

Damage, Fear, and Transformation:
International Currency Systems and Postwar Japan's Currency Policies

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Abstract

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Entitled “Damage, Fear, and Transformation: International Currency Systems and Postwar Japan’s Currency Policies,” my dissertation sheds light on how economic damage/loss arouses fears of politicians, monetary authorities, economic experts, and business groups and how those fears can propel changes in the economic system. This can be seen through a case study of Japanese currency policy since 1945. We are accustomed to the paradigm that regards economic changes as largely the consequence of people’s proactive and voluntary actions as embodied in entrepreneurship, challenge spirit, and profit-seeking, but my research shows that another large factor affecting the economic system is reactive actions driven by fear of losing accumulated wealth. Although researchers have examined the immense impact that damages and fear can cause to an economic system, they treated such damage and fear not as persistent factors but as temporary factors that emerged only during or after the time of emergency when the preexisting system became dysfunctional. In contrast, a proactive entrepreneurial spirit has been thought by many as having always been the engine of economic change from ancient times to the present.

The reason the role of damage/loss and fear has been seen in such a limited way is that earlier studies mostly focused on realized economic damage, and not on *the potential scale of unrealized economic damage* and people’s fear of it. This fear of potential economic damage has exerted a persistent influence on economic systems even in times of prosperity. What is potential economic damage? Potential economic damage expands in tandem with economic growth because we come to have more things to lose as we attain larger economic scale and property (scale of accumulation, transaction, etc.). And why does potential damage/loss consistently affect an economic system? As economic scale expands, the preexisting economic system gradually becomes unsuitable for the overgrown scale of the economy. Since such an unsustainable state destabilizes the containment of potential loss that has been growing along with economic expansion, the

fear of losing accumulated wealth becomes increasingly widespread, leading both decision-makers and businesspeople to seek the fortification or transformation of the preexisting system. Demonstrating such a relationship, the dissertation argues that damage/loss and fear were not intermittent external causes, but consistent prime movers of economic change.

To support the argument, the dissertation focuses on potential and realized losses related to currency, and their influence on the currency system, especially in Japan. Because a country's currency rate affects its products' overseas price and because trade had high importance for Japan, fear of economic damages that would result from a destabilization of the currency system and foreign exchange market attained massive proportions in Japan. Therefore, through the case of Japanese currency policy, we can relatively easily discern the interrelation between fear of potential/realized economic damage and systemic change. Specifically, the interrelation can be found in the following phases where potential economic damage and fear of it propelled Japanese politicians, monetary authorities, economic experts, and the business community to fortify the fixed exchange rate system until the early 1970s, replace it with the floating exchange rate system between 1971 and 1973, and fortify the floating exchange rate system since 1974. To test this argument I have examined a large number of primary sources such as documents issued by the officials of the Japanese government and the central bank, as well as newspapers and economic magazines issued at each phase. Such extensive archival work confirmed that people's fear of potential economic damage/loss played a large role in defending or altering the preexisting currency system.

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Introduction

Aim and Focus

This dissertation shares with all the other academic research the aim of revealing covert structures and mechanisms of the world we live in, but among others it is the following points that it attempts to reveal.

Firstly, as expressed in the title “Damage, Fear, and Transformation,” the dissertation attempts to demonstrate that **the existence of potential or realized damage arouses people’s fear and then people’s fear propels change**. To put it in the context of economic history, which is the genre of this study, it can be rephrased thus: the dissertation sheds light on the aspect that **the existence of potential or realized economic damage arouses people’s fear and then people’s fear drives the formation and transformation of the economic system**.

We are accustomed to the paradigm which regards developments and changes of the economic system as largely the consequence of people’s **proactive actions** as embodied in entrepreneurship, challenge spirit, profit-seeking. But this dissertation suggests that such a commonly accepted paradigm expresses only one aspect of reality, and that another large aspect which we tend to miss but actually contributes to the formation and transformation of economic systems is people’s **reactive** actions driven by fear of losing their accumulated wealth. In other words, this study challenges the uncritically accepted paradigm that history is naturally the product of people’s proactive and voluntary actions, and attempts to provide instead **a more diverse and comprehensive paradigm of history** that encompasses both proactive and reactive actions as important factors.

To avoid a misunderstanding, it is necessary first to define the terms above. We will set aside the definitions of potential and realized damages for the moment, and provide the definitions of other terms here. The economic **damage** referred to in this dissertation is not physical damage, but **monetary loss of wealth**. Although physical damages incur monetary losses, the dissertation will not cover the issue of physical damage because it would excessively broaden the scope of research. Also, the term **people** referred to in this dissertation does not point to the general public, but **politicians, monetary authorities, economic experts, and business groups**, unless indicated otherwise. The fears of the general public may also have a major impact on the economic system, but the present dissertation does not cover it for the same reason given above - it would broaden the scope of research too much at this stage. At time I refer to ordinary workers, but the actors that appear in this dissertation are mostly the policy and business elites mentioned above, along with journalistic and academic experts. Although the general public comes to our mind when we hear the word “people,” the dissertation often uses the term to mean above elites simply because sometimes the flow of the narrative makes it cumbersome to list all their titles. However, whenever possible, I will clarify who the actors are in the text.

Also, the term **reactive action** or **passive reaction** often used in this dissertation does *not* refer to a state of “doing nothing to overcome the situation” but an action that is driven by circumstances **in order to avoid economic losses/damages**. It is an action that is taken **after** circumstances **force** them to do so. On the other hand, **voluntary or proactive** action refers to an action that is not forced by circumstances but voluntarily taken **in order to change the circumstances proactively and make further profits**. If we see the outcome only, both reactive and proactive actions turn out to be active actions after all that aimed at overcoming difficult situations, but the point of this dissertation is that **such voluntary and proactive actions are often born out of fear-driven reactive actions or passive reactions**.

To avoid a misunderstanding, it must be also added that the dissertation does not intend to suggest that people’s reactive action plays a larger role than voluntary and proactive efforts in forming and transforming economic system. Although the reactive aspect is much more emphasized in this dissertation, it is not to trivialize or deny the influence of voluntary and proactive actions, but to point out, amidst the prevalent historical paradigm presupposing the dominant role of proactive actions, that the reactive aspect is as influential and must not be neglected. The issue is not about choosing between the two, because proactive profit-seeking and reactive damage-hedging are inseparable, and are **two sides of the same coin**.

To facilitate a better understanding, behavior of animals in the wild may be a useful analogy. To an animal, to be in a more advantageous position for survival is to avoid physical damage, and to avoid physical damage is to be in a more advantageous position for survival. We can say that the two aspects - being advantageous and avoiding damage - are inseparable pairs, and that in pairs they affect the formation and transformation of animals’ cognitive and behavioral patterns. Because damage must be avoided to be more advantageous for survival, it would be nonsensical to say that an animal chooses a certain behavior not to avoid damage but to be more advantageous for survival. Likewise it would be nonsensical to say that an animal chooses a certain behavior not to be more advantageous for survival but to avoid damage. The degree of fear of damage can change depending on the situation, but, as long as animals attempt to gain advantage for survival, we can assume that their fear, with differing degrees, is **always** in action, **consistently** affecting their cognitive and behavioral patterns.

But the role of fear of damage, which we can observe in animal behavior, has not yet been incorporated in the studies of economic history and other fields of humanities and social sciences. Of course, there has been a great deal of research that has discussed damages and fears’ immense impacts on the economic system when there were such adversities as the bursting of an economic bubble, depression, and war. However, damages and fears explored in those studies, even when they are considered to have exerted substantial influence on the economic system, are not considered to have exerted **persistent and continuous** influence on it, because they are treated as **temporary** factors that emerged only during the time of emergency when the preexisting system became dysfunctional. In other words, **whereas people’s voluntary and proactive aspects, represented by “one’s voluntary desire to expand profit,” are thought by many as having always been the prime mover and internal cause of economic changes from ancient times to the present, damages and fears have been regarded merely as things**

that emerged and influenced economic system only during or after emergency occurred.

For example, Joseph A. Schumpeter and Peter F. Drucker famously emphasized “entrepreneurship” (which represents the active spirit and behavior of entrepreneurs that proactively change circumstances, rather than passively accepting the given circumstances) as a primary factor that brings about economic development and innovations, but they did not develop the point that active entrepreneurship often emerges in response to crisis situation.¹ The entrepreneurship that they referred to is something that is necessary for overcoming crises and difficulties, and thus the role of crisis and the sense of crisis is not absolutely discernible in their explanations, but their focus is on entrepreneurship that overcomes crisis, not on the influence of crisis and fear in stimulating entrepreneurship. Also, when Max Weber stressed the “spirit of capitalism” which is based on “the Protestant ethic” as an important factor that brought about the birth and development of capitalism,² his focus too was not on the influence of crisis and fear on formulating the spirit of capitalism, but on the spirit of capitalism that might have assisted the overcoming of crises and fears. Also, when Karl Marx explained the process by which the capitalist bolstered and innovated the capitalist system against the backdrop of deepening contradictions of production relations and emerging crisis situation,³ his focus was mainly on the process by which the capitalist bolstered and innovated the capitalist system, not on the aspect that crisis situation and fears boosted such efforts. In such a manner, in economic historiography, the role of crisis and fear over economic damage has not been treated as a crucial and persistent factor.

The reason why the role of damage and fear has been seen by many in such a limited and confined way is because earlier studies focused mostly on **realized damages**, and not on **unrealized potential damage and people’s fear of it, that must have exerted persistent influence on systems even in the times of economic prosperity**. This dissertation attempts to examine the idea and argue, by shedding light on both **realized temporal damages and potential damages which have been continuously existed and expanded**, that damages and fears were **not just intermittent external causes** of systemic developments, but they have always been its **consistent prime movers and internal causes**, as “one’s voluntary desire to expand profit” have been.

Specifically, what is potential damage, and what is the reason to think that potential damage has been continuously existent and operative? To put it simply, to say that there is potential damage is to say that **there are things that could be lost or damaged**. And the reason why potential damage expands is because **we come to have more things to lose as we attain larger economic scale and property (scale of accumulation, transaction, etc.)**. When the economy expands and along with it natural resources, processed products, and services diversify and become abundant to us, we come to feel that threat of damage is rather reduced. But what is reduced in that case is the **risk** of damage that should be distinguished from potential damage. Risk refers not only to the

¹ Schumpeter, Joseph A. *The Theory of Economic Development: An Inquiry into Profits, Capital, Credit, Interest, and the Business Cycle*. Harvard University Press, 1934; Schumpeter, Joseph A. “The Creative Response in Economic History.” *Journal of Economic History*, November 1947; Drucker, Peter F. *Innovation and Entrepreneurship: Practice and Principles*. Harpercollins, 1985.

² Weber, Max. *The Protestant Ethic and the Spirit of Capitalism* (1905). Repr., Penguin Classics, 2002.

³ Marx, Karl. *Capital: Critique of Political Economy* (1867). Harmondsworth, U.K.: Penguin, 1990-1992.

potential scale of damage but also to **the probability that damages would occur**. Thus **risk is reducible**, because it is possible to reduce the probability of damage occurrence through institutional and technological improvements, along with other risk management skills. But such risk reduction does not imply that the scale of losable and destructible things (= potential damage), which could become real damages when risk management fails, will diminish along with risk reduction. Because the scale of losable things can only grow as economic scale expands, **potential damage grows in tandem with economic expansion**, whereas risk can be reduced.

Since it is possible through risk management to prevent potential damage from becoming real damage, we often develop a false assurance that the scale of possible damage itself can be diminished. As a result of trivializing the potential damage and expanding economy without improving risk management, we often suffer tremendous damage when risk management malfunctions and then potential damage which has been growing but contained by then turns into real damage at once and at a great scale. **The subprime mortgage crisis that started in 2007 and Fukushima nuclear disaster in 2011** were typical examples. Use of the financial product and nuclear plant had been expanding on the premise that their potential threats were made small through risk management, but even if we admit that their threats were being diminished, what had been diminished was the possibility of damage occurrence, not the scale of potential damage that could turn into real damage when a problem occurs. After all, when risk management failed in the financial sector, companies were damaged to the degree that they had been expanding the utilization of the financial product. Further, when nuclear risk management failed due to the earthquake and tsunami, Japan suffered serious electricity shortages and its economy was damaged to the degree that it had been expanding the utilization of nuclear power (in regard to nuclear power, besides damages related to electricity, there are damages resulting from radionuclide and nuclear radiation). To prevent such reckless economic activities based on the illusory security, it is essential to distinguish the concept of potential damage from risk.

Accordingly, what is the reason to think that economic expansion and the consequent increase in potential damage have been the prime mover and internal cause of the formation and transformation of economic systems? The reason is as follows: **as economic scale (scale of accumulation, transaction, etc.) expands, the preexisting economic system gradually becomes unsuited to the scale, and since such an unsustainable state destabilizes the containment of potential damage that has been growing along with economic expansion, people's fear of losing their accumulated wealth increases, leading to a fortification or transformation of the preexisting system through political and institutional measures in order to contain the potential damage**. If not contained, potential damage will erupt as realized damage, and so, before or after suffering real damage, a community/society/country has to either fortify or transform its economic system. Such a process or history of systemic fortification and transformation **does not end**, because the fortification or transformation of an economic system, while containing potential damage enlarged by then, enables a further expansion of economy and of potential damage on the basis of the containment. Such expansion necessitates further fortification or transformation of the system.

Now a question can be raised that, even if potential damage truly continues to expand, it often does not seem that people's fear increases accordingly, but instead, as a result of

economic affluence people seem to become even more unconscious of the potential damage; how then can it be that damage and fear have been the prime mover of the formation and transformation of the economic system? Every person has a different degree of exposure and susceptibility to potential damage, but it is true that, in spite of ongoing growth of potential damage, optimism can spread widely during economic boom, reducing people's fear for an extended period of time; a good example is people's "irrational exuberance" (to quote Alan Greenspan, the former chairman of the Federal Reserve, referring to the stock market in 1996) during the 90s' dot.com bubble and the 2000s' subprime mortgage bubble.

Even when fear seems generally alleviated in society, there are many, among people in positions that can influence the economic system, who conduct economic activities largely driven by fear that their group, company, or country could be defeated in fierce competition. For example, it is often explained that it was because of "greed" that Bear Stearns and Lehman Brothers expanded the business of subprime securitization. But greed was only one aspect. Another aspect was that, as they were losing market share to other investment banks, fear that they could go out of business rose, leading them to turn their attention to the risky but supposedly profitable business of subprime securitization. Then as Bear Stearns and Lehman Brothers achieved rapid growth by selling and investing securitized products, their competitors came to feel the necessity of beginning and expanding their securitization business as well. In that manner, driven by both greed and fear, the American-style risky financial system formed and developed. The point here is that fear was continuously at work, even amidst "irrational exuberance" where fear seemed to have disappeared.

Even if we assume that there are times when fear of damage actually largely disappears among people in the forefront of economic world, the important point is whether fear of potential damage was influential at important phases of the formation and transformation of the economic system. This dissertation assumes so, because, even when people's fear largely disappears amidst an economic boom, the source of fear (= potential damage) does not decrease but rather increases due to an overall increase of property in society, forcing people to immediately recognize the existence of enlarged potential damage as soon as something threatens the economic boom; such recognition fuels fear at once, and forces people to inevitably work on either fortification or transformation of the preexisting economic system.

As seen above, this study maintains that the potential damage continues to expand and affect the economic system as long as the economic scale expands. In that sense, potential and realized damages and fears are defined here not **as intermittent external causes**, but as **consistent prime movers and internal causes** of the formation, fortification, and transformation of economic systems. In other words, it is to see **the development of the economic system not as an accidental product, but as a process strongly driven by the growth of economic scale and potential damage.**

Comparisons with other views of history may facilitate a greater understanding. For example, there is a liberalistic view of economic history, which considers history as a process of expanding market liberalization, whereas there is a view that regards economic history as a process of power concentration and market control fortification through globalization. This dissertation interprets it differently. Because this study puts the role of damage and fear at the core, it posits that **the choice between liberalization and**

centralization depends largely on whether the choice is appropriate at the moment under the economic agent's conditions to contain expanding potential damage or realized damage. Of course, it is not to assert that such an aspect always determines the choice. There have been innumerable cases where centralization proceeded at the time when liberalization was necessary for containing potential damage, and there also have been many cases where market liberalization proceeded at the time when centralization was necessary for containing potential damage. As Jeffrey A. Frieden has pointed out, every social group has different preferences concerning the choice between the fixed exchange rate system and the floating exchange rate system, and choice between overvalued currency and undervalued currency.⁴ Thus, there may be cases where influential social groups' preferences play large roles in determining the choice between liberalization and centralization, regardless of the situation of potential damage. However, when damage erupts as a result of a choice inappropriate for the scale of potential damage, it becomes inevitable for the social groups to make an alternative choice for damage containment. In that sense, the dissertation assumes that a society, **in the long term**, switches between liberalization and centralization and changes their balance in a way that is suitable for containing its expanding scale of potential damage. In short, this study considers such expansion of potential damage as a non-negligible factor of systemic transformation, in the long term.

However, to avoid misunderstanding, the following must be quickly added: although it is suggested here that the economic system forms or transforms in a way that contains expanding potential damage, it does not mean that contingent/accidental events in nature and society have no power to bring about historical changes, or that there is an inevitable destiny or predetermined goal of history. For instance, if a huge meteorite collides with the earth and wipes out all flora and fauna, human history ceases to exist, together with any such thing as a pattern or direction of systemic change. Another issue is that, people who attempt to find a pattern and direction of history always meet with criticism that accuses them of subordinating the creativity of human activity and nature to abstract laws, and thus of depicting those as uncreative, passive, and reactive. What this study attempts to do, however, is not to deny the roles of voluntariness and creativeness, but to point out inseparable and interactive relations between proactive and reactive actions by highlighting the fact that human beings have been reactively driven by the result of their own voluntary activities, and that such reactive actions in turn led to the birth of new voluntary activities. By looking at both, this study attempts to overcome one-sided explanations that views history either as an outcome of voluntary and proactive actions or as an outcome of historical laws that work independently of human efforts. Nevertheless the reason why this dissertation focuses relatively more on the reactive aspect than the proactive aspect is because of the fact that the nonnegligible role of reactive actions has been largely ignored by earlier studies. It must be brought into light.

However, because there are innumerable numbers of factors and variables in society and the economic sphere, the aforementioned mechanics of systemic change cannot be proven like formulae in the field of mathematics. When dealing with mechanics in society, what we can do, if any pattern or mechanism is observed, is to examine its validity with as many samples as possible. If such empirical verification demonstrates

⁴ Frieden, Jeffrey A. "Exchange Rate Politics," in Frieden, Jeffrey A. and Lake, David A. ed., *International Political Economy*, Bedford/St. Martin's, 2000, pp. 257-69.

that the mechanism is valid to certain extent, we can utilize the knowledge thus gained. If it is found to be invalid, there is no other choice than to improve it or replace it by other explanations for further understanding of society and history. In short, the dissertation does not attempt to present the above mechanics as an ideational truth but as a hypothesis that includes falsifiability (which Karl Popper sees as a prerequisite for scientific research). From this standpoint the suggested mechanics will be examined in the following chapters, with as many examples as possible.

But in what range should the suggested mechanics be examined? Although it is already clear that this study deals with damage and the economic system, there are a great many different types of damage and system in economy. Among them, what this dissertation focuses on are, as expressed in the subtitle “International Currency Systems and Postwar Japan,” the potential and realized damages related to currency, and their influence on the formation and transformation of currency system, especially in Japan. The following are the reasons why such a focus was chosen among many other possible choices.

As well known, along with its huge domestic market, trade played large part in Japan’s economic development. And, because a country’s currency rate affects its products’ overseas price, and because trade had high importance for Japan, fear of damage that would result from a destabilization of its currency system and foreign exchange market was of major significance in Japan. Therefore, by focusing on Japan’s reactions to currency problems, we can readily observe and examine the interconnections between fear of potential/realized damage and systemic fortification/transformation.

