

1988

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Publication Info

Published in *Journal of Public Policy*, Volume 8, Issue 2, 1988, pages 175-194.

<http://journals.cambridge.org/action/displayJournal?jid=PUP>

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Explaining Policy Failure: Japan and the International Economy, 1969-1971

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ABSTRACT

This paper examines the determinants of Japan's most serious postwar blunder: failure to define and implement effective and timely counter-measures to deal with its change from deficit to surplus international monetary status during the 1969-1971 period. It concludes that intense bureaucratic compartmentalization and a lack of supra-ministerial leadership of national policy were key determinants of this failure, leaving Japan's political system dependent upon irresistible external pressure (*gai-atsu*), in this case from the United States, to define and force implementation of necessary policy changes. This critical but largely ignored episode illustrates a negative aspect of the traditional insulation of Japan's national bureaucracy from political (as opposed to administrative) interference in the definition and pursuit of basic national policy objectives.

Much of the scholarly and journalistic material available today about Japan was written in search of the determinants of Japan's postwar 'economic miracle'.¹ The natural consequence of this attention is a Japanese and English language literature heavily weighted toward description of the more positive attributes of Japan's econo-political system, those features thought most responsible for her rapid postwar economic growth. Japan's government has received much of the credit. Often mentioned governmental attributes include a highly qualified, relatively honest, and motivated natural bureaucracy; a preference for bottom-to-top policy initiative flows rather than the dictatorial top-down model implied as characteristic of other systems; an amazing ability to promote cooperation among groups with diverse interests; 'consensus' style policymaking which encourages the participation of all actors with even potential interests in any issue under consideration; and a minimum of interference from the political (as distinct from the bureaucratic) sector in important economic policymaking.

Although Japan's postwar Constitution clearly assigns ultimate political responsibility to a prime minister elected by the Diet and the cabinet of ministers he appoints, a minimum of political interference in the work of the bureaucracy, raises a fundamental question about the nature of the Japanese state. To what degree are Japan's highly respected governmental ministries insulated from the control of the popularly elected representatives constitutionally responsible for their actions? Questions of democratic principle aside, minimization of 'political interference' in the work of the bureaucracy may increase the efficiency of individual ministries as they pursue broad predetermined objectives. But it also may leave the system as a whole vulnerable to delay, even immobilization, when faced with issues that require fundamental changes in national policy over which powerful ministries disagree.

In this paper I examine the determinants of Japan's most serious postwar blunder: failure to define and implement timely and effective countermeasures to deal with Japan's change from deficit- to surplus-prone international economic status during the late 1960s to early 1970s. Extreme bureaucratic compartmentalization and a lack of 'supra-ministerial' leadership of national policy were key factors in this failure, making Japan's political system dependent upon irresistible external pressure (*gai-atsu*) to determine and implement necessary policy changes.

Events

From Balance-of-Payments Deficit to Surplus

The architects of Japan's postwar economic growth and development were well aware of the importance of international monetary affairs to the achievement of their objectives. Japan had been driven painfully up against its balance-of-payments ceiling at least five times by the mid-1960s, when rapid expansion of domestic demand increased imports and diverted exports to domestic consumption, reducing Japan's foreign exchange reserves to levels considered dangerous. This forced the Ministry of Finance (MOF) to impose politically painful policies to restrain business expansion.

The government made every effort to conserve Japan's scarce foreign reserves and to avoid the unpleasant consequences of those credit tightening exercises by vigorously promoting exports and restraining non-essential imports under the authority of the Foreign Exchange and Foreign Trade Control Law of 1949. They were very successful and Japan, as a result, entered the turbulent latter half of the 1960s with a political economy-designed to cope with recurring bouts of foreign exchange scarcity, managed by officials highly skilled in its manipulation,

but with a system unprepared to cope with the emerging challenge of destabilizing international *surpluses*, a problem they found difficult even to imagine as late as the mid-1960s.

The business boom that began early in 1966, true to historical pattern, within a year pulled Japan's foreign exchange reserves below the psychologically important \$2-billion level, and the government responded with traditional credit-tightening countermeasures. Lack of improvement by March, against a background of turbulent international monetary conditions, inspired rumors within Tokyo's financial community and media of a yen *de*-valuation. Senior Ministry of Finance officials, in fact, considered approaching the IMF with the suggestion of a devaluation. But in public they made a vigorous effort to discourage speculation by describing the situation as just another trough in the postwar cyclical pattern that could be managed without resort to extreme measures.

By August the international outlook was again bright enough to allow a discount rate cut and relaxation of 'window guidance'. The upward trend continued throughout 1969 with reserves already reaching \$3 billion by the end of the year. Rapid balance-of-payments recoveries had been achieved in the past. But the 1968-1969 upswing was unique in that it occurred without a painful recession; the domestic economy continued to boom. In spite of the upward-trending balance-of-payments performance, Japan's GNP growth in 1969, at 13.5 per cent, was only slightly lower than the 13.8 per cent recorded in 1968, with no indication that the longest postwar business boom was about to end.

