayed German decision to apply expansionary macroeconomic policy was largely attributable to a little domestic preferences regarding the exchange rate.

These examination illustrate that as far as there are strong domestic preferences regarding the exchange rate, and as far as the political structure responds to such domestic

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[14] *Ibid.*, p. 138.
[15] *Nihon Keizai Shimbun*, February 5, 1987.

preferences, the state would face a choice between exchange rate stability and macroeconomic policy in domestic political arena with regard to payments adjustment.

After 1985, Japanese industries including small-scale businesses undertook structural changes in order to cope with a high yen and changes in the international economy. Industries increased overseas direct investments, raised the share of exports denominated in the yen, and gained expertise in international capital transactions. Because of these changes, industries became less sensitive to fluctuations of the exchange rate. If there is less domestic preferences against a high yen, trade-off between macroeconomic policy and exchange rate stability in domestic political arena might be less likely in the choice of payments adjustment policy. This implies that Japan has less incentives domestically to apply macroeconomic policy in a prompt way for payments adjustment. Thus, coordination of macroeconomic policy will be more difficult, unless the countries such as the United States, Germany and Japan truly agree on the desirability of coordinating their macroeconomic policies.

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