However, to avoid any misunderstanding, it must be added that, even though this study highlights the fact that Japan was being driven by fear in fortifying and replacing its currency system, it is not to suggest that the Japanese government and companies were particularly incompetent or that reactive nature was Japan’s national trait. It is true that there was reactive aspect in Japanese policies. K.E. Calder, for example, has depicted Japan as a “reactive state” whose economic policies had been made through reactive response to the pressure of the United States, and suggested that Japan instead needed to actively plan and implement policies for the world and Japan.⁵ However, it does not mean that such a reactive aspect was observable only in Japan, or that Japan was reactive in every aspect. On the contrary, Japan, which revived with a higher growth rate than any other country in the postwar period and became the second largest economy as early as the late 60s, must have had many aggressive and proactive aspects. Thus, this study focuses on Japan, not because it assumes that reactive nature was a unique trait of Japan, but because the relationship between potential damage/fear and reactive fortification/transformation of the economic system are relatively easily observable in Japan’s reaction to currency problems.

The second reason to focus on the currency system is the global aspect. Because it is through the interactions of many countries that currency systems emerge and currency rates are determined, oftentimes damage and fear in a country that results from an unsuitability of its currency system and currency rate for its actual situation cannot be solved solely by that country’s domestic policy. For a solution, it is sometimes necessary to fortify or transform the currency system on a global scale, through global agreements and coordinated actions. Thus, by dealing with the currency system, it is possible to

⁵ Calder, K.E. “Japanese Foreign Economic Policy Formation: Explaining the Reactive State,” *World Politics*, Vol.40, No.4, July 1988.

observe the global-scale influence of damage and fear on the currency system, even while focusing mainly on domestic development. In other words, by dealing with the currency system, it is possible to observe that the influence of damage and fear on systemic transformation is something that occurs not only at the national level but also at the global level. However, due to the limit of time and the limit of ability of this author, the main focus of analysis will be on Japan, while global-scale development will be discussed in a brief manner.

Copernicus' heliocentric model expelled human beings from the center of the universe. Kant's critique of pure reason limited the power of human reason. Darwin's theory of evolution turned humans into one of animal species, and human beings even lost their control over their own minds by Freud's psychoanalysis. In such a manner, we have been losing our special privileges, and thus it would be too much for some people if they are told that even our economic activity, the symbol of human voluntariness, is in large part the outcome of our reactive responses to damages. But, if reactive action as such has actually been influential, an explanation omitting it would be an insufficient explanation. The omission will result in a biased description, and thereby will leave us only a narrow range of choice for problem solving. For example, in the past when the concept of the unconscious was unknown and unaccepted, it seemed as if the sole solution to a person's psychological wounds was to suppress the wounds and keep them under control through a fortification of the person's will power. But once unconsciousness is accepted as existing, an unveiling and exposing of the wounds became another option for a solution. The same applies to the economy. If we only interpret an economic bubble as largely an outcome of greed, it seems as if the only way to prevent an economic bubble is to suppress people's greed with restrictions. But if we accept the point that greed is often fueled by fear of losing out in competition and suffering damage, we can come up with another choice for a solution, such as the construction of legal, labor, and business environments that would alleviate our fear-driven greed/impulse to conduct high risk business. Such a widened range of choice for a solution would widen the possibility for a solution. In that sense, at the same time that this study aims at replacing earlier paradigm with a new one for further understanding of the world, it also aspires to find through this new paradigm some practical solutions to problems.

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CHAPTER 1

Fortification of the Fixed Exchange Rate System for Damage Containment and Profit Increase

As a specific case study of the currency system, this chapter will deal with the dollar-gold standard system, which is a type of fixed exchange rate system that was implemented in the postwar period. There have been numerous studies of the fixed exchange rate system in the postwar period, but, as explained in the introduction, this dissertation differs in that it focuses on the role of potential damage. This chapter will focus on the following aspect: as the global exchange of goods and capitals increased and the global economic scale (scale of accumulation, transaction, etc.) expanded on the basis of stable foreign exchange rates secured by fixed exchange rate system, it gradually became difficult to sustain the growing scale with the gold-dollar system. Since such unsustainable state destabilized the containment of the potential damage that had been growing along with economic expansion, people's fear of losing their accumulated wealth increased, leading to their attempt to protect the fixed exchange rate system for the containment of the potential loss.

In other words, this chapter explains systemic transformations by using "expanding potential damage" and "fear of loss" as crucial factors. However, details of such a historical process will be explained in Section 2 of this chapter. Accordingly, Section 1 below provides necessary background knowledge for understanding such a historical process, including how the postwar fixed exchange rate system came into existence, what its rules were, and what aspects/merits of the system contributed to economic expansion on a global scale.

Section 1 Framework - Merits of the Fixed Exchange Rate System

World War II led to a rethinking of earlier international politics and economy. Before the war, the world was divided into bloc economies, and each of them scrambled for goods and natural resources for their exclusive use, instead of creating wealth through an expansion of commerce. Such a situation was the indirect and direct cause of the war. Seeking to avoid a repeat of such a conflict, the United States and other leading countries began to plan and construct a new free trade system that would replace the bloc system, based on the perception that it was necessary to create and multiply wealth through increased exchange of resources, commodities, and capital among states.

Efforts to expand free trade were made in various ways, such as the launching of GATT in 1948 (General Agreement on Tariffs and Trade; reorganized into WTO in

1995), and the Marshall plan of the late 1940s and the 1950s. The establishment of an international currency system, which will be the focus of this chapter, was also one such effort. Because one of the causes of the formation of economic blocs was a currency devaluation race aimed at export increase and import decrease, the leading countries began to work on an establishment of a new international currency system that would have power to undermine such a race.

It was as early as July 1944, in the last full year of the war, when a new international currency system began to be planned. In Bretton Woods, representatives of 44 nations gathered and discussed the framework of the postwar currency system. However, although 44 nations were gathered, discussion was basically led by two nations, the United States and Britain. And in fact, the resulting agreements were made mostly in a way intended by the United States which by then had become the world's most powerful nation, replacing Britain. The planned currency system, as intended by the United States, became a real system after the war, supported by the organizations such as the IMF (International Monetary Fund) and IBRD (International Bank for Reconstruction and Development, which later became the World Bank after merging with the International Development Association).

The result was a dollar-gold standard system, a type of fixed exchange rate system often called the Bretton Woods system. The content was this: the IMF articles stipulated that 1 ounce of gold equaled 35 US dollars, and obligated IMF member states to prevent their currency rates from deviating more than $\pm 1\%$ of their agreed currency rates from the US dollar. Only if a country's balance of international payments lapsed into "fundamental disequilibrium," and only if there was a low possibility that the country could improve the balance and acquire sufficient foreign currencies, would the country be allowed to change their currency rate pending the approval of the IMF. Member states, however, were advised to make efforts to improve their conditions before they lapsed into such a situation. Another agreement was that, in case a country wanted to keep its currency value but self-improvement was difficult, that country could request the IMF to provide financial support for the improvement of its international balance and foreign currency acquirement.¹ But such support obligated the country to meet the IMF's reform requirements.

There were several intentions for constructing the Bretton Woods system. One intention was to firmly establish the dollar as a standard currency by ensuring its exchangeability with the trusted gold, and thereby expand the influence of the United States. Another intention was to prevent a repeat of the currency devaluation race that occurred in the prewar period, by creating a circle of currency ties in which currencies of many countries were tied to dollar, with the dollar in turn tied to gold. Another intention was to remove the risk of exchange rate fluctuations, so that free trade would expand on the basis of stable exchange rates. For instance, if exchange rates are fixed, it is possible to avoid the case where export goods which had a competitive export price at the time of production come to have an uncompetitive and unsellable export price at the time of export because of changes in exchange rates.

¹ For example, when Japan made 600 million dollars of international payments deficit in 1957, Japan borrowed 125 million dollars from IMF, and when there was one billion dollars deficit in 1961, Japan borrowed 350 million dollars (Volcker, Paul. and Toyoo Gyohten. *Changing Fortunes*. Times Books, 1992, 51).

However, a system that reflected the intention of the United States was not realizable if other leading countries did not share the intention. There were things that did not change as they intended, such as the failure of many countries to maintain their currency rates, which was necessary for the stability of the fixed exchange rate system. Although it was stipulated by the IMF articles that a country's decision to change its currency rate needed the IMF's approval, such approval did not seem actually necessary in reality. It is not clear if there were the IMF's approvals when some countries decided to devalue their currencies.² However, alongside such unintended development, there were things that changed as the U.S. and other countries intended, such as the fact that currency devaluations did not lead to a devaluation race. It is true that there were phases that looked similar to devaluation races, but, as the revaluation of Deutsche mark in the 60s reflecting Germany's rapid economic growth shows, they were not races. Devaluations occurred in many countries often because their currency rates became unsuitable for their actual economic power, rather than because they just wanted to take advantage of devaluation. One of the reasons why a devaluation race did not occur was the pressure by the United States, which wished to maintain the Bretton Woods system. Another reason could be the fact that leading countries already experienced disastrous consequences that a devaluation race can bring, such as falling credibility of the country's economy and outflow of capital. A devaluation race did not occur even when the fixed exchange rate system collapsed in the early 70s. Instead, because the dollar had to be devalued at the time, other currencies even increased their relative value (we will discuss this period in Chapter 2).

In such a manner, sustained by many countries' reflection on the prewar bloc economy as well as U.S. leadership, the Bretton Woods system was formed and maintained. However, this does not necessarily mean that all the nations in the world were incorporated into the system immediately after the war. For example, Japan was incorporated into the Bretton Woods system as late as April 1949, about three and half years after its defeat in August 1945. After being impeded by confusion resulting from war defeat and inflation, the Japanese currency rate was determined by Occupation Forces in April 1949 to be 360 yen for 1 dollar (from the war's end to April 1949, different rates were applied to different major export items). The IMF Executive Board's official recognition of the fixed exchange rate of 360 to the dollar (1 yen=0.246853 mg of pure gold) came even later than that - it was in May 1953, after Japan's new membership in the IMF in August 1952. Another example is Canada, which left the fixed exchange rate system from 1950 to 1961. France also occasionally left the system between 1950 and 1958. On the other hand, the communist bloc was attempting to have its own currency zone, with the Soviet Union at its core.

Thus, the Bretton Woods system was not something that was applied to the whole world immediately after the war, in its stated form, with a mandatory power. As will be discussed in Section 2 in detail, the Bretton Woods system was gradually made into a strong and globalized system by many participating countries. At the outset, the Bretton

² According to Paul Einzig, an economic journalist, "... up to the beginning of 1969 member countries devalued on more than two hundred occasions, and on none of these instances was there any objection voiced in public by the IMF ... To this number another was added in 1969 - the devaluation of the French franc, for which no authorization was asked from the IMF." (Einzig, Paul. *The Case against Floating Exchanges*. St. Martin's Press, 1970, 14).

Woods system was supported in order to prevent economic blocs and expand free trade, and later, it was supported mostly with the intention to prevent potential damage, which grew along with the expansion of free trade, from becoming real damage. Such efforts at systemic fortification continued until the early 70s when the Bretton Woods system collapsed.

Background knowledge for understanding such a process will be discussed in Section 2 in detail. In Section 1 below, it will be briefly explained what kinds of merit in the system motivated many countries to maintain it, and how those perceived merits contributed to the expansion of free trade. It is already mentioned above that one of the system's merits is its function to remove the risk of exchange rate fluctuation, but merits from wider angles will be explained below.

To avoid misunderstanding, however, the following point needs to be added: as implied by the fact that the next chapter of this dissertation points out that the merits of the fixed exchange rate system later became the seeds for problems, this dissertation, even though it lists merits of fixed exchange rate system in this chapter, in no way insists that it is the best currency system any time and anywhere. However, the global fixing of exchange rates had many positive effects, particularly in the postwar environment where the world economy had been destroyed by bloc economies and at a time when early realization and expansion of the free trade system was an urgent necessity. Although Japan and other leading countries abandoned the fixed exchange rate system in the early 70s and moved to floating exchange rate system, the merits of the former still enjoy wide support, as suggested by the fact that even today many countries adopt some sort of fixed exchange rate system, such as a pegging system. What were the merits, then?

(1) One merit is that, the fixed exchange rate system stimulates competition between developed and developing countries because the system tends to work to the advantage of the trade performance of developing countries that have high industrial growth rates.

If a country's currency is overvalued compared to the country's export competitiveness, the foreign price of the country's exports becomes relatively high in terms of their competitiveness, and thus the currency rate works as an adverse factor against exporting. On the other hand, importing will be aided because the country's overvalued currency makes the domestic price of imports relatively low. As a result, the country will be in a disadvantageous position in trade. Conversely, if a country's currency is undervalued compared to the country's export competitiveness, the foreign price of the country's exports become relatively low compared to their competitiveness, and thus exporting will be aided by the currency rate. On the other hand, importing will face adversity because the undervalued currency makes the domestic price of imports relatively high. As a result, the country will be in an advantageous position in trade.

Thus, a developing country with a high industrial growth rate will find itself in a more and more advantageous position in trade because improvements in the productivity and quality of the country's exports will make its fixed currency value relatively undervalued compared to its export competitiveness. In other words, it is not only by its rapid industrial growth but also by its relatively undervalued currency rate that the developing country will gain an advantageous position in trade.

Such a transition from overvaluedness to undervaluedness was seen in Japan where productivity grew rapidly. Between 1949 and the early 1960s, Japanese industry tended to feel that the fixed rate of 360 yen to the dollar was relatively overvalued, but thereafter, the rate began to be seen as either just right or relatively undervalued compared to the competitiveness of Japanese companies. With enhancements in the productivity and quality of products, in addition to the help of price advantage resulting from its undervalued currency, Japan rapidly improved its trade balance, and began to consistently maintain a trade surplus from the latter half of the 1960s. In such a manner, unless a country's currency rate is so high that its exporting is largely hampered, a fixed exchange rate system tends to give developing countries with high industrial growth rates more and more advantage in trade, and stimulates the competition between developing countries and developed countries, thereby contributing to the expansion of free trade. Of course, a country's trade performance is not determined solely by its exchange rate, and that is why there were countries that could not improve their trade balance in spite of the undervalued rates they had. But it does not change the fact that a country's exchange rate largely affects the price competitiveness of its exports.

Regarding such characteristics of the fixed exchange rate system, Miyohei Shinohara, who had been a researcher in government ministries and university professor, commented as follows: "By taking advantage of the [Japanese] exchange rate that was 'unfair' to international society but advantageous to Japan, Japan could continue its world's best growth rate in export for a quarter-century. Of course, other factors are also responsible for the differences in export growth rate among countries, such as activeness of domestic investment and the excess and deficiency of labor power. However, once a country's undervalued rate meets with excess-supply of labor and rapid technological evolution, the country experiences a 'virtuous cycle' of growth process."³ Toyoo Gyohten, who was the Vice Minister of Finance for International Affairs (*zaimukan*) in the 80s, also said, "The exchange rate of 360 yen per dollar was considered overvalued when it was first introduced in 1949 because our major export items were not competitive in price, and indeed our exports declined briefly afterward. However, Japanese export industries quickly adjusted to the exchange rate, and in fact 360 yen per dollar soon became very comfortable for them."⁴

As wage stabilization and technological advances improved the productivity of Japanese industry, the exchange rate for the yen that was felt as overvalued gradually came to be felt as undervalued, working to the advantage of Japanese exports. As will be explained in Section 2, it is true that politicians, monetary authorities, economic experts, and the business community were divided over what degree the currency was being undervalued compared to Japan's export competitiveness. They also disputed over whether the currency was undervalued to the extent that it was enormously advantageous to Japan's trade. However, at least everyone will agree that, as time passed from the 1950s to the 1960s, the currency gradually came to be felt as more undervalued than earlier.

(2) The second merit is that, because fixing exchange rates is largely a result of political determination, the fixed exchange rate system was something that could be

³ *Nihon Keizai Shimbun*, 22 September 1971 (Morning edition).

⁴ Volcker, Paul. and Toyoo Gyohten. *Changing Fortunes*. Times Books, 1992, 58.

realized relatively rapidly, once there was strong political leadership and political agreements among countries.

It was under the leadership of the United States, which grew to be the world's most powerful country as it underwent two world wars, that the framework for the international currency system was determined as early as 1944. In the postwar period, it was again under the strong leadership of the United States that the exchange rates of many countries could be rapidly fixed through intergovernmental arrangements. It was through such strong influence of the United States and other leading countries' conformity that liberation from the prewar-style devaluation race could be realized rapidly, and early stabilization of currencies could take place. In order to recover from the chaotic postwar situation, a speedy stabilization was necessary, and what enabled it was the fixed exchange rate system, which could be immediately implemented once political agreements were made.

However, the fact that the fixed exchange rate system could be rapidly realizable through political agreements implies that likewise the system could rapidly lose its function because of political disagreements. In fact, the political agreements and unifying force concerning the dollar-gold standard system underwent a process of dismantlement from the 60s to the early 70s, and such disagreements were one of the causes of the collapse of the Bretton-Woods system. International agreement on the exchange rate is often difficult to achieve not only because each country has its unique economic situation that hampers agreement but also because each country has its own political concerns. For example, many Japanese politicians in the late 1960s and early 1970s opposed the yen revaluation not only out of concern for its economic impact but also out of concern that a revaluation might lower their political popularity.

(3) Another merit of the fixed exchange rate system is that it sends out strong danger signals when a country heads for an unhealthy economic structure, and thereby induces the restoration of economically sound structure.

A domestic economic boom raises purchasing power and production volume. As a result, there can be an increase in the import of raw materials for consumption and production. In that case, trade balance can be aggravated, especially for a country like Japan that depends largely on import of raw materials. Domestic economic boom can easily result in an increase of imports. Therefore, it is possible for the government of such a country to sacrifice its trade balance in an attempt to continue its economic boom. In the long term, such a choice can lead to unhealthy outcomes such as inflation, a bubble, increased debts to foreign countries, and deceleration of industrial growth due to increased market share of imported goods. In spite of it all, the government can choose the continuation of domestic economic boom at the expense of trade balance, because of industrial lobbies and political judgments which emphasize growth.

But, in the fixed exchange rate system, trade deficit and the consequent foreign currency shortage always lead to crises such as increased devaluation pressure, fallen credibility of national economy, and outflow of capital abroad. Thus, the country must move in such a way as to avoid external deficit and secure foreign currency. In other words, although external deficits and foreign currency shortage would be problematic in

any currency system, those problems send stronger danger signals especially in the fixed exchange rate system, and the signals induce a country to choose the improvement of trade balance even at the expense of domestic economic boom.

Yusuke Kashiwagi, who played active roles in the Ministry of Finance and Bank of Tokyo, referred to this aspect of the system as follows: “Under the fixed exchange rate system, external equilibrium tends to be prioritized over domestic equilibrium (such as stability of growth and prices), and that tendency is often considered as a weak point of the fixed exchange rate system. But the weak point can be seen as a strong point in that the maintenance of external equilibrium requires financial discipline in each country’s management of national politics.”⁵ In fact, every time Japan experienced foreign currency shortage from the 1950s to the 1960s due to economic upturns and increases in imports, restrictive monetary policies were deployed to bring about economic stability and trade equilibrium. When high growth is underway, the government can be motivated to maintain growth, but the strong danger signal of external deficit and foreign currency shortage under the fixed exchange rate system forced the Japanese government to implement restrictive monetary policy at the expense of growth. Such policy led to Japan’s growth deceleration in the short term but it is considered to have had the role of maintaining the soundness of Japanese economy in the long term, because the policy must have been effective in preventing inflation, economic bubbles, debt increase, and large inflows of foreign goods between the 1950s and the 1960s.

Of course, even though external deficit and foreign currency shortage send strong danger signals under the fixed exchange rate system, sensitivity to the signal differs among people. Also, even if the danger is fully comprehended by the authorities, an adverse trade balance may not always be avoided. For example, in spite of danger signals, Britain and France sometimes failed to improve their trade imbalance in advance, and as a result, they had to devalue their currencies multiple times between the 1940s and the 1960s. In short, danger signals did not work to prevent dangers in some countries as it did in Japan. However, although a country may ease its foreign currency crisis through devaluation, devaluation can lower the credibility of the currency, causing outflow of capital abroad, and worsen the country’s crisis situation in the long term. Therefore, regardless of whether a country can actually avoid dangers, we can still say that the fixed exchange rate system has a function to send strong danger signals when there are external deficit and foreign currency shortage.