Japan's sensitive international economic position was further aggravated during 1969 by evidence of economically and politically dangerous levels of inflation. By the end of March the wholesale price index was increasing at a monthly rate equal to the annual rate for 1968. Although more willing than West Germany to accept moderate inflation as a cost of rapid growth, the government could not ignore the possibility of double-digit inflation by the end of the year. A large increase in the official discount rate, from 5.84 to 6.25 per cent, was announced on 30 August, accompanied by increased bank reserve requirements. This too was a significant departure from customary practice, since for the first time in Japan's postwar history the government was forced to impose economic restraint measures to cope with domestic rather than international economic problems. These anti-inflation measures also strengthened Japan's propensity toward balance-of-payments surplus.

Takafusa Nakamura, a noted Tokyo University professor of economics and former Director-General of the Economic Planning Agency's Economic Research Institute, has criticized this move on domestic as well as international grounds, arguing that monetary restraint was less than

effective against the wholesale price rise which was caused chiefly by a rise in the price of imported primary products.

If a small-scale upward revaluation of the yen – for example, on the order of 5 to 8 per cent – had been implemented at this time instead of monetary restraint, the influence of international price increases on the domestic economy would have been effectively checked, excessive increases in exports would have been restrained, and the desired objectives, rather than a large-scale recession would most likely have been achieved. (Nakamura, 1981, 217–218)

Within an environment of declining confidence in the stability of the international monetary system and the US dollar, Japan's balance of payments began to attract a different kind of attention abroad. Foreign observers with increasing frequency suggested that the government take countermeasures to slow what by mid-year had become an alarming upward trend. Even the 1969 OECD annual country survey on Japan released in July – one of a diplomatic series that normally avoids divisive finger-pointing – stated: ‘. . . with the attainment of a more adequate level of external reserves, Japan is, for the first time in her history, experiencing the problems of surplus countries trying to avoid undue strains on international liquidity.’ (OECD 1969, 5) The *Survey* specifically mentioned the need for more rapid trade and investment liberalization.

By late 1969, in the midst of the most severe crisis the Bretton Woods international monetary system had experienced since its formation, Japan had moved from deficit-prone to surplus-prone status, a change which, under Bretton Woods rules, required a fundamental re-ordering of Tokyo's international monetary priorities.

Early Official Response

With rumors of a *devaluation* less than two years old, Japan's international moneymen were, with some justification, less optimistic about their international monetary future than were their foreign critics. Front-line troops with decades of experience in the battle against foreign reserve scarcity, they publicly described their position in the late 1960s as an unusually high point in the traditional up-and-down pattern. They were determined to avoid any hasty, irreversible response to increasingly intense foreign demands for change that might permanently weaken their nation's ability to accumulate foreign exchange, and instead focused their energies upon neutralizing international pressure for change until the situation returned to ‘normal’.

The late Taizo Hayashi, in 1969 director of the Research Division of the Finance Minister's Secretariat and later Deputy Director General of the MOF International Monetary Bureau, revealed in a post-retirement

article that the Ministry was well aware at the time that Japan had experienced a fundamental change in its relationship with the world economy. MOF economists, according to Hayashi, prepared quarterly a *shojiki besu* [candid basis] projection of domestic and international economic trends for the next six quarters in addition to their regularly published projections. These projections were used only for internal MOF policy discussions, kept secret, in principle, to avoid the effect of public release. In 1977 Hayashi wrote that according to the MOF's 1969 *shojiki besu* estimates, Japan's balance of payments had hit bottom around 1961 or 1962, and thereafter, with periodic ups-and-downs, it was likely to register a surplus. (31 January 1977, 38) In other words, MOF economists privately accepted the main contention of the 1969 OECD report.

Still, official energy was directed toward public defense of the *status quo* at home and abroad rather than toward consideration of a substantive change in policy. For example, in early 1969 after a surprising 50 per cent increase in foreign exchange reserves the previous calendar year, Finance Minister Takeo Fukuda argued that official reserves of even \$3 billion was not excessive in the light of Japan's international trade volume. He and other officials in public statements raised the possibility of bad times in the coming years during which the accumulated reserves would again be welcome, conveniently ignoring the more important issue of the speed of their rate of increase, and their continued growth under boom conditions.

Japan's international moneymen did implement some temporary corrective measures during the late 1960s in response to foreign pressure, most significant of which was encouragement of the 'yen shift', or substitution of domestic sources for the customary dollar-denominated international sources of import and export credit. As long as interest rates on domestic financing remained lower than international rates this yen shift policy helped to reduce Japan's total accumulation of dollars. Its effect was weakened though, once domestic interest rates began to rise later in 1969.

Foreign charges of Japanese protectionism also inspired public endorsements of more rapid trade and investment liberalization, especially from Ministry of Finance and Bank of Japan officials who had little or no direct responsibility for their implementation. In a routine that would become all too familiar during the next two decades, travel-weary officials just returned from international conferences at which they had been scolded for Japan's unseemly coincidence of balance-of-payments surpluses and heavy domestic market protection, declared the urgent need for more rapid liberalization during their airport press briefings.