However, one may argue that the United States was an exception. The United States’ deteriorating international balance of payments in the 1960s and early 1970s also sent out danger signals but the signals were not felt as strong as the Japanese felt about their external deficit, because the currency with which the U.S. paid its increased external expenditures and debts to other countries was the dollar, and it could be printed as much as the U.S. government wanted, as it was their own currency. In such a manner, the U.S. could overcome its impending responsibility for liabilities. However, another alarming danger signal was coming from a different place. As the U.S. continued its huge external spending, credibility of American economy and dollar continued to fall and consequently dollar-selling and gold-buying occurred. Because the U.S. gold holdings were decreasing whereas there was oversupply of dollar due to the overspending of the U.S., there was a

⁵ Honda, Keikichi. and Hata, Tadao. *Kashiwagi Yusuke no shogen - Sengo nihon no kokusai kin'yushi*, Yuhikaku. 1998, 30.

risk of falling into default in case other countries demanded the U.S. to exchange dollar for gold on a large scale. In short, the way danger signals sounded for the U.S. was different from the way it did in other countries because the U.S. was a key-currency country. Nevertheless, a sense of crisis about the outflow of gold from the U.S. existed as early as the late 1950s, sending out a danger signal. In that sense, we can say that the fixed exchange rate system has a function to send out strong danger signals even toward a key-currency country, when the country experiences worsening external balance. However, the danger signal was made less distinct in the 1960s because the U.S. chose a stopgap measure such as gold pool agreement. This was an agreement made among the U.S. and seven European countries in 1961, to intervene in the gold market with their gold holdings, for the purpose of maintaining the gold price, instead of improving its balance of international payments to bring a fundamental solution to the dollar-selling and gold-buying tendency. Details concerning this will be explained later.

As has been explained, the fixed exchange rate system, by sending out danger signals, functions to restore the soundness of a country's economic structure, but such danger signals also had another good effect on developing countries. A country like Japan that restarted as a developing country after the war could use the possibility of crisis that may result from foreign currency shortage as an excuse to postpone its deregulation of trade and capital, continue its protection policy of domestic industry, and strengthen its economic health. Such restrictions on foreign exchange and imports were tolerated by the U.S., the leader of the IMF and GATT, because the U.S. also wanted to prevent such crises from happening. However, not all countries could practice such protectionist policies. Even Japan, as it gained economic clout, had to change its status from IMF Article 14 status (a country that is allowed to implement foreign exchange control in order to maintain a good balance of international payments) which it acquired in 1952 to IMF Article 8 status (a country that is not allowed to implement foreign exchange control) in 1964 (following the change of status, Japan's foreign currency budget system was abolished in 1964, although foreign currency holding restriction system continued until 1972). With regards to GATT, Japan also had to change its status from Article 12 status (a country that is allowed to implement import restriction in order to maintain a good balance of international payments) that Japan acquired in 1955 to Article 11 status (a country that is disallowed from implementing import restrictions) in 1963. In such a manner, no small part, if not the large part, of protection policy was stripped from Japan, as it moved toward the mid-1960s.⁶ However, up to 1964, Japan could use the necessity of maintaining its currency value and avoiding foreign currency shortage as an excuse to implement restrictions on foreign currency and import, and in so doing, it protected and nurtured its industry.

(4) The next merit that derives from the above is that the fixed exchange rate system effectively contained the possibility of a devaluation race, economic bloc, and collapse of

⁶ Concerning the IMF's opinions about Japan's transition to Article 8 status, and the Japanese government's reactions to the IMF's opinions, see Asai, Yoshio. "IMF hachi-jokoku iko to boeki, kawase jiyuka (jo)." *Kenkyu hokoku* (Seijo Daigaku Kenkyujo), No. 42 (2005); Asai, Yoshio. "IMF hachi-jokoku iko to boeki, kawase jiyuka (ge)." *Kenkyu hokoku* (Seijo Daigaku Kenkyujo), No. 46 (2007); Ito, Masanao. *Sengo nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, Chapter 2, Section 2.

free trade system, and then helped free trade to expand on the stable basis of the containment.

To summarize, fixed exchange rate system contributed to the prevention of economic blocs and the expansion of free trade, firstly by stimulating trade competition between developing countries and developed countries through its tendency to work in a way that is advantageous to developing countries with high growth rates. Secondly the system contributed to the prevention of economic blocs and the expansion of free trade by being an institutional medium of the leadership of the U.S. and other countries. It also functioned by sending strong danger signals and inducing the restoration of an economically sound structure when countries were moving toward an unhealthy economic structure.

In short, what should be emphasized here is that the expansion of free trade was not something that could be naturally realized as long as people tried hard to conduct trade activities. The expansion required the establishment of a system that could contain the possible resurgence of bloc economies, which once disabled free trade in the prewar period. In other words, what is emphasized here is that it is not only “people’s desire to further expand profit” but also “the necessity to contain potential damage” that play large part in the formation or transformation of the system.

We have seen how the merits of the fixed exchange rate system contributed to the prevention of bloc economies and the expansion of free trade. In the next section, we will look at the process by which the fixed exchange rate system was gradually made into a strong and globalized system involving many participating countries. Such efforts at systemic protection and fortification continued until the early 70s when the Bretton Woods system collapsed.

Section 2 Historical Development

In this section, we will look at the process by which the fixed exchange rate system was gradually made into a strong and globalized system involving many participating countries. At the outset, the fixed exchange rate system was looked to in order to prevent economic blocs and expand free trade, and later, mostly to prevent potential damage (“what could be lost”), which grew along with the expansion of free trade, from becoming real damage. As emphasized earlier, what this dissertation tries to demonstrate by looking at such a process is the fact that changes in economic system have been driven not only by state, company, or individual’s “voluntary desire to expand profit” but also by the growing “potential loss/damage” and people’s reactive fear of it. Voluntary action and reactive action work as two sides of the same coin.

It is true that countries, even within the liberal camp, propelled the establishment of the fixed exchange rate system at different paces because each had its own unique situation. For instance, the U.S. willingly planned the fixed exchange rate system even before the end of WW2, and actively promoted it immediately after the war, but there also was a country such as Japan, which was passively incorporated into the system in the beginning, and then gradually became its active supporter as Japan’s economic scale expanded on the basis of the system and as Japanese industries and government became fearful of the scale of loss that could result from a malfunction of the system. But, even if the pace was different depending on the country, we can say that the countries in the liberal camp generally tended to make an effort to maintain and strengthen the fixed exchange rate system (this point will be demonstrated below). In that sense, the case of Japan, while showing Japan’s unique situation, was also the one that reflected the global trend of the postwar currency system.

(1) The Period Prior to Japan’s Incorporation into the Fixed Exchange Rate System: 1945-1949

As mentioned earlier, the leading countries in the postwar period shifted toward the fixed exchange rate system, having reflected critically on the economic bloc system caused by the prewar devaluation race. Japan, however, was not part of the Bretton Woods system from the beginning. The reason for this lay in the policy of the General Headquarters, the Supreme Commander for the Allied Powers (GHQ/SCAP hereafter) which began to rule Japan after the war.

The policy was the following. Only GHQ/SCAP was allowed to trade with foreign countries directly, and to decide for Japan what to import and export, while the Japanese government and civilians were forbidden to be involved in trade, currency exchange, and financial transactions directly with other countries. As for exports, Japan was permitted, through the intermediary work of the Trading Agency (Boekicho) founded on December 14th of 1945, to purchase exports from domestic exporters and sell them to GHQ/SCAP. As for imports, the Trading Agency received imports from GHQ/SCAP and sold them to the Japanese domestic market. GHQ/SCAP traded with countries using international market prices, and paid the cost of exports and imports in dollars from their special

account (the trade account for Japan, managed by the United States Department of War). On the other hand, the Trading Agency's purchasing price for exports and selling price for imports were determined by domestic official prices in Japan, independently of the price of imports and exports paid by GHQ/SCAP. The Trade Agency's payment was made in yen, from the special account of the Trade Agency.⁷ Because the yen account and the dollar account were managed separately, trading could continue without an exchange rate.

In the absence of a formal exchange rate, what was implemented instead was the "multiple rate system" which applied a different exchange rate to each major good. In the multiple rate system, the Japanese government purchased exports that were relatively expensive compared to their competitiveness, and then applied a low exchange rate to the exports and sold them to GHQ/SCAP at a lower price. As for imports, the Japanese government purchased from GHQ/SCAP the imported living necessities and materials that were relatively expensive when converted to yen, and then applied a high exchange rate to the imports to sell them to Japanese domestic market at a lower price. The multiple rate system continued until April 1949, when the yen exchange rate was formally set at 360 yen to the dollar.

Even if the multiple exchange rate system might have contributed to the protection of Japan's weakened industries, it entailed a side effect. Because the act of purchasing exports at a relatively high price and selling imports at a relatively low price was supported by government spending, the multiple rate system caused a growing fiscal burden for the Japanese government. Moreover, because the increased fiscal burden was supported by financial aid from the U.S. and the Bank of Japan's additional money printing, the multiple rate system contributed to an expanded money supply and thus the acceleration of inflation.⁸ As a result, prices continued to rise in Japan. For example, if we say that the official wholesale price was 100 in 1945, it rose to 464 in 1946, to 1375 in 1947, to 3651 in 1948, to 5961 in 1949, and to 7047 in 1950.⁹ However, it must be added that the multiple rate system's contribution to inflation should not be overemphasized because the inflation rate was beginning to decrease in the latter half of 1948, when the multiple rate system was still in use and prior to the setting of Japan's official exchange rate in 1949. Many factors caused inflation at the time. However, it is not the purpose of this dissertation to weigh each factor's degree of contribution to inflation. The point is only that the multiple exchange rate system was one of the factors that hampered the fixing of the single exchange rate of the yen because it spurred inflation, a drastic change in currency value. At the time, there were voices that pointed out these problems of the multiple rate system and called for the establishment of the single exchange rate system,¹⁰ but there also were strong voices against it in GHQ/SCAP. GHQ/SCAP maintained that the single exchange rate should not be applied until after the

⁷ For details, read Ito, Masanao. *Sengo nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 19.

⁸ Young, Ralph. "Report of the special Mission on Yen Foreign Exchange Policy" 12 June 1948. Yoshino, Toshihiko. "'Yangu Hokoku' no rekishiteki igi." *Ekonomisuto*, 7 March 1972.

⁹ Kondo, Takehiko. *Kokusai tsuka to APEC - Nihon taigai kodoron -*, Okurasho insatsukyoku, 1996, 8-9.

¹⁰ "Kawase soba kettei ni tsuite no jakkan no kosatsu," 27 October 1946. "Fukusu kawase sei ni taisuru ichi hihan," 25 November 1946 (included in Okurasho Rizaikyoku Chosagakari, *Chosa geppo*, dai 36-kan tokubetsu 6-go).

stabilization of the Japanese economy and prices was achieved.¹¹ As a result of this discrepancy in opinion, the establishment of the single exchange rate was postponed.

However, international circumstances surrounding Japan were beginning to change drastically, and the issue of the yen exchange rate came to be influenced by the change. The change was, namely, the sharpening confrontation between the liberal and communist camps. GHQ/SCAP began to suppress the left wing as exemplified in GHQ/SCAP's ban on the "February 1st General Strike" in February 1947. The next month, in March 1947, President Truman announced to the world the Truman Doctrine, which expressed America's containment policy against the communist countries. Because of the sharpening confrontation, the United States abandoned its initial plan to make Japan a non-militaristic agrarian country, and set a new plan that aimed at making Japan a bulwark of anticommunism and an independent economic power. Such a new policy was intended by the U.S. government as a way to help containing communism and lighten their burden.

In 1948, the policy change became more evident. For example, on January 6th 1948, Army Secretary Kenneth C. Royall publicly announced in San Francisco that Japan was the bulwark against communism. Civilian research led by Clifford C. Strike, which was requested by the United States Department of War, was another example. In the "Strike Report," which was submitted in March 1949, an opposing opinion was made against the earlier plan of the U.S. and Far Eastern Commission to dismantle the infrastructure of Japan's steel industry and use the dismantled parts, pig iron, and steel ingots for war reparation. Strike and his team opposed it because such compensation could hamper Japan's recovery, and thus advised that the planned scale of dismantlement needed to be reduced. Another example of the policy change was the "Draper Report" submitted in May by William H. Draper, then the Under Secretary of the Army. The report referred to Japan's shortage of important primary materials, bad conditions of plant equipment, poor transportation capacity, unsolved issues of compensation, and inflation, as the factors that were undermining the independence of the Japanese economy. The report maintained that there should be a mitigation of the burden of compensation, a production increase on the basis of primary materials and materials for equipment (the U.S. must help providing those materials), further promotion of trade, and the containment of inflation. The report reflected the development of East-West confrontation, and the shift in the U.S. occupation policy toward Japan.¹²

But, although it was suggested in the report that the establishment of the single yen-dollar rate was desirable, the report could not decide specifically what rate it should be. Therefore, Draper requested Ralph A. Young, then Associate Director of the Research Division of the Federal Reserve Board, to investigate and submit a report to the U.S. government by June 16th, on the adequate yen-dollar rate.¹³ It was not only Draper who felt the necessity of the establishment of the single exchange rate. As mentioned earlier, GHQ/SCAP at the time deemed that it was still too soon for Japan to have a single exchange rate, but voices questioning this position were increasing within the U.S. government. With international trade rapidly growing after the restart of Japan's civilian

¹¹ Marquat to Chief of Staff, Establishment of a Foreign Exchange Rate, 22 May 1947.

¹² Yoshino, Toshihiko. *En to doru - Endaka e no kiseki to haikai*. Nihon Hoso Shuppan Kyokai, 1987, 88-89.

¹³ *Ibid.*, 89.

international trade in August 1947, and East-West confrontation sharpening, there was a deepening perception among them that it was necessary to end the multiple rate system and instead establish the single exchange rate, in order to achieve the normalization of the Japanese economy and the expansion of civilian international trade.¹⁴

In such a situation, a delegation led by Ralph Young came to Japan in May 1948, as requested by Draper. As early as June, he submitted the so called “Young Report” that recommended the exchange rate of 300 yen \pm 10% (between 270 and 300 yen) to the dollar. However, this report was treated as a classified document, and thus the content was not known to the public. It became accessible only in 1972, when it was translated by Toshihiko Yoshino, who was then working for the Domestic Research Division of the Bank of Japan.¹⁵

But why did the report reach the conclusion that 300 yen \pm 10% to the dollar was the adequate rate? Toshihiko Yoshino, who had a friendship with Young and for that reason translated the Young Report, summarized the reason as follows: “If the yen exchange rate is set too high compared to its competitiveness, exporters who should sell their products to the government at the rate of 400, 500, or 600 yen to be economically viable will be out of business. Concerning that point, Doctor Young, after analyzing the details of import and export situation at the time, thought that the single exchange rate needed to be set at a level that allowed the maintaining of 80% of Japanese export volume. He thought that the exporters who could not be economically viable unless the government purchased their products at a more preferable exchange rate should either thoroughly rationalize their operations or go out of business.”¹⁶ Young estimated that a range between 270 yen and 300 yen was adequate because the range was not too much detached from the exporters’ actual capacity and at the same time it was the range that would stimulate people’s efforts to rationalize their businesses.

Ralph Young was also concerned about inflation, and maintained that the prompt establishment of the single exchange rate was necessary to stop inflation. Whereas GHQ/SCAP claimed that establishing the yen exchange rate was difficult because of inflation, Young, on the contrary, stated that it was because the single exchange rate was not established that inflation was worsening - the multiple exchange rate system was inducing further government subsidy and growth of money supply. Thus, in the Young Report, he recommended that the U.S. government fix the single yen exchange rate by October 1, 1948.¹⁷ But GHQ/SCAP responded with an opposing opinion, that the single exchange rate should not be introduced until after Japan’s exporting capacity had recovered, because a hasty establishment of the single exchange rate could lead to a drastic price increase of imports, and thereby worsen inflation. It could also invite, they insisted, an increase in unemployment because export would decrease due to the single exchange rate. They worried that such a situation could incur social instability in Japan.¹⁸

¹⁴ Yoshino, Toshihiko. “‘Yangu Hokuoku’ no rekishiteki igi.” *Ekonomisuto*, 7 March 1972.

¹⁵ *Ibid.*, and Yoshino, Toshihiko. “Beru o nuida kyu heika settei no jijo.” *Ginko kurabu*, July 1972.

¹⁶ Yoshino, Toshihiko. *En to doru - Endaka e no kiseki to haikai. Nihon Hoso Shuppan Kyokai*, 1987, 108.

¹⁷ *Ibid.*

¹⁸ Fukao, Mitsuhiro, Masao Taikai, and Kimihiro Eto. “Tan’itsu kawase reto saiyo to boeki min’eika” in Kosai, Yutaka. and Juro Teranishi eds., *Sengo Nihon no keizai kaikaku - Shijo to seifu*, Tokyo Daigaku Shuppankai, 1993, 96-97.

Partially influenced by GHQ/SCAP's opposition to the opinions of the U.S. government and the Young Report,¹⁹ the establishment of the single exchange rate was postponed.

But a shift toward the single exchange rate was gradually advancing. For example, from around November 1948, Japanese government began to draw up its "Outline Plan for a New Economic Policy" (Shin Keizai Seisaku Daikoan) in which they planned a new price system based on the single exchange rate and looked for a way to make companies independent from government subsidies.²⁰ Also, in its "Nine-Point Economic Stabilization Program," which the U.S. government delivered to Japan through GHQ/SCAP, it was emphasized that the program had to be actively implemented in order to realize the establishment of the single exchange rate.

Such a shift toward the establishment of the single exchange rate accelerated when Joseph Dodge, then the chairman of the Detroit Bank, came to Japan as the economic advisor to GHQ/SCAP in February 1949. His task was to implement the Nine-Point Program. He brought reform to Japan in numerous ways, such as cutting and removing government subsidies in order to promote the independence of the Japanese economy, but here we will focus on his role in the establishment of the single yen exchange rate.

After the Nine-Point Program was announced in December 1948, many research reports seeking to identify an adequate yen exchange rate were released by both GHQ/SCAP and the Japanese government.²¹ However, according to Yusuke Kashiwagi, then Deputy Budget Examiner in the Ministry of Finance, the Office of Prices (Bukkacho) under the Economic Stabilization Board ordered Kashiwagi, after negotiating with GHQ/SCAP, to "calculate the budget using the rate of 330 yen to the dollar." Therefore, Kashiwagi and others "used the rate of 330 yen to the dollar during the budget preparation period, which was two to three months prior to" the adoption of a new budget in April 1949.²² In other words, GHQ/SCAP and the Japanese government were beginning to expect that the yen exchange rate would be somewhere around 330 yen to the dollar. A plan to establish the rate at 330 yen seemed to have become solid by late March of 1949, according to GHQ/SCAP's telegram on March 22 (approved by Dodge) to the United States Department of War. The telegram proposed the implementation of the rate of 330 yen to the dollar from April 1st.²³

But the staff committee of the NAC (National Advisory Council on International Monetary and Financial Problems), which examined GHQ/SCAP's proposal in

¹⁹ Regarding the debates between GHQ/SCAP and government organizations, read NAC The Staff Committee, Memorandum, June 25 1948, National Archives, RG56. NAC Minutes, Meeting No. 98, 28 June 1948, National Archives, RG56 (Included in Okurasho Zaiseishishitsu ed. *Showa zaiseishi - Shusen kara kowa made* (dai 20-kan). Toyo Kezai Shinposha, 1982, 601-7). Read also, Yamaguchi, Kenjiro. "360 en tan'itsu kawase reto settei katei ni tsuite - SCAP shiryō no bunseki o chushin to shite." in *IMES Discussion Paper Series*, Nihon Ginko Kinyū Kenkyūjo, July 1996. Read also, Okurasho Zaiseishishitsu ed. *Showa zaiseishi - Shusen kara kowa made* (dai 3-kan). Toyo Kezai Shinposha, 1976.

²⁰ Kuroda, Masahiro. "Sengo infure ki ni okeru bukka, busshi tosei" in Kosai, Yutaka. and Juro Teranishi. eds., *Sengo Nihon no keizai kaikaku - Shijo to seifu*, Tokyo Daigaku Shuppankai, 1993, 33.

²¹ On those research reports, read Ito, Masanao. *Sengo nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, Chapter 1, Section 3.

²² Honda, Keikichi. and Hata, Tadao. *Kashiwagi Yusuke no shōgen - Sengo nihon no kokusai kin'yūshi*, Yuhikaku. 1998, 10.

²³ SCAP to Dep. of Army, OUTGOING MESSAGE (DRAFT), Telegram, 22March49 (Included in Okurasho Zaiseishishitsu ed. *Showa zaiseishi - Shusen kara kowa made* (dai 20-kan), Toyo Kezai Shinposha, 1982, 622-4).

Washington, concluded that the rate of 330 yen to the dollar was an overvaluation of the yen, considering the further inflation since the Young Report, and submitted a negative opinion about the rate to NAC on March 25th.²⁴ As a result, NAC decided at their plenary session on March 29th to strongly recommend the U.S. Department of State and the Army to consider a rate of 360 yen instead of 330 yen, although 330 yen was somewhat acceptable.²⁵ To this, Dodge thought that, if the yen exchange rate was set at the level that was more undervalued than the rate of 330 yen, such an undervalued rate would not work as a strong incentive for the rationalization of Japanese industries. But he also thought that somewhat undervalued yen rate would be acceptable if there was no effective plan that would help Japanese exporters to increase their exports in the midst of drastic subsidy reduction.²⁶ Thus, the earlier plan by GHQ/SCAP to establish the rate at 330 yen to the dollar was replaced by the plan to establish it at 360 yen.²⁷

But, Japan was not informed of these developments. Kiichi Miyazawa, then a secretary to the Finance Minister Hayato Ikeda, gave testimony as follows: “Probably on April 2nd, in the talk between Dodge and Ikeda, Dodge said in trying to expose and cut the scale of subsidy, he had to use a tentative exchange rate to calculate the amount of subsidy. He said that he used the rate of 330 yen to the dollar as a tentative rate ... Certainly, because the scale of subsidy is difficult to calculate without using an exchange rate, it is understandable that he had to use the tentative rate ... and that the tentative rate used in the calculation does not necessarily have to reflect reality. But, when 330 yen was specifically mentioned, Finance Minister Ikeda replied at the time that it would be very fortunate if 330 yen became the actual exchange rate. Ikeda also said that it would be difficult to set the exchange rate until they observed at least for half a year the implementation of the 1949 budget. Ikeda guessed that the single exchange rate would be established in July at the earliest, and that it would be 350 yen at least ... Thereafter, they never talked about specific numbers again ... But suddenly there came a newspaper article on April 23, which reported, based on a United Press telegram from Washington, that the yen exchange rate would be 360 yen to the dollar, and that it would be in effect from April 25. It was a bolt from the blue for us too.”²⁸ Thus, the exchange rate of 360 yen to the dollar began on April 25th of 1949, and it continued until 1971.

As can be seen from the fact that the Japanese government and GHQ/SCAP first adopted a multiple rate system for the protection of Japanese domestic industry, Japan in the period immediately after the war was not actively pursuing the establishment of the single fixed exchange rate, although it was felt to be necessary. Instead, Japan was incorporated into the Bretton Woods System, pushed by inflation pressure, the sharpening of the East-West confrontation, the change of U.S. policy toward Japan, and Dodge’s decision.

²⁴ NAC Staff Committee to NAC, Memorandum, March 25, 1949 (Included in Okurasho Zaiseishishitsu ed. *ibid.*).

²⁵ Ito, Masanao. *Sengo nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 101.

²⁶ J. M. Dodge, Memorandum (Telegram-W846348), March 30, 1949 (Included in Okurasho Zaiseishishitsu ed. *Showa zaiseishi - Shusen kara kowa made* (dai 20-kan), Toyo Kezai Shinposha, 1982, 625-6).

²⁷ Exchange of opinions between GHQ/SCAP and Washington is well described in Ito, Masanao, *op. cit.*

²⁸ Miyazawa, Kiichi. *Tokyo - Washington no mitsudan*. Chuko Bunko, 1999, 31-33.

In such a manner, the single fixed exchange rate for the yen was accepted passively. But, as will be explained later, the Japanese government and companies gradually became active supporters of the yen exchange rate and also of the fixed exchange rate system that enabled the continuation of the rate at that level. What will be explained throughout this chapter is the trend for government officials, entrepreneurs, and economic experts gradually to strengthen their support for the yen exchange rate and the fixed exchange rate system, and shift toward institutional fortification of the system. In order to reveal such a trend, we will first look in the section below at the period prior to the emergence of this active support. The period between 1949 and the mid-1960s was the adaptation period, rather than the period of active support, during which the Japanese government and Japanese companies tried various measures to survive within the rules of the fixed exchange rate system.

(2) Passive Acceptance of the Fixed Exchange Rate System: From 1949 to the Mid-1960s

At the time the yen exchange rate was decided, there were different opinions about it. Some claimed that 360 yen to the dollar was an overvalued rate while others claimed that it was undervalued. There also were people who regarded the rate as adequately reflecting the actual value of yen. Because it is not the purpose of this dissertation to find out whether the rate was overvalued or undervalued considering the Japanese economic situation at the time, we will not enter into such arguments. But what is clear from the fact that there were widely divided opinions is that there was no active and widespread support for the rate of 360 yen to the dollar at the time. Likewise, there was no active and widespread support for the fixed exchange rate system/Bretton Woods System either, in which Japan, obstructed by the intention of the United States and international society, could not freely devalue its own currency.

Below, we will look at how Japanese reacted to the yen exchange rate when it was first decided. However, because not much time had passed since the end of the war, the number of magazines and newspapers was still relatively small. Moreover, censorship by GHQ/SCAP might have worked to reduce the free expression of public opinion about the imposed yen exchange rate. Thus, to supplement the limited number of quotable sources, we will also look at later testimonies of the experts on the field, in order to understand the actual reactions of politicians, monetary authorities, economic experts, and business people at the time.

First, let us take a look at the opinions that regarded the rate of 360 yen to the dollar as an undervalued rate, even in the context of the late 1940s and the early 1950s. Today there are hardly any who hold that view, but not a few people did so at the time.

For example, as already quoted above, when Dodge told Finance Minister Hayato Ikeda that he used a tentative exchange rate of 330 yen to the dollar in order to calculate the amount of subsidy, Ikeda replied that, according to his secretary Kiichi Miyazawa, it would be very fortunate if 330 yen became an actual exchange rate. He said that the fixing of the yen exchange rate would be difficult until they observed at least for half a year the effects of the 1949 budget. He guessed that the single exchange rate would be

implemented in July at the earliest, and that it would be 350 yen at least.²⁹ From this testimony, we can assume that Ikeda must have considered the rate of 360 to the dollar at the early stage of April as an undervalued rate.

Let us consider other examples. Before the setting of the yen exchange rate, the Economic Stabilization Board was preparing under the name of “Project R” (R-sagyō) for the single exchange rate system. The exchange rate they were predicting during their preparation was as high as 300 yen to the dollar.³⁰ Also, a month prior to the decision on the yen exchange rate, Mansaku Takeda, a board member of the Nippon Kangyo Bank, predicted that the single exchange rate would be determined within the year and that it would be 300 yen to the dollar. He said, “There are people who argue that the rate of 300 yen to the dollar will make most exports not exportable, but that argument is based on the premise that companies will continue the irrational business managements that they are doing today.”³¹ Because he predicted that the rate would be 300 yen to the dollar and that it would be decided within half a year, he must have regarded the rate of 360 yen per dollar determined at the early stage of April as an undervalued rate.

Let’s turn to reactions that monetary authorities, economic experts, and mass media showed after the yen exchange rate was announced. There were not few opinions that viewed the rate as undervalued.

For example, an article in the Asahi Newspaper noted, “It was announced that the single exchange rate was decided to be 360 yen to the dollar. We attach weight to the fact that the decision was made earlier than expected and that the rate was unexpectedly an undervalued one.”³²

Two years later, the Economic Advisory Agency (Keizai Shingi Cho, which later became Keizai Kikaku Cho, or the Economic Planning Agency) implied that the yen exchange rate was an undervalued one, when they, after their own investigation, expressed their view that the real value of the yen in 1949 was between 272 and 270 yen to the dollar.³³ It was not only the Economic Advisory Agency which referred to the 200 yen level. Miyoei Shinohara, who was then a researcher in the Research Laboratory of Finance and Economy in the Ministry of Finance, and later the Director of the Economic Research Institute of the Economic Planning Agency (Keizai Kikaku Cho Keizai Kenkyūjo), stated that the rate of 360 yen to the dollar was around 20% undervalued because the real yen exchange rate in 1949 was 277 yen to the dollar, if the yen was evaluated based on the relative purchasing power parity of 1939.³⁴

Tomoo Yano who was a staff member at the Research Division under the Economic Stabilization Board at the time, also referred to the 200 yen level. According to the journalist Nobuhito Kishi, Yano said, “The rate of 360 yen to the dollar gave a tough impression to some people because diverse multiple rates were unified into the single rate. However, according to our calculation on each individual item, it seemed that the real rate was around 280 yen to the dollar. We can say that with absolute certainty,

²⁹ *Ibid.*

³⁰ *Sekai Keizai*, April 1949, 20.

³¹ Takeda, Mansaku. “Tan’itsu kawase reto settei no gutaiteki eikyo.” *Sekai Keizai*, March 1949, 37.

³² *Asahi Shimbun*, 24 April 1949.

³³ Kuwano, Hitoshi. *Kokusai tsuka kiki*. Shin Nihon Shuppansha, 1968, 150.

³⁴ Shinohara, Miyoei. “Yushutsugata seicho to kawase reto - Sairon - .” *Keizai Kenkyū*, dai 40-kan 3-go, July 1989.

considering the fact that Japan's export gradually increased after the establishment of the exchange rate."³⁵

Although many did not go as far as to say that a 200 yen level was appropriate, there were more opinions that viewed the newly set yen exchange rate as undervalued. For example, Masao Kanno, who was an executive director of the Bank of Japan, said, "At the time when the yen exchange rate was established, the general opinion was that it was a more undervalued rate than people expected ... we cannot deny the fact that the rate was favorably decided based on Dodge and others' idea to promote Japan's exports. The decision was also based on the circumstance at the time when the IMF took part in directing countries to decide their exchange rates at a somewhat undervalued level."³⁶ Also, Shigeto Tsuru, who was the Vice Chair of the General Coordinating Committee (Sogo Chosei Iinkai) under Economic Stabilization Board in 1947 and later a university professor from 1948, said in hindsight that "The rate he [Dodge] decided, as some of us evaluated it at the time, was an undervalued rate of the yen."³⁷

According to Kuwano Hitoshi, who was a professor at Department of Commerce, Chuo University, there were people who predicted that the rate of 360 yen to the dollar would cause hardship to Japan's exports because they regarded it as an overvalued rate. But, on the other hand, there also was a viewpoint at the time that the rate was not such a big burden in reality because, under the multiple rate system, Japanese exporters had been hiding profits, and also because foreign merchants' intermediary exploitation rate was high due to unequivalent exchange [that the multiple rate system allowed].³⁸

Next, let's take a look at the view that the rate of 360 yen to the dollar adequately reflected the Japanese economic situation at the time.

For example, economic analyst Shigeo Kurebayashi stated in the journal *Sekai Shuho* (World News Weekly) as follows: "It can be said that the rate of 360 yen to the dollar is satisfactory in the current situation. I have been maintaining that the exchange rate must be between 350 and 370 yen, for the following reasons. (1) Unless export subsidy is provided, extremely high exchange rate of the yen must be avoided in order to expand our export capacity. (2) Although the price of imports can go up if an undervalued rate is adopted for the purpose of maintaining export volume, the price can be controlled by using import subsidy for a certain period of time. (3) The exchange rate that is once established must be maintained in order to stabilize the value of the yen. All of these three must be taken into consideration. If too much emphasis is put on (1), we will need greater import subsidies which will either invite the increase of our tax burden or make the overall rise of prices unavoidable. These will work as the propellant of inflation. For that reason, we should find a middle ground among the above three points ... We can say that the rate of 360 yen to the dollar is adequate."³⁹

There also were later evaluations that had the same view. For example, looking back on those days, Osamu Shimomura, who once worked at the Ministry of Finance and later became a very influential economist, maintained that the rate of 360 yen to the dollar was

³⁵ Kishi, Nobuhito. *Keizai hakusho monogatari*. Bungeishunju, 1999, 53.

³⁶ Kanno, Masao. "Genjitsu ni awanai giron." *Ekonomisuto*, 8 December 1959, 12

³⁷ Tsuru, Shigeto. *Nihon no shihonshugi - Sozoteki haiboku to sono go*. Iwanami Shoten, 1995, 86.

³⁸ Kuwano, Hitoshi. *Kokusai tsuka kiki*. Shin Nihon Shuppansha, 1968, 150-151.

³⁹ Kurebayashi, Shigeo. "360 en to kongo no keizaikai." *Sekai Shuho*, 18 May 1949, 3.

close to the equilibrium rate “because, as of June 1950, the rate of 360 yen to the dollar enabled the expansion of exports, which cancelled out the cost of imports. In that sense the rate brought about the equilibrium in our balance of payments. It was close to equilibrium rate also because, as of June 1950, the level of efficiency wages and the level of wholesale price were in balance.”⁴⁰

Another example is the evaluation by Kenjiro Yamaguchi from the Institute for Monetary and Economic Studies, Bank of Japan. He maintains, “According to the purchasing power parity, the rate of 360 yen to the dollar was a 20 yen undervaluation, when compared to the equilibrium rate of the official price. On the other hand, it was a 20 yen overvaluation when compared to the equilibrium rate of the actual market exchange price including the black market price.”⁴¹ It is implied in this evaluation that the rate of 360 yen to the dollar was not far removed from the actual value of the yen.

Next, let’s take a look at the view that the rate of 360 yen to the dollar was an overvalued rate.

In January 1, 1949 issue of the magazine *Sekai Shuho* (World News Weekly), Keiji Mizutani, a reporter for the Domei News Agency (Domei Tsushinsha), stated as follows: “In this situation of progressing inflation, the rate that would be considered appropriate would vary at different periods. In July of last year [1948], when the exchange rate of military scrip went up from 50 yen to 270 yen to the dollar, the rate of 270 yen to the dollar was considered as appropriately reflecting the ratio of the purchasing power between the dollar and the yen. And, in the fall of last year [1948], there were many who held that the range for the appropriate exchange rate was between 300 and 350 yen. But by April of this year [1949], perhaps 400 yen per dollar would be the appropriate rate that reflects the objective value of yen to the dollar.”⁴² Because he predicted that the appropriate rate would be around 400 yen to the dollar in April 1949, he must have considered the rate of 360 yen to the dollar, which was actually decided in April, as an overvaluation.

In fact, when many European countries including Britain and West Germany devalued their currencies in late 1949, which was after the yen exchange rate was determined, there arose opinions in Japan claiming that the yen exchange rate was relatively high compared to Japan’s competitiveness and thus the yen ought to be devalued. 1949 was the year when economic recession occurred not only in the United States but also on a global scale. Because of the recession, Britain’s exports diminished and there continued the pound selling and gold buying. As a result, Britain determined a 30.5% devaluation of the pound, and other countries followed suit, devaluing their currencies in the range between 8% and 53.2%. Because of such developments, Japan, which did not devalue its currency, faced a relative disadvantage, and exporters in Japan raised their voices for the devaluation of yen. In the midst of this, General MacArthur announced on October 15th 1949 that the yen exchange rate would not be changed, but discontent on the part of Japanese continued. For example, under the title of the article “Relatively high price of

⁴⁰ Okurasho Zaiseishishitsu ed. *Showa zaiseishi - Shusen kara kowa made* (dai 15-kan). Toyo Keizai Shinposha, 1977, 405.

⁴¹ Yamaguchi, Kenjiro. “360 en tan’itsu kawase reto settei katei ni tsuite - SCAP shiryō no bunseki o chushin to shite.” in *IMES Discussion Paper Series*, Nihon Ginko Kinyū Kenkyūjo, July 1996.

⁴² Mizutani, Keiji, “Ippon reto settei,” *Sekai Shuho*, 1 January 1949, 53.

shipbuilding etc. caused by the devaluation of the pound,”⁴³ the December 2 issue of the newspaper *Nihon Keizai Shimbun* reported on the difficulty that the Japanese shipbuilding industry was facing due to the devaluation of the pound. To such discontented voices, Dodge, who was visiting Japan again until December 4, said that “The single exchange rate of 360 yen to the dollar was rather an undervalued rate at the time it was decided, and thus we can say that the yen was already being devalued in advance of other countries’ currency devaluation”⁴⁴ [This is a translation from the Japanese newspaper. Original expression in English is unknown]. He maintained that difficulties regarding exports must be solved by the rationalization of Japanese industry and by the implementation of appropriate economic policies. However, discontent persisted, as the *Nihon Keizai Shimbun* reported. In the article titled “Half the people want yen devaluation,” it introduced the survey result by the Osaka Institute of Public Opinion [Osaka Seron Kenkyujo] that half of traders and producers surveyed were hoping for yen devaluation.⁴⁵ But the policy of the GHQ under the leadership of MacArthur was carried through, and devaluation was not realized.

Another example is November 9, 1949 issue of the magazine *Sekai Shuho* (World News Weekly). An article in the magazine argued: “The question whether the decision of the single exchange rate of yen to be 360 yen to the dollar was appropriate for bringing rational economic cycles is something that cannot be judged by its short 6 months-history. But we cannot say that the timing of the decision was good for the Japanese economy ... The stage setting was bad, as exemplified by the recession in the United States, the economic crisis of the countries participating in the Marshall Plan such as Britain, the civil war in China, and the unstable situation of Southeast Asia. Japan’s trade performance in the postwar period gradually recovered after the restart of civilian international trade. Export volume last year ... increased approximately 50% compared to that of two years ago. Even this year, exports showed a remarkable increase by April. However, exports decreased after the establishment of the single exchange rate, and grew at a sluggish pace in the latter half of the year.”⁴⁶ According to this view, it was not certain if the exchange rate of 360 yen to the dollar itself reflected the actual economic situation of Japan, but it was certain that the rate worked disadvantageously in the global circumstance at the time.

Let’s consider a later evaluation. Toshihiko Yoshino, who was a researcher in the Domestic Research Division of the Bank of Japan, said that the yen exchange rate was “not something that correctly reflected the actual market price which must have been calculated with the consideration of the transaction weight of both official and black market price at the time. Considering the actual market price at the time, keeping the rate of 360 yen to the dollar was a difficult task as to require not just a disinflation policy but even to some degree one of deflation.”⁴⁷ He also stated, “Perhaps because some of the Japanese involved, after hints from GHQ that the rate would be 330 yen to the dollar, were predicting that the exchange rate would be at that level,”⁴⁸ “newspapers and others

⁴³ *Nihon Keizai Shimbun*, 2 December 1949.

⁴⁴ *Nihon Keizai Shimbun*, 5 December 1949.

⁴⁵ *Nihon Keizai Shimbun*, 14 December 1949.

⁴⁶ *Sekai Shuho*, 9 November 1949, 13.

⁴⁷ Yoshino, Toshihiko. “‘Yangu Hokuoku’ no rekishiteki igi.” *Ekonomisuto*, March 7, 1972.

⁴⁸ Yoshino, Toshihiko. *En to doru - Endaka e no kiseki to haikei. Nihon Hoso Shuppan Kyokai, 1987*, 118.

reported as if the established rate of 360 yen to the dollar was undervalued. But the exchange rate was seen as undervalued only because people were predicting the rate of 330 yen to the dollar. The rate of 360 yen to the dollar was the level that could not be sustained unless the black market price was adjusted so that it became closer to official price, and for that reason, the rate was an overvalued one.”⁴⁹ In short, he maintained that the yen exchange rate was an overvalued rate when the black market price was taken into consideration.