As foreign pressures increased, even the leaders of Japan's organized business community joined the chorus. For example, on 13 October 1969 the Chairman and Vice Chairmen of Keidanren [Federation of Economic

Organizations] strongly endorsed rapid trade and capital liberalization, and promised to hold more meetings of their liberalization-related committees to promote the process. (NKSB, 14 October 1969, 1) As international tensions increased, it eventually seemed that all of Japan endorsed – in principle, at least – the more rapid liberalization demanded by her foreign critics.

The Cabinet on 17 October 1969 announced an accelerated schedule for the liberalization of 55 separate items by the end of 1971, an early example of what would become known in later years as a 'liberalization package'. (NKSB *ev. ed.*, 17 October 1969, 1) But implementation of the package came nowhere near the level of the widely publicized proposals of international economic meeting returnees, and nowhere near the level required for any lasting impact on world opinion.²

As short-term steps to placate fuming foreigners while waiting for the return of the status quo, such efforts were moderately successful. But in longer-term perspective, by raising performance expectations abroad to levels higher than could or would be implemented, Japan's international reputation as a reliable and responsible world economic actor suffered as a result of this strategy, and she received little or no credit abroad for domestically painful liberalization measures even when they eventually were implemented.

Plans also were announced in 1969 to reduce the politically irritating accumulation of international reserves through expansion of foreign aid. During the first half of the 1960s Japan's official development assistance had risen by an annual average of only 2.5 per cent, and between 1966 and 1971 the average annual rate of increase was boosted to 16.2 per cent. Although impressive in percentage terms, it began from quite a low base, and again, the measures actually taken did little to dampen international criticism, let alone reduce significantly the troublesome foreign exchange reserves. In 1969 Japan's official development assistance represented only 0.25 per cent of GNP, nowhere near the 0.7 per cent level to which Japan was committed through OECD membership.³

Less significant measures to cope with Japan's new international economic status included a 40 per cent increase in the amount of foreign currency businessmen and tourists could take abroad, plans to negotiate an increase in Japan's relatively low \$725-million IMF quota, early repayment of World Bank loans, purchase of medium-term World Bank bonds, and even a change in the name of the 'Supreme Export Council' to 'Supreme Trade Council'. Still, fear that foreign exchange scarcity might someday again dampen domestic economic growth continued to dominate the thinking of Japan's economic policymakers, making them reluctant to consider genuine reform measures.

By the end of 1969 a clear pattern of response had been established.

Each new threat to the stability of the international monetary system or shower of foreign criticism inspired:

1. An official denial of any fundamental disequilibrium;
2. Implementation of some technical, easily reversible adjustments, such as the yen shift program, expected temporarily to slow the increase in official external reserves; and
3. A flurry of public relations efforts abroad by government and business sector designated speakers to seek the understanding of Japan's critics, and to describe plans for more rapid trade liberalization in the near future, efforts maintained until the crisis or international criticism abated.

Avoided at all cost was any policy initiative that might significantly affect Japan's long-term international economic competitiveness, especially any consideration of a change in the parity of the yen – the one policy instrument over which the MOF international moneymen actually exercised direct and immediate control. According to former MOF Research Division Director Hayashi, by the end of 1969 that subject had become what he labeled a *sei-iki* [sacred territory], upon which the MOF leadership allowed no one with international policy responsibility to tread. (31 January 1977, 39) Even in-house staff discussion of its likely consequences, according to Hayashi's article and personal interviews with other policy participants, was highly restricted.

This prohibition against consideration of a change in the yen's parity was maintained – even strengthened – in spite of the mid-August 1969 11.11 per cent devaluation of the French franc, and West Germany's surprise announcement of a Deutsche mark float on 29 September in the midst of a sensitive national election. Germany's decision left Japan even more vulnerable to foreign criticism for lack of international economic cooperativeness and lack of any sense of responsibility for the health of the Bretton Woods system, and the yen more vulnerable than ever to speculative attack.

Japan, however, remained adamantly opposed to a parity change, even within a multilateral context. During the 1969 International Monetary Fund meetings Finance Minister Fukuda strongly opposed proposals which had been debated by the IMF Executive Directors since January for slightly more multilateral exchange rate flexibility on the grounds that the success of the international economic system depended upon firmly fixed rates.⁴ This refusal during 1969 to support even a multilateral effort to introduce modest flexibility, a measure that might have helped to stabilize the system at that early date, and thereby to reduce chances later for changes of a more radical and unpredictable nature, gave clear evidence of that determination.

The Crisis Intensifies

By early 1971, international monetary instability occasioned by exchange rate rigidity and speculative international capital flows had once again reached crisis levels. The framers of the Bretton Woods agreement hoped to bring the world *stable* rates of exchange. They never intended that parities should remain permanently fixed. In fact, the IMF Articles of Agreement included elaborate rules by which parities could be changed once it was determined that a nation was in 'fundamental disequilibrium'. The drafters of the Agreement unfortunately did not (could not?) include a definition of that important term adequate to serve as a guide to action for the economic managers of countries experiencing imbalance problems. Parity changes, especially for larger countries, were nerve-racking, expensive events, a far cry from routinized adjustments to changing circumstances.