An example of a later scholarly evaluation is that of Shozaburo Fujino, who was a professor at Hitotsubashi University. He said, “Considering the purchasing power parity (PPP) in 1955, regardless of whether we look at relative PPP or absolute PPP, the appropriate rate was between 450 and 490 yen to the dollar. 360 yen was an overvalued rate.”⁵⁰ Kazuo Ueda, a professor at the University of Tokyo, maintains that, based on the estimation of export/import function, the adequate rate was approximately 600 yen to the dollar.⁵¹ Also, Kiyoshi Kojima, who was a professor at Hitotsubashi University and others, says, like Toshihiko Yoshino, that the exchange rate did not reflect the real price: “The PPP of Japan and the U.S. at the time [April 1949 when the yen exchange rate was determined] indicates that the adequate yen rate was 330 yen to the dollar. Based on that calculation, there have been arguments that the rate of 360 yen to the dollar was an undervalued rate. But it was a calculation based on official price. If calculated with the actual market price, the real exchange rate far exceeded 400 yen per dollar. Probably many people must have felt that the rate of 360 yen to the dollar was rather overvalued. My own research that I published in this journal at that time was already pointing out that the rate of 420 yen to the dollar was necessary in order to achieve international balance of payments.”⁵²

We have seen Japanese opinions that viewed the rate of 360 yen to the dollar as an overvalued rate, but there also was such a view abroad. For example, when the Japanese government requested that the IMF give its official approval to the rate of 360 yen to the dollar in 1953, the Latin American, Middle Eastern, and Far Eastern Departments of the IMF conducted research and drew up “The Par Value of the Japanese Yen.” It was submitted to the IMF Executive Board. The report recommended that the IMF accept the request of the Japanese government, and described the yen exchange rate as rather overvalued considering the economic situation of Japan, although it was preferable to maintain the exchange rate than to devalue it, for further rationalization and modernization of Japanese industry.⁵³

In the above, we have seen the opinions that viewed the yen exchange rate as low, adequate, and high. As mentioned earlier, what this dissertation pursues is not whether the rate of 360 yen to the dollar was an undervalued or overvalued rate considering the

⁴⁹ Yoshino, Toshihiko. *Sengo ekonomisuto no kiseki*, Shakai Keizai Kokumin Kaigi, 1993.

⁵⁰ Fujino, Shozaburo. “Sengo Nihon no kokusai shushi,” *Keizai Kenkyu*, dai 39-kan dai 2-go, April 1988.

⁵¹ Ueda, Kazuo. “Sengo Nihon no keijo shushi, koeki joken - Chochiku, toshi baransu kara no apurochi. Paper presented at Zushi Conference in Japan, 1985.

⁵² Kojima, Kiyoshi. “Teian no shin’i wa doko ni aru noka.” *Ekonomisuto*, 8 December 1959, 9.

⁵³ IMF Latin American, Middle and Far Eastern Department “The Par Value of the Japanese Yen” Prepared by the Far Eastern Division April 21, 1953 (Included in Suzuki (Gen?) Bunsho IMF (1), 1951-1953, Okurasho shiryō Z522-164; Okurasho Zaiseishishitsu ed. *Showa zaiseishi - Shusen kara kowa made* (dai 11-kan). Toyo Kezai Shinposha, 1983, 76-77. Requoted from Ito, Masanao, op. cit., 171-172.

economic circumstance at the time, but how the fixed yen exchange rate was perceived at the time. As can be assumed from the discrepancy in opinions that we have seen above, monetary authorities, economic experts, and mass media's attitudes toward the yen exchange rate was not that of active support, but that of mixed attitudes of support and discontent - precisely speaking, the latter attitude was somewhat more prevalent than the former. Although they had complaints, they had to accept the imposed exchange rate, because the circumstances of international politics and economy did not allow them to change it.

In what follows, we will look at how Japanese politicians, monetary authorities, economic experts, and business groups' involuntary acceptance of the yen exchange rate and the fixed exchange rate system was transformed into a different attitude as time passed. In other words, we will look at how they became the active supporters of the fixed exchange rate system as Japan gradually accumulated wealth based on the yen exchange rate, and as they gradually became fearful of losing their accumulated wealth.

However, an argument can be raised that the attitude toward the rate of 360 yen to the dollar and the attitude toward the fixed exchange rate system are two different matters, because people can be discontented with the preexisting rate and supportive of devaluation without rejecting the fixed exchange rate system. This is because devaluation can be carried out within the framework of the fixed exchange rate system. However, this situation changes as improvements in a country's trade competitiveness turn the country's exchange rate into an undervalued one. In that case, the attitude toward their exchange rate and the attitude toward the fixed exchange rate system could converge, because, in order to maintain the undervalued rate, the fixed exchange rate system must be defended. For example, if Japan abandons the fixed exchange rate system and instead adopts the floating exchange rate system, which allows the market to decide the exchange rate, the yen will inevitably appreciate, reflecting the growth of the Japanese economy. In order to prevent such currency appreciation and maintain the rate of 360 yen to the dollar, people must first defend the fixed exchange rate system, and then resist revaluation that could occur within the fixed exchange rate system. For that reason, in Japan, support for the rate of 360 yen to the dollar and support for the fixed exchange rate system were not two different matters but two sides of the same coin.

Next, let us take a look at the period immediately after the yen exchange rate was set, as a first step of observing the process by which politicians, monetary authorities, economic experts, and businessmen changed their attitude toward the fixed rate of 360 yen to the dollar from a passive acceptance to active support.

Even though there was a discrepancy in opinions about whether the yen exchange rate was an undervalued or an overvalued one, it was undeniable that a domestic economic boom in Japan tended to increase imports, especially raw materials, and cause a trade deficit and foreign currency shortage. Every time Japan experienced a shortage, the Japanese saw the rate of 360 yen to the dollar as a big hurdle. For instance, *The Financial History of Showa (Showa Zaiseishi)* edited by the Ministry of Finance describes the situation as follows: "As early as 1951, when foreign currency reserves diminished, anxieties over the possibility of yen devaluation emerged. Also in 1953, when Japan made 300 million dollars of foreign exchange receipts and payments deficits due to its consumption growth and poor harvest, there arose claims that the rate of 360 yen to the

dollar was an overvalued rate.”⁵⁴ In short, Japanese exporters tended to have complaints, rather than support, about the rate of 360 yen to the dollar. And the complaints about the rate of 360 yen implied their potential complaints about the postwar fixed exchange rate system as well, because the system did not permit Japan to choose yen devaluation without the consent of the United States.

However, a yen devaluation was something that was difficult to carry out in reality, because of the pressure from international society and the possibility that it could lower the credibility of the Japanese economy. Thus, Japanese officials searched for other ways to avoid Japan’s external deficit. Besides devaluation, there were other ways to ease the shortage of foreign currency reserves, such as restrictive monetary policy that would reduce imports, foreign exchange control that would effectively allocate foreign currencies, and assistance measures for promoting export.

Foreign exchange control was implemented as follows. A little before the setting of the yen exchange rate in April 1949, GHQ/SCAP decided to transfer their foreign currency management right to Japan, as a necessary step for supporting Japan’s restarted civilian international trade. In order to carry out the transfer, the Foreign Exchange Control Commission (Gaikoku Kawase Kanri Inkai) was established in March 1949, and, under the management of the Commission, Japan started its self-management of foreign currencies from December 1949: first, the Japanese government promulgated “the Foreign Exchange and Foreign Trade Control Law” (Gaikoku Kawase oyobi Gaikoku Boeki Kanriho, or Gaitameho in an abbreviated form) by which Japan’s foreign currency reserves were allocated directly to the industries of their high priority. The priority was given to imported machines that were necessary for Japan’s industrial growth as well as raw materials that were essential for producing exports. However, according to Yusuke Kashiwagi, who was then working at the Ministry of Finance, the foreign currency control based on the Foreign Exchange and Foreign Trade Control Law was not something that Japan launched independently. According to him, a person called Jan Victor Mladek came from the IMF and directed both the officials of the Ministry of Finance (Okurasho) and officials of the Ministry of International Trade and Industry (Tsusansho) for the establishment of Japan’s foreign currency control system.⁵⁵ From the testimony of Kashiwagi, we can assume that the foreign exchange control, which was carried out for the maintenance of foreign currency reserves and the yen exchange rate, was not only what Japanese government wanted. It was also supported by the IMF, which was concerned about the stability of the international currency system.

Circumstances began to change. From the 1950s, the Japanese economy gradually began to take an upturn, and its reintegration to the international community advanced: First of all, the Korean War, which broke out in June 1950, was a good opportunity for Japan, which was suffering a serious deflation after Joseph Dodge’s reform policies. Spurred by demand from the U.S. army and its allies, Japan suddenly experienced a special procurements boom, which gave Japan an opportunity to accumulate the dollar. The problem was, however, that the economic boom accelerated inflation in Japan. Reflecting it, there appeared black currency markets abroad, where the yen was traded at

⁵⁴ Okurasho Zaiseishishitsu ed. *Showa zaiseishi - Shusen kara kowa made* (dai 15-kan). Toyo Kezai Shinposha, 1977, 404.

⁵⁵ Honda, Keikichi. and Hata, Tadao. *Kashiwagi Yusuke no shogen - Sengo nihon no kokusai kin'yushi*, Yuhikaku. 1998, 122-123.

an undervalued rate (more than 500 yen to the dollar).⁵⁶ What it implied was that the inflation made the exchange rate of 360 yen to the dollar an overvalued rate in reality. However, the problem did not last long. With the end of the boom, inflation decelerated and the feeling of overvaluation gradually dissipated.

In the meantime, Japan regained its sovereignty through the San Francisco Peace Treaty in September 1951, and gained its IMF membership in 1952. In August 1952, the aforementioned Foreign Exchange Control Commission was disbanded, and instead, the Ministry of Finance came to manage foreign currency reserves under the Foreign Exchange Fund Special Account Act (*Gaikoku Kawase Shikin Tokubetsu Kaikei*). Thereafter, the liberalization of foreign exchange began to advance in certain degrees. For example, exchange banks were permitted to hold the dollar beginning in December 1952, and they were also permitted to hold the British pounds from March 1953. Also, the IMF officially recognized the rate of 360 yen to the dollar in 1953.

Despite Japan's gradual reintegration into the international community and the firm foreign exchange control, Japan's foreign currency reserves did not increase as much as officials expected. It is true that the reserves increased as the Korean War and procurements boom started, from 493 million dollars in late 1950 to 1.59 billion dollars by late 1951, but the reserves began to decline in 1953. One reason was that Japan's textile exports to the sterling area declined, because Britain implemented import restriction / export promotion policies from the latter half of 1952 in defense of the pound. Another reason was that the Japanese government, as its foreign currency reserves increased thanks to the wartime special procurements boom, expanded the budget for imports; imports from the sterling area and others continued to increase, causing the decline of foreign currency reserves.⁵⁷ For these reasons, Japan faced the shortage of the British pound.

To cope with the shortage of the British pound, the Japanese government concluded agreements with Britain in April 1953 on currency swaps, which allowed the swapping of the dollar and the pound. By offering dollars in exchange for the pound, the Japanese government attempt to overcome the shortage of the pound. But, the agreement alone did not solve the problem. Hence, in late August 1953, the Japanese government determined to borrow the pound from the IMF, and withdrew the accumulated total of 44.3 million pounds (equivalent to 124 million dollars) by December 21, 1953.⁵⁸ In addition, as Japan's international balance of payments once again deteriorated in 1954, the government formulated an austerity budget to save the dollar and implemented import restriction / export promotion policies, in an attempt to maintain its foreign currency reserves.

Thanks in part to such efforts by the government as well as civilian efforts to increase the competitiveness of Japanese firms, Japan's export volume took an upturn from 1955 and foreign currency reserves increased to 1.45 billion dollars in April 1956. Meanwhile, domestically, facility investment increased in the businesses of steel, shipbuilding,

⁵⁶ Kuwano, Hitoshi. *Kokusai tsuka kiki*. Shin Nihon Shuppansha, 1968, 152.

⁵⁷ For details, read Ito, Masanao. *Sengo nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 154. Regarding the foreign exchange crises of 1953 and 1957, read Asai, Yoshio. "IMF hachi-jokoku iko to boeki, kawase jiyuka (jo)." *Kenkyu hokoku* (Seijo Daigaku Kenkyujo), No. 42 (2005)

⁵⁸ Ito, Masanao. *Sengo nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 157.

automobile, petrochemistry, and etc., culminating in an economic boom called the “Jinmu boom.”

Unfortunately the good time was transient. The domestic economic boom led to an excessive import of machines and raw materials that were necessary for production. Japan again fell into trade deficit from July 1956 and lapsed into another foreign currency crisis as its trade deficit surged on a large scale in 1957.

To overcome the situation, the Japanese government made a cabinet decision to adopt the “Emergency Measures for the Improvement of the International Balance of Payments” and deployed measures such as the adjustment of the execution period for the general account and special account budgets, the strengthening of monetary restraints, and further import restriction and further export promotion. Also, the Japan government withdrew 125 million US dollars from IMF on July 2nd and 12th 1957 to use the dollars to supplement its foreign currency reserves. Thanks in large part to above measures, Japan’s budget for the second half of 1957 decreased by as much as 654 million dollars, compared to the budget for the first half of the year. As for the import of primary resources, there was a budget cut for sugar, soybean, raw materials of steel industry, heavy oil, and machine. Invisible payments (payments in non-trade transactions) were also reduced by 50 million dollars.⁵⁹ Through these strict measures, the situation began to take a favorable turn, and Japan’s foreign currency reserves rapidly increased from 1957 to 1960.

And, as Japan increased its export volume and restricted imports, the Japanese government and companies began to see the yen exchange rate as less overvalued. But it did not mean that it began to be seen as undervalued either. Although Miyoei Shinohara, then a professor at Hitotsubashi University, maintained that the yen exchange rate turned into an undervalued rate from as early as the late 1950s, he was an obvious exception.

Shinohara stated in November 1959 as follows: “[The rate of 360 yen to the dollar] is one of the important background factors that enabled the high increase rate of our country’s export ... In our country, all the industries except for primary industries tend to become export-oriented industries ... In the business of textile, miscellaneous goods, foods, as well as steel, ammonium sulfate, shipbuilding, automobile, cement, electrical machine, and etc., we can see a clear tendency that they are directing themselves to be fully export-oriented ... In order for so many industries to become export industries, the yen exchange rate must have been undervalued to a large extent ... we can clearly say that the undervalued yen exchange rate has been the background to the tendency that so many industries have been trying to become export industries ... The development of the heavy and chemical industries in Japan has been, after all, supported by the fixed exchange rate of 360 yen to the dollar ... Because it was an undervalued rate, both the light industry and heavy industry were stimulated to become export-oriented.”⁶⁰

However, as can be seen from the fact that many counterarguments were made against Shinohara’s argument in the December 1959 issue of the magazine *Ekonomisuto* [a Japanese version of *The Economist*], there were many who could not agree with the opinion that the yen exchange rate was an undervalued one. For example, Kiyoshi Kojima of Hitotsubashi University said, “Unlike Shinohara, I do not believe that the yen exchange rate would be appreciated to 300 yen or 250 yen to the dollar if Japan advances

⁵⁹ *Ibid.*, 159-160.

⁶⁰ Shinohara, Miyoei. “Jiyuka to 360 en rēto.” *Ekonomisuto*, 10 November 1959, 39-40.

its [economic] liberalization to the level of Western industrial countries. On the contrary, I even worry that the rate could be depreciated to around 400 yen to the dollar ... We can say that the rate of 360 yen has been an appropriate one from the time when it was first set to the present, considering the situation of our international balance of payments ... Or, I would say that the rate has been rather an overvalued one, because we could eke out the balance of payments equilibrium by imposing stricter regulations than other countries did.”⁶¹ In this way, Kojima expressed the general perception at the time that the rate of 360 yen to the dollar was either an appropriate or somewhat overvalued one. Masao Kanno, an executive director of the Bank of Japan, also criticized Shinohara as follows: “Japanese economy reached its status today ... by adapting itself to the rate of 360 yen for more than 10 years ... [Shinohara] is overestimating the role of the yen exchange rate in the structural changes that the export industries underwent. Isn’t it due to the overall development of industrial structure in Japanese economy, rather than the relatively undervalued exchange rate, that the heavy and chemical industries have become the large part of the Japanese export industry?”⁶² (However, this was a simplification of Shinohara’s argument. Shinohara did not mean to say that the yen exchange rate was the *sole* reason of Japan’s increase in export). Also, Takekuni Ebihara, who worked in the Planning Bureau (Sogo Keikaku Kyoku) of the Economic Planning Agency, noted, “Because our country could eke out the balance of payments equilibrium in the postwar period thanks to the trade restriction and export promotion policies, we cannot say that the yen exchange rate is an undervalued one. On the contrary, it is an overvalued one.”⁶³

These counterarguments against Shinohara were not without flaws and contained misunderstandings, and Shinohara gave his reply in the December 22nd 1959 issue of *Ekonomisuto*. It is not easy to determine who was correct in their analysis, but what can be pointed out with certainty is that, at the time, it was a heretical view to think that the yen exchange rate was an undervalued one, and that there was a strong sense of discomfort with such a view. It is true that, after recording continuous trade deficits up to 1957, Japan recorded surpluses between 1958 and 1960, and consequently the sense of overvaluation was beginning to mitigate. But the scale of the surplus was not large enough to give a sense of undervaluation. There still were many factors that could make Japan lapse into the state of foreign currency shortage again.

One such factor was the growing foreign pressure on Japan to loosen its import restrictions and increase import volume. Because Japan’s protectionism was beginning to have adverse effects on the export performance of the U.S. and other countries, the U.S. was beginning to impose pressure on Japan. However, it was not only a problem of Japan. Such a move by the U.S. reflected the weakening power of the U.S. economy as well. The oversupply of the dollar, which was caused by such things as the U.S. government’s huge expenditure, its foreign aid as represented by the Marshall Plan, and the shift of U.S. companies’ production base abroad, was causing a decline in the real value of the dollar. The credibility of the dollar was also undermined by the fact that such outflows of capital put the United States’ overall balance of payments (both the balance of current account and balance of capital account) in the red throughout the 1950s except for 1957 (although its trade balance had always been in the black throughout the 1950s).

⁶¹ Kojima, Kiyoshi. “Teian no shin’i wa doko ni arunoka.” *Ekonomisuto*, 8 December 1959, 8-9.

⁶² Kanno, Masao. “Genjitsu ni awanai giron.” *Ekonomisuto*, 8 December 1959, 13-14.

⁶³ Ebihara, Takekuni. “Kawase rēto wa en’yasu dewa nakatta.” *Ekonomisuto*, 8 December 1959, 19.

And, the changing international situation further deepened the global distrust in the dollar: When 14 European countries recovered their currency convertibility and eased their foreign exchange control in December 1958, arbitrage transactions became possible; investors could make profits by using the differences in interest rates between the U.S. and European countries, and by taking advantage of the gaps between the spot exchange rate and foreign exchange futures. It became easier for dollar holders to operate their funds in the Eurodollar market, and also, it became possible for the holders of the British pound and Deutsche mark to convert those currencies to the dollar if they wanted to manage their funds in dollar form.⁶⁴ In such a manner, the recovered currency convertibility made it easier to carry out a global transfer of short-term capital, and it was a development that further facilitated economic activities and strengthened the free economic system, or the Bretton Woods system. But, the ample supply of the dollar and the enhancement of currency mobility, which worked to strengthen the Bretton Woods system, were a two-edged sword. The negative side was that the recovery of the convertibility created a new channel through which investors could sell the dollar and buy gold. The trend of dollar-selling and gold-buying continued, accelerating the destabilization of the dollar-gold standard system / Bretton Woods system.⁶⁵ For instance, in 1958, there was an outflow of gold amounting to 2.27 billion dollars from the U.S. to Europe. In the first half of 1959, an outflow of gold amounting to 837 million dollars occurred.⁶⁶ This situation between the U.S. and Europe even attracted Japanese attention. Concerns about the Bretton Woods System were expressed in Japan, as can be seen from the article titles in *Ekonomisuto*, such as “Gold, which became the only God” (February 28, 1959), “From the dollar to gold” (March 7, 1959), “The unstable throne of the dollar” (August 11, 1959), “Recovery of convertibility and the weakness of the dollar” (March 8, 1960), and “What should we have for our foreign currency reserves - Gold or the dollar?” (August 23, 1960).

It was against this backdrop - the necessity of improving the United States’ international balance of payments and the necessity of strengthening the Bretton Woods system - that the aforementioned pressure on Japan to liberalize its trade and capital was imposed. Facing such pressure, Japan after all had to deal with it and announced “The Outline Plan for Trade and Foreign Exchange Liberalization” (Boeki Kawase Jiyuka Keikaku Taiko) in June 1960 under the administration of Prime Minister Nobusuke Kishi. Thereafter, Japan’s efforts for deregulation slowly began, based on the plan. For example, in the same month, June, there was a loosening of the preexisting restrictions on foreign capital introduction. On July 1st, nonresident free yen deposit account was created, and nonresidents were allowed to hold short-term capital in Japan. In August, it was decided to remove the limits that had been imposed on the loan in overseas and the clean loan from foreign banks. In October, import liberalization of 257 items was announced.

As for the dollar, however, its credibility remained low in the early 1960s, as reflected by the intensive gold-buying in October 1960: Gold price in the London Bullion Market

⁶⁴ Keizai Kikaku Cho (Economic Planning Agency). *Showa 46-nen neji sekai keizai hokoku - Tenki ni tatsu buretton uzzu taisei* -. 1967, Chapter 2, Section 4.

⁶⁵ There were some who predicted that drastic dollar-selling and god-buying would not occur because only a state, not an individual or a private company, was allowed by IMF articles to demand the U.S. government to exchange the dollar with gold the U.S. had. But gold that once came out of the U.S. could be purchased by a private agent in the London Bullion Market, which reopened in March 1953.

⁶⁶ Makino, Sumio. “Kokansei kaifuku to doru no nancho.” *Ekonomisuto*, 8 March 1960, 54.

rose above the official price of 1 ounce = 35 dollars, and eventually rose up to 1 ounce = 41.6 dollars. The backgrounds to the gold price hike were the oversupply and fallen credibility of the dollar as aforementioned, but reportedly another direct cause of the price hike in October was the U.S. presidential campaign. When economic stimulus policy became a debate topic between the two candidates, Richard Nixon and John F. Kennedy, there emerged a wide speculation that a stimulus policy would worsen the United States' international balance of payments and accelerate the supply of the dollar. Reportedly this was the direct cause of the gold price hike.⁶⁷ To cope with the gold-buying and dollar-selling trend, President Dwight D. Eisenhower issued a ban order in January 1961, which prohibited American individuals and companies from holding gold or gold certificates outside the United States.⁶⁸ The newly elected President, Kennedy, also deployed his own dollar-defense measures, such as export promotion policies, burden sharing with other countries in foreign aid, and restrictions on military expenditure abroad. Kennedy administration also implemented "operation twist" by which short-term interest rate was raised to contain capital outflow while the long-term interest rate was lowered to support the U.S. domestic economy. Another attempt to stop the gold-buying speculation was "The London Gold Pool Agreement" signed in December 1961. It was an agreement among the U.S. and seven European countries to intervene in the gold market with their gold holdings, for the purpose of maintaining the gold price. As seen above, various efforts had been made in order to defend and strengthen both the U.S. economy and the Bretton Woods system.

However, Japan too was beginning to lapse into a difficult situation: Japan's foreign currency reserves were diminishing in 1961, and it had to find a way to increase the reserves. The reason for the shortage lay in Prime Minister Hayato Ikeda's "Income Doubling Plan" of 1960, which promised a doubling of the living standard of Japanese people. Under the plan, the domestic economy was stimulated, and the resulting economic boom led to the rapid increase in import and decrease in foreign currency reserves. To overcome the situation, various measures were taken. For example, the Bank of Japan raised the official bank rate by 0.1% in July 1961 to prevent the economy from overheating, and in September, the government made a cabinet decision to implement the "Measures to improve the international balance of payments," which included the Bank of Japan's tightened monetary policy such as stricter loaning policy and further raising of the official bank rate, as well as the government's import restriction, export promotion, and fiscal restraint policies. In addition, the government and the Bank of Japan made a decision to borrow foreign short-term loans as a preparation for a possible sharp decline in foreign currency reserves. Consequently the Bank of Japan received a short-term loan of approximately 200 million dollars from three American banks located in Japan in November 1961, and borrowed another short-term loan of 125 million dollars from seven American commercial banks in January 1962. Moreover, in the same month, Japan gained an approval to use IMF's Stand-By Arrangement (SBA), which permitted Japan to borrow foreign currencies up to 305 million dollars from IMF in exchange for the Japanese yen (but in the end, Japan did not use the SBA). It is true that Japan had been a recipient of an IMF loan earlier during its foreign exchange crises in 1953 and 1957. But

⁶⁷ Iwami, Tooru. *Kokusai tsuka, kinyu shisutemu no rekishi*, Yuhikaku, 1995, 115-117.

⁶⁸ Washington (AP) 14 January 1961.

earlier loans were instantaneous ones, not a kind based on a stand-by arrangement.⁶⁹ As seen above, Japan implemented various policies to secure foreign currency reserves and thereby maintain the stability of the fixed exchange rate system. Although the situation did not improve immediately, the above measures helped Japan recover its foreign currency reserves from the second half of 1962.

However, it was not only Japan that strived to secure the foreign currency reserves. The IMF, in an attempt to increase its reserves, adopted the “General Arrangements to Borrow” (GAB) on January 5th 1962. It was an agreement among 10 countries including Japan to lend their own currencies to IMF (total of 6 billion dollars), so that the member countries could easily borrow currencies other than the British pound and the U.S. dollar from IMF.⁷⁰ Such diversification of IMF’s foreign currency reserves was an attempt to give more liquidity to capital, and thereby facilitate economic activities and strengthen the Bretton Woods system.

However, despite these developments, the United States was still having the problem of capital outflow, which was worsening the U.S. international balance of payments, and deepened people’s distrust in the dollar. In order to overcome the situation, the U.S. government introduced “the interest equalization tax,” which was first proposed by President Kennedy in 1963, and established in 1964 by Johnson administration. It was a tax imposed on the U.S. residents when they acquired stocks and bonds issued by foreigners (abolished in January 1974). However, according to Toyoo Gyohten, who later became the Vice Minister of Finance for International Affairs in the 1980s, the interest equalization tax was counterproductive: “It [the interest equalization tax] shifted our sources of capital to Europe and also taught Japanese industry the advantage of generating its own reserves. And in hindsight it certainly did major damage to the New York capital market, because Japan was not the only country to shift to Europe. This became a major factor in the rapid expansion of Euromarket and the rather volatile movement of international capital, which contributed to the instability of the Bretton Woods system in the late 1960s.”⁷¹ In short, the Bretton Woods System was in a paradoxical situation: the measures for enhancing capital liquidity, which was essential for the development of the free economic system, were at the same time the cause of capital outflows and destabilization of the system; when an attempt was made to prevent the capital outflow by imposing tax, capital inflow into the U.S. slowed as well, further depleting the capital the U.S. needed.

Japan, the U.S., and IMF tackled these problems of foreign currency and capital, but the credibility of the dollar did not recover soon. Japan’s foreign currency reserves did not increase either for several years, to the level that the Japanese officials felt safe. For instance, the reserves continued to stay at the level of 1.8-2 billion dollars from 1962 to 1967 (gold + foreign currency). It was as late as the second half of 1968 that the reserves surpassed the level of 2 billion dollars and began to soar rapidly. Until then, every time Japan had a foreign currency shortage, it had no choice but to implement monetary restriction on its domestic economy to secure foreign currency. Although such a restriction could work to bring about a healthy structure to an economy in the long term

⁶⁹ The description of Japan’s response during 1961-1962 in this paragraph is largely based on Masanao Ito’s account.

⁷⁰ Iwami, Tooru. *Kokusai tsuka, kinyu shisutemu no rekishi*, Yuhikaku, 1995, 122.

⁷¹ Volcker, Paul. and Toyoo Gyohten. *Changing Fortunes*. Times Books, 1992, 53.

(as mentioned in Section 1 "Framework - Merits"), there was no reason for entrepreneurs to actively support it because it would decelerate the ongoing economic boom. Thus, between the 1950s and the mid-1960s, the Japanese government and business circles' support for the fixed exchange rate of 360 yen was not that of enthusiastic one. It was rather a reluctant support because they had no choice but to adapt themselves to it. For example, Yusuke Kashiwagi, who was then working in the Ministry of Finance, described the point as follows: "[Japan's] monetary policy from the 1950s to the 1960s clearly emphasized the external balance. The policy was accepted by the general public as well. Occasional restrictive measures that were taken to improve the international balance of payments never met with criticism in the diet, because those measures were perceived to be within the jurisdiction of the government." ⁷²

And, because the restrictive monetary policy was something that the fixed exchange rate system forced its member countries to take, it was not only a story of Japan. According to Paul Einzig, an economic journalist, measures to restore equilibrium were always very unpopular in Britain and the United States, but "Germany, Italy, Japan, France until recently, and some of the smaller continental industrial countries have been much more willing to put up with 'stop-go-stop' [a policy that imposes monetary restriction in the time of economic boom to prevent an increase in imports. When the economy is stabilized, the restrictions were loosened] in order to avoid the alternative - 'boom-slump'." ⁷³ In these countries, authorities tended to resist devaluation and adhered to the rule of the fixed exchange rate system, because of their experience of devaluation race in the prewar period as well as the experience of inflation in the wartime and postwar periods. ⁷⁴

To elaborate more on this point, the following experiences during the prewar, wartime, and postwar period and fears based on the experiences were affecting the actions of the authorities of major countries in the postwar period: When the stock market plunged in the U.S. in 1929, its impact spread around the world immediately, causing a global recession. In response, each great power attempted to overcome its domestic recession by forming its own economic bloc. In other words, each of them made its sphere of influence including the colonies a single bloc, and built tariff barriers around it, so that it could block imports from other great powers and secure the market within the bloc. At the same time, it devalued its currency to lower the overseas prices of its products and thereby promote exports. Because all great powers tried to block imports from others while trying to promote exports to them, the volume of world trade declined substantially and the global recession worsened. Under these circumstances, Japan, Germany, and Italy, which did not have large colonies compared to Britain and France, were more cornered by the shrinking market. In order to overcome the situation, they moved toward forming their own economic blocs through colonial expansion, and such moves are said to have been one of the causes of WW II. Experiencing these developments, major countries realized that a devaluation race can bring catastrophic outcomes, and thus tried to avoid it as much as possible in the postwar period.

⁷² Honda, Keikichi. and Hata, Tadao. *Kashiwagi Yusuke no shogen - Sengo nihon no kokusai kin'yushi*, Yuhikaku. 1998, 30-31.

⁷³ Einzig, Paul. *The Case against Floating Exchanges*. St. Martin's Press, 1970, 44

⁷⁴ Iwami, Tooru. *Kokusai tsuka, kinyu shisutemu no rekishi*, Yuhikaku, 1995, 126.

To focus on Japan, it had a bitter experience with both devaluation and revaluation. Let us look at the case of revaluation first. In January 1930, Minister of Finance Junnosuke Inoue and Prime Minister Osachi Hamaguchi under Hamaguchi cabinet implemented a policy that raised the value of the yen, which had fallen in the 1920s (in 1928, 1 dollar = approximately 2.300 yen), to the pre- September 1917 level (1 dollar = 2.005 yen). In short, they lifted the gold embargo that had been in effect since September 1917, and applied the above pre- September 1917 yen value (old parity) as the exchange rate between gold and the yen. In other words, Japan returned to the gold standard system with the application of the old parity. The reasons they returned to the gold standard were as follows. After the First World War, Japan suffered a long-term recession, the yen was not stable because it was not convertible to gold, and domestic prices were unstable as well. Facing a dire situation, Hamaguchi and Inoue judged that, if they allowed the export of gold with the application of the old parity and made Japan return to the gold standard, the yen rate would be fixed and stabilized. Also, they judged that the high old parity would make exports more difficult for Japanese exporters and thereby promote the rationalization of their businesses and improve their competitiveness. They thought it was a necessary measure to renovate the Japanese economy that had been based on the collusion among the government, businessmen with political contacts (*seisho*), and *zaibatsu*.

However, the situation did not change as Hamaguchi and Inoue had wished. The impact of the stock price plunge in the U.S. that had started approximately 2 months before in late October 1929 was greater than they expected. World demand rapidly slowed down, and thus the old parity with which Japan had to export its products further strangled Japanese exporters. The fact that the decrease rate of prices outside Japan was greater than that in Japan also contributed to a decrease in Japan's exports. In such a situation of deflation and worsening world trade conditions, demands for Japan's gold heightened and gold began to flow out of Japan on a large scale. Then, anticipating the Japanese government's reimplementing of a gold embargo, speculators (mostly Japanese companies) accelerated their yen-selling and dollar-buying, furthering the outflow of gold. This brought real pressure on the Japanese monetary authorities, and eventually, the reimplementing of the gold embargo was decided on. In that way, the Hamaguchi cabinet's lifting of the gold embargo at the old parity, especially because it was implemented in the time of global recession, ended up further strangling the Japanese economy.⁷⁵

But Japan's agony did not end there. Japan then suffered the side effects of the currency devaluation race. In short, as mentioned above, Japan had to suffer a chronic slump in exports and domestic recession in the 1930s under the situation where great powers formed economic blocs through devaluation races and tariff barriers. To overcome the situation, the Japanese military and business community began to seek more overseas resources and markets, and accelerated Japan's territorial expansion into China, including Manchuria. This caused the increase of the military's influence in Japanese domestic politics, and Japan's collision with the interests of the U.S. and Britain. These developments were one of the causes that paved the way to the Pacific War. And

⁷⁵ For details about the lifting of the gold embargo in 1930, see Metzler, Mark. *Lever Of Empire: The International Gold Standard And The Crisis Of Liberalism In Prewar Japan*. University of California Press, 2006.

in the Pacific War, Japan suffered enormous losses in various aspects. After crushing losses, Japan eventually lost the war, and lost its independence under the occupation of the United States. Moreover, owing to economic instability in the early occupation years, Japan had to go through hyperinflation until 1949.

Looking back at such developments since the lifting of the gold embargo, Tanzan Ishibashi, a politician who later became the Prime Minister in 1956, stated as follows in 1951: “It would be a mistake to say that things like the Manchuria incident, the May 15 [1932] incident, and the February 26 [1936] incident happened only because of the depression. However, it is probably beyond doubt that the depression supplied the best basis for these things to occur ... If we consider it like this, we can say that what placed Japan in the adversity of present days was actually the lifting of the gold embargo in 1930.”⁷⁶

Although the relationship of the lifting of the gold embargo to Japan’s militarization and the Pacific War needs detailed analysis, what can be said here at least is that many Japanese authorities, who witnessed and lived through the era, shared the view of Tanzan Ishibashi, and strongly perceived the link between economic difficulties they experienced and the war. Thus it was natural that the Japanese authorities who had recently undergone such a miserable experience feared that an arbitrary change of currency value, whether it is revaluation or devaluation, could bring about dangerous consequences. It was against the backdrop of such a perception and fear that authorities endeavored to maintain the exchange rate and avoid devaluation as much as possible.

But it did not mean that they actively supported the yen rate and the fixed-rate system, because Japan had to sacrifice its domestic economic boom whenever there was a foreign currency shortage. In order to remove the necessity of restrictive monetary policies, Japan’s export industries needed to develop to the extent that its trade balance recorded sufficient surpluses even without restrictive policies. Because it was in the mid-1960s that Japanese industries reached that level, Japan by then had to implement restrictive monetary policies from time to time, and thus by then the Japanese officials and businessmen had been reluctantly accepting the yen exchange rate as well as the fixed exchange rate system which did not easily allow a change of the rate.

In the following section, we will look at how that “reluctant acceptance” was transformed into a different attitude as time passed from the mid-1960s to the early 1970s. We will look at how politicians, monetary authorities, economic experts, and business groups became the active supporters of the rate of 360 yen and the fixed exchange rate system as they gradually expanded their trade and profits based on the yen exchange rate and as they gradually became fearful of losing their accumulated wealth.

(3) Active Support for the Fixed Exchange Rate System: From the Mid-1960s to the Early 1970s

Until the early 1960s, the Japanese government and industries had strong concerns about the future of the country’s economy, because Japan was facing the wave of trade

⁷⁶ *Ishibashi Tanzan zenshu* (Vol. 15). Toyo Keizai Shinposha, 1972, 203, requoted from Metzler, Mark. *Lever Of Empire: The International Gold Standard And The Crisis Of Liberalism In Prewar Japan*. University of California Press, 2006, 257.

and capital liberalization. For instance, in addition to the aforementioned deregulation policies, Japan shifted its GATT membership status from Article 12 status (a country that is allowed to implement import restriction to maintain its balance of international payments) to Article 11 status (a country that is not allowed to implement import restriction) in 1963. With regard to IMF, Japan shifted its IMF membership status from Article 14 status, a country that is allowed to implement foreign exchange control to maintain its balance of international payments equilibrium, to Article 8 status, a country that is not allowed to implement foreign exchange control, in 1964. And following the change of status, Japan's foreign currency budget system was abolished in 1964 (However, in reality, foreign exchange control remained strong). In April 1964, Japan also became the full member of Organization for Economic Cooperation and Development (OECD) for which Japan had to promise a further liberalization.

However, despite such deregulations and concerns about them, Japan began to run constant trade surpluses from the mid-1960s, as the quality and price competitiveness of Japanese products was enhanced. Exports began to grow radically from 1964, and trade surpluses continued throughout 1965 and 1966. Exports temporarily shrunk in 1967, but continued to grow again in 1968 and 1969. During the same period, Japan's invisible trade balance was in the red, but visible trade surpluses largely exceeded the invisible trade deficit, resulting in an increase in foreign currency reserves.

The cause of the enhanced competitiveness of Japanese products can be attributed to many things, but one of the largest causes was the fact that the rate of 360 yen to the dollar was ceasing to be an overvalued rate, and Japanese products were becoming relatively cheaper than the products of other countries given that they had the same quality. Sumio Makino, then a professor at Tokyo Keizai University, referred to the point in September 1964 as follows: "... In foreign markets such as Hong Kong, Bangkok and Zurich, there have been free yen exchange markets (= black market) where the yen notes have been traded at the exchange rate other than this [official exchange rate]. We cannot say that those exchange rates accurately reflected the value of the currency, but we can see that the yen exchange rate at those free exchange markets, which used to be far above 500 yen to the dollar, are now getting closer to the official rate of 360 yen. For example, the yen exchange rate in the Hong Kong market was 396 yen to the dollar in late January 1963, but it rose to 386 yen in late September and rose again to 370 yen by late December. Let's take a look at the purchasing power parity (PPP) to figure out the value of the yen from a different angle. This too cannot be seen as a method that accurately reflects the value, but we can see that the value of the yen was 370 yen to the dollar in 1963, if we set 1958 (a year when European currencies recovered convertibility) as a reference year, and if we consider the changes in wholesale prices. These barometers that had indicated that the official yen exchange rate was an overvalued rate in the past are nowadays indicating that it is now close to reality."⁷⁷

And, partially aided by the yen exchange rate that was mitigating its overvaluedness, Japan began to have constant trade surpluses from the mid-1960s. It was able to avoid foreign currency shortages even when an economic boom increased the import volume, because its scale of export, aided by the yen exchange rate, began to exceed the scale of import. Thus, Japan no more needed to suppress economic booms with restrictive measures in order to prevent foreign currency shortage. It is true that Japan deployed

⁷⁷ Makino, Sumio. "En no kokuaiteki chii." *Ekonomisuto*, 8 September 1964, 7.

restrictive monetary measures between 1969 and 1970, but they were used not to overcome foreign currency shortage but to achieve price stability.⁷⁸

Of course, there were other underlying causes of the increased competitiveness of Japanese products, such as the endeavors of Japanese companies to improve the productivity and quality of their goods, the U.S. economic boom that continued for years until 1968, and an increase in the U.S. gross domestic demand and import under Johnson administration due to inflation. The inflation was caused by the increased expenditures for the Vietnam War and welfare policy. The yen exchange rate, which became an undervalued one, was one of the factors that contributed to Japan's increase in exports, in addition to these factors.

As the productivity of Japanese industries grew and the yen exchange rate became advantageous for its exports, Japanese government and industries became "active supporters" of the yen exchange rate and the fixed exchange rate system. As emphasized earlier, what this dissertation attempts to accomplish by describing such a change of attitude is to show that **the attitude changed not only because the rate of 360 yen to the dollar was necessary for further profit of Japanese industries, but also because Japanese industries could suffer a huge loss without the support of the exchange rate.** Profit-seeking and fear of damage were two sides of the same coin. Fear of such damage was expressed as early as 1959, when Miyohai Shinohara showed his concern about possible huge economic damage that could be inflicted in the event of yen revaluation: "Let's suppose that the exchange rate was permitted to move freely, and it became 250 yen to the dollar ... Because all industries in the national economy have become export industries, the industrial structure will be profoundly destabilized by even a slight change in the exchange rate."⁷⁹ Shinohara was ahead of his time, but his concern and fear of such economic damage began to be shared by many Japanese by the mid-1960s.