International capital flows also created problems. The growth of the Euro-currency market, estimated to have reached \$57 billion – a huge sum in 1970 – all largely beyond the reach of any government, the multi-nationalization of large corporations, the growing number of large banks with foreign branches, and even – ironically – the success of postwar capital liberalization efforts, all had helped to weaken that control and to increase the funds available to wager against the intentions of central bankers, intensifying the system's volatility. (de Vries, 1976, 496–500)

Even more serious, Washington's new Republican administration suffered under the politically explosive combination of domestic business slump and inflation and increasingly severe balance-of-payments deficits. Those ominous signs and the politically potent domestic criticism they inspired combined to stimulate world-wide speculation on the possibility of some dramatic unilateral American countermeasure, and how such a move would affect the international monetary system when it came.

In the midst of all this systemic uncertainty, the lives of Japan's Ministry of Finance officials once again were excited in late 1970 by sudden gains in all four of their politically critical international indicators. Between October and December the global trade account jumped 26 per cent over the increase recorded in the last quarter of 1969, and the current account rose by 24 per cent. Foreign currency reserves had increased only \$262 million between October and December 1969, but were up \$621 million during the same quarter of 1970, a 237 per cent increase, bringing the total for the first time in Japan's history to over \$4 billion. The bilateral surplus with the United States rose during the same period by 31 per cent, recording as much of an increase in December 1970 for one month alone as it had for the entire fourth quarter the previous year.

A severe domestic business slump during the first quarter of 1971

strengthened Japan's export performance and reduced import demand. The government responded with a 0.25 per cent cut in the official discount rate in mid-January, but a jump in consumer prices persuaded the Ministry of Finance and Bank of Japan to resist pressure for further reductions, even in the face of British and German cuts at the end of March. (NKSB, 2 April 1971, *ev. ed.*, 1) The resulting disparity in foreign and Japanese interest rates weakened the 'yen shift' and added to Japan's foreign currency reserves. When the final fiscal 1970 (1 April 1970 to 31 March 1971) trade figures were announced at the beginning of May they showed Japan running the largest surplus in that account of any country in the world. Foreign currency reserves jumped another \$1 billion in just over two months, topping \$5 billion by early March.

Each Japanese balance-of-payments announcement was met with increasingly harsh government and business community criticism from the United States and Europe – criticism the Japanese press eagerly reported 'front page, above the fold.' These, and each spasm of the international monetary system, inspired a spate of speculative media stories about the timing and magnitude of the inevitable *en-kiriage* [yen up-valuation]. Japan's businessmen, still in favor of a fixed yen exchange rate but increasingly skeptical of the government's ability to hold out against the building foreign pressures for change, began to re-write international contracts to distribute revaluation-induced losses more equitably between themselves and their associates. The government responded to each manifestation of crisis with ever more complex and determined explanations of why a yen up-valuation was unnecessary, and of the disastrous domestic economic consequences of such a move if made. Why, they argued, should Japan alone consider a parity change when the Americans and Europeans were holding firm, still supporting fixed exchange rates?

If Japan's international moneymen were not persuaded during early 1971 that it was time to make a change in the parity of the yen, European moves in early May forced them to conclude that something more substantial than sophisticated explanations of their decision to do nothing was required if the government was to maintain the confidence of the press and business community. After numerous official denials of any such intention, similar in tone and substance to Japan's, West Germany was forced once again on 5 May to suspend trading in the Deutsche mark, and four days later to re-open their foreign exchange market under the second float in two years.

Japan again was unable to avoid comparison. The Japanese press corps and business community became even more skeptical of their government's ability to manage the situation. How long, they wondered, would Japan alone be able to run huge balance-of-payments surpluses without

taking more than the cosmetic measures so far implemented to reduce international and domestic criticism? While frantically explaining to the Japanese public and to the world the differences between the Japanese and German situations, the MOF international moneymen concluded that they must announce some positive action or risk losing control.

The June 1971 Eight-Point Program to Avoid Yen Revaluation

'Highly reliable government sources' began in May to respond to questions from trusted journalists with hints of plans for an early June economic initiative. With ample advance notice, the Economic Cabinet⁵ met in emergency session on Friday afternoon, 4 June. At the regular press conference following the meeting Finance Minister Fukuda announced the Cabinet's agreement on an Eight Point Program to Avoid Revaluation of the Yen in response to the international monetary situation. The eight points included:

1. More rapid implementation of import liberalization measures;
2. Rapid implementation of preferential tariffs for imports from less developed countries;
3. Acceleration of the tariff reduction timetable;
4. Promotion of the liberalization of restrictions on international investment;
5. Removal of non-tariff barriers to trade;
6. Expansion of foreign aid;
7. More 'orderly' expansion of Japan's exports;
8. More flexible management of fiscal and monetary policy.

This ambitious program was confirmed the same day by Prime Minister Sato as Japan's official response to the international economic crisis. Its eight points recognized and proposed rectification for virtually every international economic complaint leveled against Japan. That is, every complaint save the most severe: the grossly undervalued yen. On this point, the program's title itself proclaimed Japan's resolve to stand fast.

The eight-point program from the beginning enjoyed the strong public support of Japan's top political leadership, including Prime Minister Sato, whose statements were given maximum publicity both in Japan and abroad.⁶ The message of the publicity campaign was that Japan at least had decided to act, and in contrast to official MOF efforts prior to the 4 June announcement to suppress public mention of balance-of-payments problems, they vigorously encouraged its discussion. Japan's international public relations machine had something to sell at last.