Furthermore, as will be described below, this dissertation focuses on the fact that people's fear-driven support for the yen exchange rate and the fixed exchange rate system led to their endeavors to overcome the problems of the fixed exchange rate system through institutional reinforcement. In other words, it was not only profit-seeking but also fear that drove institutional/structural changes or reinforcements. It is true that there was a growing number of economic experts who supported the floating exchange rate system instead of the fixed exchange rate system, but government officials and business leaders, with a few exceptions, were generally against the yen revaluation and the abolition of the fixed exchange rate system by 1971.

However, even though the Japanese economy had become largely dependent on the rate of 360 yen, if there was no possibility of a change in the exchange rate and a collapse of the fixed exchange rate system, it would have been unnecessary for the authorities, business communities, and others to fear economic damages and show active support for the system. In other words, active support for the system was necessary, not only because the yen exchange rate had become advantageous for the economy but also because there was an increasing possibility of a change in the yen exchange rate and a collapse of the fixed exchange rate system. Because the global economic situation at the time was the

⁷⁸ Ishida, Sadao. "Sengo nihon Keizai naigai no ugoki to kin'yu seisaku no un'ei." *Seikei Ronso*, dai 63-kan, dai 2, 3 go (1995), 310.

⁷⁹ Shinohara, Miyohai. "Jiyuka to 360 en rēto." *Ekonomisuto*, 10 November 1959, 40.

reason that sparked Japanese fear and support for the system, in what follows we will first take a look at the global situation in the mid- and late 1960s.

From the mid-1960s, the currencies of the leading countries became increasingly unstable. For example, Britain had to devalue the pound by 14.3% on November 18th 1967, and raise the official bank rate from 6.5% to 8%, as it went through adversities such as the closing of the Suez Canal, worsening trade balance, and strikes. And such a move by Britain lowered the credibility of the US dollar as well, causing large scale gold-buying in the European gold market in November and December. Reportedly gold worth 500 million dollars were traded in November and 400 million dollars in December 1967.

To tackle the situation, President Lyndon Johnson announced on January 1st 1968 that he would take emergency measures for the defense of the dollar. The measures included legal regulations on direct overseas investment (as opposed to the self-imposed regulation that was practiced earlier), restrictions on foreign lending, restrictions on overseas travel, the government spending cut in foreign countries, and a promotion of exports. Such measures for the defense of the dollar aimed at halting dollar-selling and gold-buying, but the credibility of the dollar did not recover through those measures. The trend continued, and reportedly gold worth 1 billion dollars were traded during March.

Because of this gold rush, there was a closure of the London Bullion Market on March 15th 1968, and the next day, March 16th 1968, central bank governors from the member countries of the gold pool agreement (an agreement made among the U.S. and seven European countries in 1961 to intervene in the gold market with their gold holdings for the maintenance of gold price) made a decision to halt their activities, judging that further intervention would be ineffective in maintaining the gold price. In other words, they decided to let the gold price move by the law of supply and demand in the gold market. Instead, they agreed to adhere to the official gold price when gold was exchanged among the monetary authorities of the member countries. They also promised to voluntarily refrain from demanding the U.S. to convert the dollar to gold, although they had the right. In short, this development meant an emergence of the two-tier gold system, which allowed the coexistence of the market price and the official price of gold. Through this two-tier gold system, the U.S. and other countries attempted to prevent the outflow of gold from the U.S. and overcome the contradictions of the fixed exchange rate system / the dollar-gold standard system.

In addition, in order to tackle the problem of dollar-selling and gold-buying, ten finance ministers held a meeting in Stockholm in March 1968, under the initiative of the United States. In the meeting, it was decided to start SDR (Special Drawing Rights, actually implemented in 1969), which were “fictional” foreign exchange reserve assets based on the credit of IMF. The intention of launching SDR was to increase the international capital liquidity by allocating SDR to countries, and thereby prevent a freefall of the dollar and circumvent possible future demand by countries for a dollar-gold conversion. However, SDR after all did not circulate widely enough after its launching. It was so because, although the value of SDR was expressed by the value of gold and the dollar (1 SDR was 1 dollar until 1971, a year when the dollar was devalued), SDR was not convertible to gold, nor was it backed by any other value assurance. Also, only monetary authorities were allowed to transact SDR, and thus SDR did not circulate in civil market. In addition, SDR was used as a means of gaining foreign currencies for

foreign exchange intervention, rather than a means of direct international payment.⁸⁰ Having such limitations, SDR was not something that gave a decisive solution to the contradictions of the fixed exchange rate system.

Although these measures did not provide a decisive solution to the problems, in the short term they worked to postpone the collapse of the fixed exchange rate system by preventing the outflow of gold from the United States. In fact, the gold market calmed down for a while after that. However, as can be seen from the article titled "Revaluation of gold price is inevitable" in the April 9th 1968 issue of *Ekonomisuto*, there already was a forecast at the time that the revaluation of gold and devaluation of the dollar were a matter of time because of the contradictions of the two-tier gold system.

It was not only between gold and the dollar that problems existed. As the scale of international capital transfer grew, heavy selling of less trusted currency and heavy buying of highly trusted currency intensified. Some leading countries attempted to stabilize the situation by changing their exchange rates to the level that suited the real economic capacity of each. For example, in the face of the pound-selling, Britain responded with the devaluation of the pound in November 1967. To the franc-selling, France responded with the devaluation of the franc by 11.1% in August 1969. West Germany, which already had revalued the mark in March 1961, once again carried out a mark revaluation by 9.29% in October 1969, as a response to the heavy buying of the mark that started after a victory of the Social Democratic Party of Germany in general election became obvious in September 1969. At the same time that such devaluation and revaluation reflected the vulnerability of the fixed exchange rate system, they reflected the efforts of the leading countries to solve problems within the framework of the fixed exchange rate system, instead of shifting to the floating exchange rate system. By then they did not attempt to discard the fixed exchange rate system and shift to the floating system.

However, although the above measures helped contain the problems, they did not give a final solution. The root cause of the instability of the fixed exchange rate system lay in the falling credibility of the dollar. Restoring the trust was not easy, because the United States in the late 1960s was in the midst of worsening fiscal deficit and inflation due to the Vietnam War. Richard Nixon, who assumed the presidency in January 1969, did not change America's preexisting currency policy, namely the "benign neglect" policy, and did not (yet) attempt to solve the dollar problem. In addition, not all countries cooperated with the U.S. to solve the problem of dollar-selling. For example, de Gaulle administration of France was critical of the dollar-gold system, and endeavored to convert the dollar to gold on a large scale for its own safety.

Japanese yen too was not unrelated to the growing instability of the fixed exchange rate system caused by the dollar-selling and gold-buying and several countries' currency revaluation and devaluation.

Reportedly a rumor of possible yen revaluation started from November 1968, from the international financial community in London and Zurich.⁸¹ In 1968, a yen revaluation was less of a reality, but after the revaluation of the mark in October 1969, it became

⁸⁰ Iwami, Tooru. *Kokusai tsuka, kinyu shisutemu no rekishi*, Yuhikaku, 1995, 122-123.

⁸¹ *Ekonomisuto*, 26 August 1969.

more likely, because, in fact, the rate of 360 yen to the dollar was apparently becoming an undervalued rate.

Earlier we saw that people's sense of overvaluation towards the yen began to mitigate from the mid-1960s and that the yen exchange rate came to adequately reflect the real competitiveness of Japanese economy. But, by the late 1960s, the yen became obviously an undervalued one, compared to Japan's economic competitiveness. For example, Kunio Miki, a professor at Sophia University referred to the point in October 1968 as follows: "At the time when the single exchange rate of 360 yen to the dollar was first set, the yen rate might have been an overvalued one, but, as a result of nearly 20 years of the unchanged exchange rate and the globalization of Japanese economy, we can say that domestic prices have adapted themselves to the yen exchange rate. The present value of the yen, when compared to the Deutsche mark which is seen as one of the strongest currencies ... cannot be seen as overvalued. The external value of the yen is stable, and we can even say that the yen has become rather stronger."⁸² Yukio Cho and Kiriro Morita's *The Yen's Future (En no shorai)* shared the same view. In it, they maintained that the rate of 360 yen was an overvalued one for Japanese heavy and chemical industry during 1955 -1964, but that it became an undervalued one from 1965.⁸³

And it was with such an advancing undervaluation that the Japanese monetary authorities, businessmen, economic experts, and the mass media's moderate support for the yen exchange rate that emerged from the mid-1960 gradually turned into an active support for it. However, as mentioned earlier, even though the Japanese economy had become largely dependent on the rate of 360 yen, if there was no possibility of a change in exchange rate and a collapse of the fixed exchange rate system, it would have been unnecessary for government officials, businessmen, and others to fear economic damage and show active support for the system. In other words, active support for the system was necessary not only because the yen exchange rate had become advantageous for the economy but also because there was a heightening possibility of a change in the yen exchange rate and a collapse of the fixed exchange rate system; as a consequence of the falling credibility of the dollar, there was an increasing possibility of dollar devaluation.

Let's first take a look at those who, although being a minority, considered a dollar devaluation as a real possibility, and warned of its impact. For example, in the February 1968 issue of the leftist magazine *Keizai* (Economy), Hitoshi Kuwano, a professor at the Department of Commerce, Chuo University, noted, "After the pound devaluation in November 1967, the international financial crisis entered an explosive stage. Dollar devaluation is now a matter of time. For more than 10 years, I have been claiming that dollar devaluation was inevitable and that the international financial crisis would break out. However, it has been a minority view until now."⁸⁴ One year later, in the January 1969 issue of *Keizai*, he expressed his unchanged opinion: "In the long term, it is impossible to maintain the fixed exchange rate [of the dollar] that has become an overvalued rate due to the progress of [the United States'] domestic inflation. There shall be [dollar] devaluation after all."⁸⁵ His analysis was not always accurate, as can be seen from his prediction that the dollar-selling would weaken the yen as well, considering the

⁸² Miki, Kunio. "En wa kokusai tsuka ni nareru." *Ekonomisuto*, 20 October 1968, 27.

⁸³ Cho, Yukio. and Morita, Kiriro. *En no shorai*. Asahi Shimbunsha, 1970.

⁸⁴ Kuwano, Hitoshi. "Kokusai tsuka kiki no hanashi (1)." *Keizai*, February 1968, 131.

⁸⁵ Kuwano, Hitoshi. "Huran kiki to doru." *Keizai*, January 1969, 55.

fact that Japanese economy was not strong enough.⁸⁶ Later it turned out to be false. However, he was accurate in his assessment of the real possibility of dollar devaluation and he accurately understood that the yen would not be free from its influence.

Takashi Murano, a professor at Kokugakuin University, also suggested the possibility of dollar devaluation as follows: "I think that ... the collapse of the dollar is possible ... What is meant by the collapse of the dollar could be many things. It does not mean that the dollar will cease to be the international currency. But it means a bold retreat of the dollar as a credit currency in the current international credit system ... The two-tier gold system ... does not seem that it would last long."⁸⁷

Also, in the January 1969 issue of the magazine *Boeki to Kanzei* (Trade and Customs), Mitsuhiro Yamada, a deputy director of the foreign news sector of Kyodo News, warned that it was not improbable that President Nixon would implement gold revaluation (dollar devaluation in effect), because the economic brains of the Nixon administration, unlike the Johnson administration, included people such as Milton Friedman who preferred the flexible rate system.⁸⁸

The views above that warned of the possibility of a dollar devaluation were more accurate, for example, than the following one. Ryutaro Komiya, a professor at the University of Tokyo, noted, "With regards to the recent gold rush and the establishment of the two-tier gold system, I think that they were not that important incidents in the current situation of international finance ... The recent speculation on gold occurred because people expected that holding gold would profit them. It does not particularly mean that the dollar was under attack."⁸⁹ Although he was accurate in assessing that the dollar would remain a solid key currency, he underestimated the fact that the gold speculation was accelerating the fall of the dollar's credibility, and thereby destabilizing the Bretton Woods system. However he admitted that, *in the long term*, there was a possibility of gold revaluation and a suspension of the convertibility between the dollar and gold. He was not against yen revaluation either.

But in reality, the situation was worsening to the extent that a suspension of the convertibility between the dollar and gold was being suggested by a U.S. government official. According to the House Report issued on April 27th 1968, Frederick Deming, then under secretary of the Treasury, stated on April 12 in a closed hearing of the Subcommittee on International Finance, the House Committee on Banking and Currency, that the U.S. Treasury was ready to examine a plan to cut the official connection between the dollar and gold, and to support the dollar through foreign exchange intervention.⁹⁰

However, regarding Deming's reference to the possibility of the suspension, Professor Asao Ono, a professor at Wakayama University, stated, "[Deming's] proposal is unrealistic in today's international relations where each country is independent. That is to say, there is no other way than to use gold as a final payment method and as the key international currency, in order to conduct international transaction. In that sense, the proposed demonetization of gold is absolutely nonsubstantive. There is no way that

⁸⁶ Kuwano, Hitoshi. "Kokusai tsuka kikino bakuhatu to amerika no makikaeshi senjutsu." *Keizai*, May 1968, 29.

⁸⁷ *Ekonomisuto*, 20 April 1968, 41.

⁸⁸ Yamada, Mitsuhiro. "Nikuson no keizai seisaku o uranau." *Boeki to Kanzei*, January 1969.

⁸⁹ *Ekonomisuto*, 20 April 1968, 36-38.

⁹⁰ Washington (Reuters) April 27.

Deming, under secretary of Treasury, would not know that point ... We can see that ... it [the proposal] ... was made in order to preempt and put the brakes on the expected future request for dollar-gold conversion by other countries.”⁹¹ In hindsight we know that this view of the situation was not correct, because eventually gold was demonetized three years later.

In the above, we have seen those who warned of the possibility of a dollar devaluation and those who denied the possibility. What can be learned from it is that the late 1960s was a period when a sense of crisis concerning the real possibility of the collapse of the dollar-gold standard system began to emerge, not a period when people widely shared the sense of crisis. But, as will be explained later, the sense of crisis gradually heightened from the late 1960s to the early 1970s.

And the same was true of the issue of the yen revaluation. Between 1968 and 1969, only a small number of people maintained that the yen could actually be the target of revaluation. In other words, the monetary authorities, economic experts, and mass media were not quite linking the dollar crisis with the issue of the yen. But, from the late 1960s to the early 1970s, as the economic situation of the U.S. and other leading countries worsened, a yen revaluation gradually became a real possibility and pressure, creating people’s active support for the fixed rate of 360 yen to the dollar and the fixed exchange rate system.

Kunio Miki, a professor at Sophia University, was one of the commentators who pointed out the possibility of yen revaluation at a relative early stage. In December 1968, he noted, “I think that the yen has become a strong currency. Japan wants to maintain the rate of 360 yen to the dollar, but if an argument about international readjustment arises, foreign pressures for a yen revaluation could increase. I am not asserting that yen revaluation is good, but that, if the present state continues, Japan will be requested by other countries to raise the value of the yen, if not to the level of the mark.”⁹²

Once the possibility of yen revaluation was mentioned as such, there began to emerge, as will be explained below, those who rejected the possibility of revaluation itself as well as those who acknowledged the possibility and showed opposition to revaluation. Whether they denied the possibility or not, they were same in that they all were against the yen revaluation.

However, there were exceptional viewpoints. For example, Mitsuharu Ito, then a professor at Tokyo University of Foreign Studies in 1969, claimed that yen revaluation was even desirable: “I think there are many ways to carry out international cooperation. Yen revaluation is one of them. Japan’s international balance of payments and domestic economy are in very good condition, and thus it is natural to implement the yen revaluation. As the Economic White Paper states, it will be the utmost cooperation Japan can offer, in our challenge against the ongoing currency crisis. Also, in the domestic economy, if the rate goes up by 5%, there will be 5% price decrease for the imports, which will amount to over 10 billion dollars ... Rather than just waiting for prices and the average wage to go up under the same exchange rate, I think that a change in the exchange rate would contribute more to equality. Moreover, a change in the industrial structure will be hastened. Revaluation is also good for building a good relationship with

⁹¹ Ono, Asao. “Kin no haika wa kanoka.” *Ekonomisuto*, 14 May 1968, 18.

⁹² Miki, Kunio. “Kotei soba ka kusshin soba ka.” *Ekonomisuto*, 17 December 1968, 40.

developing countries. However, the government will not do it because it does not have such courage.”⁹³

But there were very few experts who supported yen revaluation in this period of 1968-1969. The majority maintained that Japanese economy was not strong enough to endure yen revaluation and that it was thanks to the rate of 360 yen that Japan could eke out growth by then.

For example, Chiaki Nishiyama, a professor at Rikkyo University and an opponent of yen revaluation, commented about Japan’s increased trade surplus and foreign currency reserves in 1968 as follows: “[The increase] is achieved because Japan is protected by the greenhouse of numerous direct and indirect import restrictions. Moreover, this year’s favorable turn of currency situation, which far exceeded our expectation, was largely due to the United States’ unplanned economic overheating caused by its policies based on New Economics ... We should not be misled by our own overconfidence on the strength of the yen.”⁹⁴

In the article titled “It is premature to implement yen revaluation,” Ichiro Takeuchi, a research director at the Bank of Tokyo, expressed a similar view: “If the basic balance surplus of 1.44 billion dollars that Japan achieved in 1968 was consisted of trade balance surplus, it [the strength of Japanese economy] is the real thing, but it was not. The surplus includes the excess receipt of 1.6 billion dollars of long term foreign capital such as foreign loans, impact loans, and foreigners’ stock investments. If these are subtracted, the surplus is only 380 million dollars, and thus we should not be fooled by the expression ‘the surplus of 3 billion dollars.’ In other words, it is true that Japan is having surpluses, but it is not as large as it looks on the surface ... [The surplus trend is] not still stable because it is largely sustained by the external factor, namely the United States’ inflation boom which led to an increase in Japan’s exports. In fact, when the economy of the United States stagnated in the first half of 1967, it influenced Japan’s exports and Japan ran substantial deficits in the international balance of payments in 1967.”⁹⁵

And, as arguments against the yen revaluation began to emerge as seen above, the Japanese government began to seek a way to avoid the revaluation as well. For example, thinking that the ongoing increase in foreign currency reserves would increase foreign pressures for yen revaluation, the government attempted a reduction in the foreign currency reserves. The Bank of Japan, based on a perspective that foreign currency reserves would drastically increase in 1969, announced a policy that encouraged each exchange bank to improve their short term reserve position and accelerate the yen shift, in order to suppress the rapid increase in the foreign currency reserves. As a consequence, reportedly there had been a yen shift of approximately 800 million dollars during 8 months between May and December 1969. Moreover, in September 1969, before the General Assembly of IMF where the heads of the Ministry of Finance and the Bank of Japan planned to participate, it was decided in Japan to implement a last minute emergency measure for the reduction of foreign currency reserves that was rapidly increasing in late September. In order to achieve a reduction of 100 million dollars in one week, yen funds, which were supplied by using obligation security, were used for

⁹³ Tsujimura, Kotaro et al. “Symposium: Shin dankai no nihon Keizai to kongo no kadai.” *Ekonomisuto*, 25 July 1969, 34.

⁹⁴ Nishiyama, Chiaki. “Shinjiyushugi to nihon.” *Ekonomisuto*, 24 December 1968, 38.

⁹⁵ Takeuchi, Ichiro. “En no kiriage wa jiki shoso.” *Ekonomisuto*, 20 May 1969, 20-21.

purchasing foreign currencies from the foreign exchange special account, and those foreign currencies were used for exchange banks' repayment of Eurodollar.⁹⁶ For the same purpose, other measures were also implemented, such as increasing Japan's loan to the World Bank, overseas investment, yen-denominated export, and advancing import deregulation (although these measures had some effect in reducing the foreign currency reserves, the increase rate of the foreign currency reserves was far higher).

But in the same period, the General Administration Division of Foreign Department of the Bank of Japan drew up a report titled "Suggestions for introducing more flexibility to the exchange rate system," in which the merits and demerits of expanding the fluctuation range of foreign exchange, of crawling pegs,⁹⁷ and of the floating exchange rate system were explained. In other words, at least research on an alternative currency system existed within the circle of the Bank of Japan. But it was an investigation at best, and the report did not represent the intention of the Bank of Japan. It had no intention to accept yen revaluation.