With the 1971 international economic crisis perceived and defined as a

balance-of-payments problem, the international monetary group within the Ministry of Finance naturally assumed primary responsibility. Thus, the 4 June eight-point program was designed and drafted by a small group of MOF officials under the leadership of Vice Minister for International Monetary Affairs, Yusuke Kashiwagi. As the official custodians of the yen's fixed $Y360 = \$1$ parity, defenders of what Hayashi called the 'sacred territory' of the yen's exchange rate, it was predictable that their definition of the problem and solution would include maintenance of the yen's fixed parity.

Kashiwagi himself was vague about the authorship of the plan during a personal interview on 28 May 1976. But other policy participants, including Mikio Mizuta, who became Finance Minister in July 1971, Ichiro Hatoyama, then Director General of the MOF Budget Bureau and soon to become MOF Vice Minister, Takashi Hosomi, then Director General of the MOF Tax Bureau soon to be named to succeed Kashiwagi, and Takehiro Sagami, then Director of the Research and Planning Division of the Finance Minister's Secretariat, all confirmed during separate interviews that the program had been designed under Kashiwagi's direction.

The urgency of the situation, the technical and complex reputation of international monetary issues, and Kashiwagi's personal reputation and style of operation, enabled him and his group to draft their plan with a minimum of contact with official counterparts in other government ministries and agencies – the officials who would be responsible for the program's implementation. Once drafted, Kashiwagi continued to avoid the bureaucratic *nemawashi* process by obtaining the approval of his Minister, Takeo Fukuda, who in turn quickly presented the plan to his cabinet-level colleagues and finally to the Prime Minister as Japan's last-ditch effort to cope with foreign and domestic balance-of-payments criticism. It was then announced immediately to the press corps as the government's final plan. As a result, officials in other ministries learned on 4 June that the MOF international moneymen had decided that they were to make policy adjustments in their areas of jurisdiction which would extricate Japan from the MOF's balance-of-payments problem.

It was after the plan had been announced to the world that attention was turned to inter-ministerial coordination. That responsibility was assigned to a committee composed of the directors of the Ministerial Secretariats [*Daijin Kambo-cho*] of the ministries of Finance, International Trade and Industry, Agriculture, Transportation, Foreign Affairs and the Economic Planning Agency. This committee, under the chairmanship of the Ministry of Finance, met twice in June, and monthly thereafter, to review implementation progress to date.⁷ Each meeting was followed by public announcement of any progress, dramatic appeals for more rapid

implementation, and explanations that significant results would take more time. Substantive inter-ministerial agreement even on long-term implementation was minimal.

Apart from some immediate minor changes and vague commitments of action in the future, the only meaningful accomplishment during the first few months was the 27 July announcement of a comprehensive economic stimulation program: reduction by a quarter point of the official discount rate and commitment of significant additional funding in the next budget to social infrastructure development. (NKSB 27 July 1971, ev. ed., 1) However, long-standing business community pressure for more anti-recession government spending and a lower discount rate probably had more to do with the stimulation program announcement than did the eight-point program.

So, if the real objective of Japan's liberalization package was implementation of measures intended to improve Japan's international balance-of-payments surplus situation, the program was a failure. This judgment was shared even by its main author and strongest supporter, Yusuke Kashiwagi (1972, 189). Every important sector of Japan's econo-political system made strong public statements of support in principle for the program. Cabinet ministers cheered the effort on with apparent sincerity at nearly every press conference. But colorful ministerial expressions of support at press conferences carry less weight in government than stern talks about career prospects with bureaucratic subordinates in the privacy of the minister's office.

Keidanren issued statements supporting the program in principle, primarily on the grounds that it had already been announced abroad as Japan's official position, but did little internally to achieve business community cooperation with specific measures. The Japan Chamber of Commerce officially endorsed the program, but in mid-July tempered its support with insistence that businesses adversely impacted by liberalization should be compensated directly by the government. (NKSB 16 July 1971, 3) This question of government compensation was to bedevil the Ministry of Finance throughout the year. While the Ministry's international monetary men were anxious to press their liberalization plan on the rest of the economic bureaucracy as an alternative to a revaluation of the yen, the Ministry's budget officials were absolutely opposed to opening the Pandora's box of direct government compensation for business losses which might be attributed to international monetary problems. Perhaps the most remarkable example of non-cooperation was the Japan Foreign Trade Council's (*Nihon Boeki-kai*) vigorous public opposition and lobbying campaign against abolition of the export promotion tax system included under point seven. (NKSB 20 June 1971, 1)

By the beginning of August 1971 there was little hope the program

could achieve agreement on liberalization adequate to avoid severe criticism of Japan at the IMF and World Bank annual meetings scheduled for late September in Washington. If the MOF international moneymen still believed they would be able to continue to resist foreign pressure for a change in the parity of the yen, they were members of an exclusive minority. According to a poll of 222 political, academic, business, labor, and consumer group leaders taken by the influential economic daily, *Nihon Keizai Shimbun* on 30 June 1971, 72 per cent said they opposed a change in the yen's parity, but 76 per cent said they thought it would occur by 1972. (NKSBS 1 July 1971, 3) Nonetheless, high level statements of support and optimistic forecasts for the eight-point program as Japan's final gesture continued to pour from Japan's official public relations organs.

The Second Nixon Shock

Just before 10 a.m. on Monday morning, 16 August 1971, US Secretary of State William Rogers placed a direct telephone call to Prime Minister Sato asking that he and his colleagues listen to the short-wave Voice of America broadcast of a television address President Nixon was about to deliver in Washington [9.15 p.m., 15 August, Washington time]. Rogers' unusual call, reminiscent of the embarrassing last-minute notification Japan received of Nixon's plan to visit the People's Republic of China just one month before, at last transformed Tokyo's 'business-as-usual' atmosphere.

In his speech, Nixon announced a comprehensive domestic and international New Economic Policy which included temporary suspension of the dollar's convertibility into gold and imposition of a 10 per cent surcharge on all dutiable imports, measures designed ' . . . to make certain that American products will not be at a disadvantage because of unfair exchange rates.' The long-awaited second shoe had fallen at last. Nixon's speech did not include a list of specific American demands, but it was obvious that something more meaningful than international press announcements of possible future eight-point program implementation would be required to persuade Washington to suspend the surcharge and re-establish the dollar's convertibility.

Global time differences and European designation of 16 August as an official holiday combined to leave Tokyo the only major financial market open when the Nixon announcement hit the airwaves. The response was uncontrolled panic. Traders rushed to sell export-dependent corporate stocks at any price with predictable effect on the Nikkei-Dow Average. By mid-day foreign exchange market dollar sales were reported to surpass \$400-million, nearly all of which had been absorbed by government

intervention purchases. The afternoon press was full of the photojournalism cliché that accompanies news of international monetary crises in any country: large pictures of frenzied young men in shirt-sleeves talking into two telephones at once.

Drastic American action of some kind had been predicted for some time, but Japan's government officials were caught without a contingency plan with which to face such a sudden change in their international environment. So they spent the first day monitoring the domestic market pandemonium, frantically scrambling to gather more specific information from a sleeping Washington, and arguing among themselves about what to do.

The government could have closed the Tokyo market at any time during that first hectic day, a move, in fact, proposed by MOF Administrative Vice Minister Ichiro Hatoyama. But Hatoyama had spent his whole MOF career on the more prestigious domestic side of the ministry, and thus was not considered – nor did he consider himself – an expert on international monetary affairs. The certified MOF international monetary experts remained strongly opposed, arguing that Japan shouldn't be the first country to suspend trading, that they should wait to see how the Europeans would react on Tuesday morning, European time, and most important, that once the exchange was closed, Japan would be forced to make some change in the yen's exchange rate when it was re-opened.

By the end of the first day of turmoil, MOF staff opinion was still divided between those who supported opening the exchange the following day with a controlled float, under which the parity would be allowed to rise gradually at a rate strictly controlled through government market intervention, and the international monetary specialists who argued for maintenance of the fixed Y360-\$1 rate.⁸ After a 6.30 p.m. meeting with his discordant senior staff, Finance Minister Mizuta decided to support the latter option, to continue to stand pat, persuaded by the confidence the international monetary specialists expressed in their ability to handle the situation without a float, his fear that a change in the yens parity would have a severely deflationary impact on the already depressed Japanese economy, and reluctance to have Japan take any such fundamental action before they knew what the European nations would do. In a personal interview some years later, Mizuta recalled his actions and concluded that his decision to support the fixed rate had been a serious mistake.

Late that night Mizuta finally made an official statement to the expectant Japanese press corps, the first since news of the Nixon speech had reached Japan, in which he assured the public of the government's intention to continue to support the current parity of the yen and to press for more rapid implementation of the eight-point program. In spite of the

severe sanctions announced by Washington on the morning of the 16th and their inevitable tumultuous impact on Tokyo's foreign exchange market, and in spite of strong diplomatic – and downright undiplomatic – pressure from the United States and European countries, it took the Government of Japan eleven more days to agree to move to a controlled float of the yen – their first substantive policy response to two years of international economic imbalance.

Interpretation

Japan's policymaking system during the 1969–71 period failed to respond to changes in the international economic environment and in her relationship to that environment until forced by paroxysmal, diplomatically corrosive, American external pressure in mid-August 1971. The economic and political consequences of that delayed response were severe for Japan, for her trading partners, and for the international system upon which the economic well-being of each, but especially Japan, depended.

No imaginable measure of Japanese trade and investment liberalization, or even of yen up-valuation, during the period would have improved operation of the IMF system to the point that it no longer required fundamental systemic reform. But certainly Japan's domestic economy would have benefited from earlier, self-initiated liberalization of outdated protectionist laws and regulations. And, according to Professor Nakamura, the longer-term advantages for Japan of a modest yen upward valuation in response to the imported inflation experienced in 1969 would have been enormous.

Actual impact on the trade statistics would have been delayed, but early implementation of these measures at least would have reduced the rate of increase in Japan's sensitive balance-of-payments surpluses. It also would have reduced speculative purchases of yen, calmed the Tokyo foreign exchange market, and reduced the need to impose trade-stifling foreign exchange controls. Official reserves would have accumulated throughout the period at a less alarming rate, and Japan's 'designated speakers' would have gone out into the world armed with more persuasive arguments and far more credibility.

The political advantages of an early, self-initiated response would have been more important. Self-initiated liberalization and parity adjustment would have been a less wrenching experience, less uncertain, more easily controlled, with more predictable outcomes. They would have soothed official and private international criticism of Japan as a selfish, neo-mercantilist power, making harsh countermeasures by other nations, like the 15 August Nixon Shock, more difficult to justify. Meaningful self-initiated liberalization and up-valuation would have made a great

improvement in the tone of the US–Japan economic dialogue, to the long-term benefit of both countries. It would have shortened considerably the period of uncertainty required to reach final agreement on a re-ordering of the IMF system once that process began at the end of August 1971 by reducing on all sides the time required for theatrical posturing, and by soothing European concerns about cross-rate problems with Japan.

With the potential for such gain, why did Japan's system fail to respond with appropriate countermeasures of its own to changes in its relationship with the international economic environment? The simple explanation is that Ministry of Finance officials with responsibility for international monetary affairs controlled Japan's official response. They opposed any meaningful change in policy, confident the status quo was in Japan's best long-term interests, and confident they could weather the storm of international criticism through skilful manipulation of international elite and public opinion. They particularly opposed any change in the parity of the yen, the one area of policy relevant to the problem over which they had immediate control. After decades of struggle against limitations on Japan's domestic economic growth and development imposed by foreign exchange scarcity, career government personnel of the agency charged with balance-of-payments oversight instinctively rejected any policy option that would weaken Japan's future ability to accumulate balance-of-payments surpluses.

There is nothing unusual about dedicated civil servants assigned for many years to one job equating their own area of responsibility with the national interest, and defending their turf with great ferocity from outside interference. The struggle to overcome bureaucratic rigidity when changes in environmental conditions dictate a change of institutional direction is a universal challenge for the senior management of all large private and public organizations. So, with responsibility for only one part of Japan's international economic policy, the actions of MOF international monetary officials alone do not explain Japan's failure to adapt to changes in the international economic environment with appropriate self-initiated countermeasures.

In spite of the great influence of Japan's career bureaucrats Japan's Constitution designates the *political* sector (as distinct from administrative), especially the prime minister and his cabinet, as ultimately responsible collectively for the supervision of the administration of domestic and international affairs, and individually for each government ministry and agency. Long before August 1971, Prime Minister Sato and his cabinet should have recognized this problem of bureaucratic sectionalism and have realized that the nation's overall, long-term interests would be better served by more positive action and demanded

change in that direction. They didn't. Why they didn't provides a more useful explanation of why Japan's policy process faltered in 1971 than would a narrow focus on one group of government officials.

During personal interviews several years after the event, the nature of the issue – especially the exchange rate – was often given by the politicians and other political sector interviewees as a reason for their hesitation to intervene in the policy process. They described international monetary affairs as highly technical, impossible for amateurs to understand. They also said involvement was avoided for fear of being accused of trying to manipulate the foreign exchange market to their personal financial advantage – a situation similar to changes in the official discount rate. Several interviewees also commented that there was little political advantage to be gained from association with international economic affairs during the 1969–71 period. Voters and financial supporters were interested in other issues; so then were the politicians.

Another factor of more general significance which kept politicians from assuming a meaningful role is that things just aren't done that way in Japan. Etiquette requires bureaucrats to be deferential – embarrassingly so by American standards – during direct personal contact with politicians. But even greater deference is paid to the principal of 'political non-interference' in the work of Japan's bureaucracy. 'Political non-interference,' often compared favorably with the clumsy amateurism of the American system and the under-qualified political appointees it produces, has been described as an important factor in Japan's economic success, one which discourages the particularistic and self-interested meddling of politicians in the highly qualified bureaucracy's efforts to promote the national interest through formulation and implementation of 'correct' economic policies.

Chalmers Johnson describes this phenomenon in his impressive study of MITI:

The Japanese bureaucracy jealously guards the practice of making no political appointments below the ministerial level; the bureaucrats believe that this helps establish *their claim to be above politics and to speak only for the national interest*. One of the bureaucracy's greatest fears is "political interference" in its internal affairs or, worse, a ministry's being made subservient to a party or a politician. (Johnson, 1982, 52)

He associates this practice, which has survived the war and the 1947 constitutional reform, with a 'separation between power and authority,' rooted in Japan's feudal tradition and the adoption of the Prussian model of the 'developmental state' during the Meiji period. Although Professor Johnson and most other commentators have emphasized the positive impact this separation of power and authority and minimization of

'political interference' has had on Japan's economic development, other observers have lamented this distortion of the principles of democratic government. But even those critics, concerned more with questions of popular control of the government bureaucracy, do not suggest that limited political participation in Japan's policy process could reduce the immediate effectiveness of its output. It is Japan's highly regarded career civil service which is relied upon to understand what is best for Japan and to do the right thing.

This view was confirmed from a different perspective during my 1975-76 personal interviews. By then, many of Japan's government and private sector observers described the government's handling of international economic relations during the 1969-71 period as a failure. Yet none of the more than one hundred politicians, political staff members, bureaucrats, businessmen, or journalists interviewed for the study were inclined – even when nudged – to blame Japan's political leadership for what happened. They blamed instead the bureaucracy or individual bureaucrats, charging that they, with their superior qualifications and experience, should have adapted their stand pat position to changing international economic reality earlier in the game. One business organization senior staff member, for example, repeatedly referred to the whole episode as a *gyosei misu* [administrative error]. Even interviewees openly hostile to individual politicians involved, to the LDP, or to the political sector in general, declined to settle blame for the policy failure on the politicians.

Japan's national policy system seems at its most effective when implementing universally accepted, clearly defined goals – especially those which fall under the exclusive, or near exclusive, domain of one powerful ministry, or at least those goals which pose little danger of inter-ministerial conflict. When external conditions change, and preservation of Japan's most general, long-term national interests requires a powerful ministry or agency to deviate from established policy on issues it considers important, or when the interests of the client groups of two important bureaucracies collide, constitutionally mandated political responsibility for oversight and integration becomes something more than an ideological nicety. Here, in the realm of supra-ministerial policymaking, the performance of Japan's system is much less impressive.

Lacking effective central political coordination of her separate bureaucratic fiefdoms, Japan, in a pattern reminiscent of the Occupation, once again in 1971 substituted the *deus ex machina* of irresistible American external pressure (*gai-atsu*) for political decisions in order to force the required changes. With the simultaneous suspension of the US dollar's gold convertibility and the imposition of the import surcharge, the Nixon Administration in one crushing blow forced Japan toward the required

adjustments by rendering the status quo so obviously less appealing than the disadvantages anticipated from the necessary change.

The application of *gai-atsu* was successful – at least in the short-term. Japan soon agreed to make significant adjustments to adapt to her new international economic status; Japan's political leaders avoided blame from any of their business group supporters for ordering the required changes. American political leaders and bureaucrats involved seemed almost to enjoy the opportunity once again to talk tough to foreigners, and certainly suffered no domestic political damage as a result. But the longer-term costs both for Japan and the United States were enormous. This episode left the policymakers and publics of both countries more resentful and suspicious of the other, the Japanese more inclined to see the United States as an insensitive bully and Americans more likely to see Japan as a devious, unfair exploiter of an international economic system which she was unwilling to support until forced.

Gai-atsu, especially but not exclusively from the United States, has remained a significant, and increasingly unwelcome, aspect of national politics in Japan since this dramatic episode in late 1971. In the absence of strong central Japanese political leadership, it continues to create serious problems both for Japan and for her diplomatic partners. Only a dramatic improvement at the supra-ministerial level, in the policy coordination functions of Japan's prime minister and cabinet, can provide an alternative.

NOTES

1. This material is adapted from my 1985 Columbia University doctoral dissertation, 'Japan's Foreign Economic Policymaking Process: Response to the 1971 International Monetary Crisis'. I gratefully acknowledge the guidance of my faculty advisors at Columbia, especially Professor James W. Morley, the valuable comments of an anonymous reviewer, and the generous financial support of Columbia's Graduate Faculty of Arts and Sciences, the East Asian Institute, the Social Science Research Council, and a Fulbright fellowship which financed a year of written source materials collection and personal interviewing during 1975–1976.
2. Alfred K. Ho provides a contemporary summary and assessment of Japan's liberalization effort in *Japan's Trade Liberalization in the 1960s* (White Plains, NY: International Arts and Sciences Press, Inc., 1973), especially pp. 15–19.
3. For a US Treasury Department official's evaluation of the late 1960s and the early 1970s Japanese foreign aid program as it related to her overall international economic relations see Wilbur F. Monroe, *Japan: Financial Markets and the World Economy* (New York: Praeger Publishers, 1973), pp. 194–197.
4. For an account of the IMF reform proposal see Margaret Garritsen de Vries, *The International Monetary Fund: 1966–1977, Vol. 1: Narrative* (Washington, DC: International Monetary Fund, 1976), pp. 500–516, and for a report of Fukuda's comments see *Nihon Keizai Shimbun*, 1 October 1969, p. 1.
5. Finance Minister Fukuda, Foreign Minister Aiichi, MITI Minister Miyazawa, Agriculture Minister Kuraishi, Economic Planning Agency Director General Sato and Chief Cabinet Secretary Hori.
6. See, for example, *Nihon Keizai Shimbun*, 16 June 1971, p. 1, and *Nihon Keizai Shimbun*, 19 June 1971, p. 1 for the general outline of the publicity campaign.

7. See *Nihon Keizai Shimbun*, 26 June 1971, p. 4, and 21 July 1971, p. 3 for accounts of the June and July meetings and public reaction to their press releases.
8. Details of the intra-ministerial debate during the first day are taken from personal interviews with Ichiro Hatoyama, Tokyo, 27 August 1976; Takasha Hosomi, Tokyo, 13 February 1976; Yusuke Kashiwagi, Tokyo, 28 May 1976; and, Takehiro Sagami, Tokyo, 27 May 1976.

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