The anti-revaluation stance of the government and the Bank of Japan remained unchanged, even as the mark-buying intensified in Europe in September 1969, and a revaluation of the mark became more likely. For example, while the speculative buying of the mark continued, Finance Minister Takeo Fukuda stated that, "Considering the reality of the Japanese economy, the Japanese yen is not in a situation to be revalued."⁹⁸ Also, Makoto Usami, then the Bank of Japan Governor, stated that "those who know Japan well do not talk about yen revaluation,"⁹⁹ implying his stance that the situation of the mark and the yen were unrelated matters.

During the same period, some scholars expressed their anti-revaluation stance as well. For example, Osamu Shimomura, who was an official in the Ministry of Finance by 1959 and later a professor, had earlier made somewhat pro-revaluation comments, but during this period he changed his stance and said, "We cannot expect a stable growth or a steady development, if devaluation and revaluation of the yen occur every time the strength [of the Japanese economy] changes."¹⁰⁰ "First of all, if we cannot know when and to what extent a change in the exchange rate would occur, there will be confusion in our business activities, which are expected to be increasingly large-scale, long-term, and global. Secondly, in an economy in which a revaluation is expected, the wage growth rate must be slower than the productivity growth rate. But such a requirement cannot be satisfied in Japanese economy. It would result in labor-management confrontations and we will not be able to maintain stable growth."¹⁰¹

Meanwhile, an important change was taking place on the international scene. Unable to withstand the intense inflow of speculative capital, West Germany temporarily switched to the floating exchange rate system on September 30th 1969, and decided to revalue the mark by 9.29% as it returned to the fixed exchange rate system on October 24th. The

⁹⁶ Saito, Yoshio. "Seifu no en kiriage taio senryaku" in *En no ronri*, Best Books, 1971, 157.

⁹⁷ Crawling peg is a form of the fixed exchange rate system which allows gradual depreciation or appreciation in an exchange rate. The pace of depreciation or appreciation is adjusted according to a formula determined by the monetary authorities. Crawling peg is aimed at preventing a sudden and significant change of the currency value, which can happen under a straight peg system.

⁹⁸ *Yumiuri Shimbun*, 26 September 1969 (Evening edition).

⁹⁹ *Nihon Keizai Shimbun*, 29 September 1969.

¹⁰⁰ *Nihon Keizai Shimbun*, 1 September 1969.

¹⁰¹ *Toyo Keizai*, 7 March 1970.

speculative capitals were so-called Eurodollars, which were dollars deposited in banks located in Western Europe. Eurodollars had become speculative capital and was inflating its size.

And, in reaction to the mark revaluation caused by speculative capital, what the Japanese government chose was not a change of the yen exchange rate or the currency system, but an unchanging adherence to the yen exchange rate and efforts to strengthen the fixed exchange rate system. For instance, after the revaluation of the mark, Finance Minister Fukuda stated at a press conference on October 25th 1969 that "because there is confidence among us that the revaluation of the mark would not have any influence on our country, we will not revalue the yen." The Bank of Japan Governor Usami also stated that the Bank of Japan intended to maintain the yen exchange rate at the same level.

The reaction among journalists was similar. Mainichi Newspaper evening edition introduced a view that "West Germany has been a surplus country for nearly ten years, while Japan ... was even worrying last year if loans from IMF were necessary or not." The newspaper reported that even the OECD headquarters in Paris understood well that the yen had been sustained by various protection measures and that the yen could not be compared and paralleled to the "naked mark." The newspaper also noted that bankers in New York and scholars laugh and say that "it will be five years before yen revaluation becomes a real issue."¹⁰² While there were such tones that negated the possibility of yen revaluation, there also were articles that concerned about the real possibility of the yen revaluation such as the article "Increased pressure on the yen" (Asahi Shimbun/Asahi Newspaper¹⁰³) and "Yen revaluation has become a real issue" (Nihon Keizai Shimbun/Nihon Keizai Newspaper¹⁰⁴). Although each had different nuance, those newspapers all shared the same assumption that Japan would suffer tremendous economic damage in the event of yen revaluation.

In academia, there also were views that there was no possibility of yen revaluation. For example, Nobuyoshi Araki, who had worked in the Ministry of Finance and then became an assistant professor at Chuo University, expressed his view that the yen was different from the mark: "Even though it is said that the yen has become a strong currency, unlike the mark, it is the strength protected by residual import restriction, regulations on capital transaction, and foreign exchange control ... Therefore, it is premature to talk about yen revaluation."¹⁰⁵ Also, Shoichi Kase, a counselor at the Research Division of the Bank of Tokyo, noted, "The yen is still an internationally unfamiliar currency, and thus it is not a currency that everyone wants to have. In addition, because Japan is implementing foreign exchange control, speculations can be curbed. Thus, we do not need to worry if speculative capital would cause a transition to the floating exchange rate system, as West Germany experienced. I think that yen revaluation will not be a real issue."¹⁰⁶

In fact, in Japan, foreigners' investment in stocks was very limited. Also, industry sectors that underwent capital deregulation through foreign investment act were not numerous either. Therefore, there was a limit in the scale of speculative capital that could

¹⁰² *Mainichi Shimbun*, 25 October 1969 (Evening edition).

¹⁰³ *Asahi Shimbun*, 25 October 1969 (Evening edition).

¹⁰⁴ *Nihon Keizai Shimbun*, 25 October 1969 (Evening edition).

¹⁰⁵ Araki, Nobuyoshi. "Tsuka chosei to en no shiren." *Ekonomisuto*, 28 October 1969, 47.

¹⁰⁶ Kase, Shoichi. Araki, Nobuyoshi. Namiki, Nobuyoshi. "Maruku no ato nani ga okorunoka." *Ekonomisuto*, 4 November 1969, 51.

flow into Japan for yen-buying. However, as became apparent later, from the late 1960s to the early 1970s, the scale of dollar-selling and yen-buying that could be carried out by Japanese exchange banks and trading companies grew beyond the government's estimates, and it later worked as a real pressure for yen revaluation. But, because politicians, monetary authorities, economic experts, and business communities in Japan had been taking the rate of 360 yen to the dollar for granted for a long time, and because they had no experience of intensive dollar-selling and yen-buying thanks to Japan's strong foreign exchange control, there were many who were not aware of the fact that ongoing capital deregulation was gradually creating an environment that enabled exchange banks and trading companies to carry out a large-scale dollar-selling and yen-buying. For that reason, many people did not realize that there was a real possibility of yen revaluation, until they were later faced with such large-scale speculation.

As seen above, there were authorities and experts who did not consider the yen revaluation as a real issue, because they assumed that Japan's foreign exchange control would block yen-buying and thus prevent yen revaluation. There certainly was a pressure for yen revaluation from the Western countries, but many economic experts in Japan interpreted that those countries had another intention.

For example, Finance Minister Fukuda stated, "There really is a pressure for yen revaluation, but it is rather a strategic move and the real intention of the pressure is to demand Japan's capital and trade liberalization."¹⁰⁷ Aforementioned Nobuyoshi Araki also noted, "The real intention of the other countries' criticism of the surplus country Japan is not to criticize Japan's resistance to yen revaluation but to deregulate import restrictions and raise the official bank rate."¹⁰⁸ Also, in the magazine *Keizai* (Economy), an unknown commentator under the pen name of Sugi noted, "There is a reason why they [foreign countries] are raising a clamor for yen revaluation. They are using the issue of revaluation as a tool for intimidation and trying to force Japan to deregulate, aid Southeast Asia, and strengthen its [military] self-defense."¹⁰⁹ Also, Einosuke Ashiya, a professor at Seikei University, stated, "We should not think that the yen revaluation itself is the request of the international community. The yen, unlike the mark and other Western major currencies, is not a currency that is used for external settlement. It is not a reserve currency either. Thus, there is no way that the yen revaluation becomes a real issue. The demand for yen revaluation is in fact an indirect way of pursuing the responsibilities of a surplus country."¹¹⁰ (However, as will be explained below, he was not against yen revaluation.¹¹¹)

But, it should not be overlooked that, after the revaluation of the mark, there began to emerge those who either perceived yen revaluation as a real possibility or supported the revaluation or suggested currency systems alternative to the fixed exchange rate system. Before looking at the anti-revaluation stance that was growing rapidly, let us briefly look at those opinions.

As the examples of the opinion that suggested alternative currency systems, there are articles such as "Examining the crawling peg system" (the October 7th 1969 issue of

¹⁰⁷ *Yomiuri Shimbun*, 5 October 1969.

¹⁰⁸ Araki, Nobuyoshi. "Tsuka chousei to en no shiren." *Ekonomisuto*, 28 October 1969, 50.

¹⁰⁹ Sugi (penname) "En kiriage rongi no imi suru mono." *Keizai*, December 1969, 161.

¹¹⁰ Ashiya, Einosuke. "Saikin no kokusai kin'yu mondai." *Boeki to Kanzei*, December 1969, 34.

¹¹¹ Ashiya, Einosuke. "Toron: Sekai Keizai wa donarunoka." *Asahi Journal*, 9 November 1969, 23.

Ekonomisuto) and “Argument on the floating exchange rate began” (the October 21st 1969 issue of *Ekonomisuto*). After the revaluation of the mark, there appeared a perception that the fixed exchange rate system was destabilizing. And, as the above titles reflected, economic experts in Japan began to argue about the crawling peg, wider band, and floating exchange rate system which had been already gaining support in the Western countries.

As an example of those who perceived the yen revaluation as a real possibility, there is Koei Narusawa, then the Bank of Tokyo’s branch manager at Hamburg. He stated, “Regardless of the fact that there is strong anti-revaluation mood in Japan and regardless of the validity of its reasoning, the mood outside Japan seems to be more hostile than people in Japan assume. In Japan, it seems that the liberalization of import and capital, the loosening of residual exchange restrictions, and active foreign aids are considered as alternative paths that would replace the yen revaluation. But it seems that people here [West Germany] doubt if those measures could really replace the necessity of the yen revaluation. In other words, they view that those measures would work to strengthen Japanese economy after all, and therefore the yen could end up being even more undervalued. They say that those measures cannot be used as an excuse for not working on the issue of the exchange rate.”¹¹² In short, he warned that the Western pressure was not just a pretense. Also, Takehei Miyashita from the Economic Research Institute, Japan Society for the Promotion of Machine Industry, stated, “Regardless of whether or not the yen revaluation is good, and despite opposition in industrial circles, there is a high possibility of a yen revaluation in near future. In the event of revaluation, I think that the yen will be revalued by 5%.”¹¹³ And he estimated the influence of the yen revaluation on various industries in the event of 5% revaluation.

As an example of the opinion that viewed the yen revaluation as desirable, there is an article titled “Round-table talk: We support the yen revaluation - Positive evaluation of the merit of revaluation” (the December 2nd 1969 issue of *Ekonomisuto*). In the article, although the three commentators Yoshitomi Ishimaru (a research director at Toyo Menka-Kaisha Limited), Hisao Kanamori, and Takashi Murano did not agree on everything, they all suggested that the yen revaluation was a desirable option, for the following reasons: The yen exchange rate was in fact working to the advantage of Japanese trade, causing other countries’ complaints; because the productivity and competitiveness of the Japanese economy have grown significantly, the yen revaluation would not give tremendous damage to Japanese export performance, nor will it cause a drastic increase in import; revaluation is effective in suppressing inflation; if austerity measures are taken to suppress inflation, growth rate will be lower, but if revaluation is implemented, growth rate will be higher; in order to avoid a drastic revaluation and big damage later, it is better to implement a modest level of revaluation in advance.¹¹⁴

Although not all of their comments were correct in hindsight, such opinions that viewed the revaluation as a real possibility were valuable ones because strong pressures for the yen revaluation really emerged in their near future.

¹¹² Narusawa, Koei. “Genchi ni mita maruku kiriage.” *Ekonomisuto*, 25 November 1969, 75.

¹¹³ Miyashita, Takehei. “En kiriage to Yushutsu kyosoryoku.” *Ekonomisuto*, 2 December 1969.

¹¹⁴ Ishimaru, Yoshitomi. Kanamori, Hisao. and Murano, Takashi. “Zadankai: En kiriage o shucho suru - kiriage merito no sekkyokuteki hyoka -.” *Ekonomisuto*, 2 December 1969.

However, during this period, there were more economic experts against the revaluation. We have already seen those who did not admit the pressure for revaluation to be a real one. In what follows, let us take a look at those who, feeling a sense of crisis, accepted the pressure as a real pressure and then opposed to the revaluation.

For example, Zentaro Matsumura, a professor at Osaka Prefecture University, asserted that the pressure that had been exerted by foreign countries was unfair: “The fact that the dollar is a key currency is used as an excuse to give pressure for the revaluation of the currency which has become stronger than the dollar. It is like aged parents holding their son down” and he continued, “Those theorists who claim that Japan has become a constant surplus country are supporting the idea of the crawling peg system and the idea that an extended range of the yen exchange rate is preferable. These ideas are contrary to the interests of a surplus country. The principle of our country’s trade is ‘small profits and quick returns’ and thus the net profit margins of exports are usually only between 2% and 3%. For that reason, industries will be damaged if strong yen continues. In the future, if the fixed exchange rate system is abolished, such damage will be constant.”¹¹⁵ In this way, he expressed his sense of crisis concerning the possible future revaluation and a collapse of the fixed exchange rate system.

Another example is the book titled *Yen Revaluation - What will happen?* (En kiriage - Sono toki donaru) published by Nihon Keizai Shinbunsha in 1969. The book showed its opposition to the revaluation and expressed a sense of crisis, arguing that the United States’ pressure for the yen revaluation is something like an underachiever demanding an honor student to stop studying. Hisao Kanamori, who worked in the Economic Planning Agency and Japan Center for Economic Research, commented on this book that “This was the general view at the time. People were afraid if the productivity and competitiveness that had been rising with continuous efforts would collapse due to the yen revaluation.”¹¹⁶

On the other hand, while in the same anti-revaluation camp, some suggested necessary measures for preventing revaluation.

A suggestion made at an early stage was the one by above-mentioned Hisao Kanamori. A few months before the revaluation of the mark, he asserted in his article “Economic growth and foreign exchange policy” (Keizai seicho to kawase seisaku) that Japan’s international balance of payments surplus must be reduced by abolishing import restrictions, expanding public investment, and accelerating foreign investment. He expected that such measures would help Japan prevent yen revaluation (though he later changed his opinion and stated that the yen revaluation was desirable).¹¹⁷

Another commentator who suggested necessary measures was aforementioned Nobuyoshi Araki. He stated, “Considering various factors, Japan’s foreign currency reserves will increase to a considerable amount in a few years. Thus, Japan should not deploy a policy that would lead to an acceleration of exports ... Japan should stop the policy that encourages the export of low price goods. Instead, we should use our money to enhance the social capital and our life environment. By doing so, we can prevent a

¹¹⁵ Matsumura, Zentaro. “Tsuyoi tsuka, yowai tsuka no chosei mondai.” *Boeki to Kanzei*, November 1969, 21, 26.

¹¹⁶ Kanamori, Hisao. “Dai 50-kai Nikkei, Keizai tosho bunkasho kinen ni yosete.” *Nihon Keizai Kenkyu Senta*, November 2007, 19.

¹¹⁷ Kanamori, Hisao. “Keizai seicho to kawase seisaku.” *Keizai Hyoron*, March 1969.

continuous accumulation of foreign currency reserves, which could invite reaction from other countries. It is necessary to change the direction of our policy in that way.”¹¹⁸ He also suggested that, after comparing the demerit of revaluation, namely a decrease in exports, and its merit, namely a rise of the people’s living standard and a suppression of inflation resulting from an increase in imports, it was premature to implement revaluation because the demerit (a decrease in exports) was larger than the merit of revaluation. He maintained that Japan should have a sufficient time in order to change its economic character and minimize the demerit regarding export. He also advised that, if foreign pressures resulting from Japan’s growing trade surplus and foreign currency reserves were expected, Japan should reduce the reserves through long-term capital export, because Japan’s surplus would continue to increase even if there was an increase in import.¹¹⁹

Also, Yushin Yamamuro, a foreign division manager of the Mitsubishi Bank, gave his suggestion as follows: “The international balance of payments, which is regarded as the most important criterion for judging the strength of a currency, has been under the influence of the government’s strict regulations on trade and foreign exchange in the postwar Japan ... When those regulations are removed and the international liquidity of the yen is enhanced, we can know the real strength of Japan’s international performance and the strength of the yen” and he continued, “If the deregulation of capital and trade continues to be slow and lags behind, Japan’s international balance of payments surplus will expand evermore. In that case, more pressures for the yen revaluation may well be imposed. Furthermore, if speculative capital inflow from overseas occurs and slips through the dragnet [of Japan’s regulations], such a force will be nonnegligible. And if such developments corner Japan to choose the yen revaluation without understanding the actual strength of the yen, it will be a tragedy for Japan. In order to avoid it, we should prepare for comprehensive measures.”¹²⁰

Toshihiko Yoshino also emphasized the necessity of active deregulation: “If we neglect promoting deregulation and think only about limiting subsidies, Japan will eventually be forced to choose the yen revaluation ... If the impact of the revaluation is expected to be huge, isn’t it natural to choose the path of promoting the liberalization of import and capital, the path of expanding economic aid, and the path of normalizing export finance, in order to avoid the revaluation?”¹²¹

While such calls for necessary measures were rising in Japan, the November 8th 1969 issue of *The Economist* (London edition) carried an article claiming the inevitability of the yen revaluation. According to the article, even if Japan promoted the liberalization of capital and trade, its rapid export increase rate would push up Japan’s foreign currency reserves, and cause other countries to impose import restriction on Japanese products. The article insisted that, because of such pressure, Japan will have no choice but to revalue the yen.

And, reflecting people’s expectation of the yen revaluation, there was a speculative buying of the yen in foreign exchange markets in Europe on November 12th 1969. As a

¹¹⁸ Kase, Shoichi. Araki, Nobuyoshi. Namiki, Nobuyoshi. “Maruku no ato nani ga okorunoka.” *Ekonomisuto*, 4 November 1969, 51.

¹¹⁹ Araki, Nobuyoshi. “Koeki joken kara mita en kiriage no sontoku.” *Ekonomisuto*, 24 February 1970.

¹²⁰ Yamamuro, Yushin. “Tsuka huan wa chukan antei e.” *Ekonomisuto*, 11 November 1969, 54.

¹²¹ Yoshino, Toshihiko. “Kaigai de takamaru en no hyoka.” *Ekonomisuto*, 18 November 1969, 54.

result, in the Tokyo foreign exchange market, the value of the yen in futures trading (10 months, interbank transaction) reached an all-time high of 354.90 yen to the dollar.¹²² It was not a big rise compared to the yen appreciation that took place later, but this development of situation made Japanese authorities and economic experts realize that the yen-buying by international capitals could actually work as a pressure for the yen revaluation.

While there was such speculation in the foreign exchange market, calls for measures to avoid the yen revaluation arose from the industries as well. For example, in the shipbuilding industry, its received orders between 1969 and the early 1970 were almost all on a dollar basis. Because contracts quoted in yen were 0% in 1968 and only 4% in 1969, a yen revaluation was expected to bring about heavy losses to the industry. According to the estimation of the Shipbuilders' Association of Japan (Nihon Zosen Kogyokai), the scale of construction in late March 1970 was 999 billion yen, and the amount of deferred payment receivables was 812 billion yen. Because the period of deferred payment was 8 years, interest of 300 billion yen had to be also received from the buyers. After all, a total of 2.1 trillion yen was exposed to a potential loss. It was estimated that a revaluation by 5% would cause a loss of 100 billion yen for the entire shipbuilding industry.¹²³ For this reason, in the report "Measures regarding the issue of exchange fluctuation" ("Kawase hendo mondai ni kan suru taisaku") written in December 1969, the Shipbuilders' Association of Japan requested the government to take the following measures that may prevent yen revaluation: "If our country faces the situation where it has to implement yen revaluation or adopt the floating exchange rate system, the foreign exchange loss related to shipbuilding industry's claims in foreign currency and orders on hand will be huge, and the shipbuilding industry could fall into a crisis. But it is almost impossible to cover these risks only by the industry's own efforts, and thus it is a difficult situation in which we have to rely on the government's bailout."

It was not only the shipbuilding industry that was expected to suffer losses by revaluation. Noboru Tsuda, a professor at Senshu University, explained the range of economic damage that could be inflicted by revaluation as follows: "With regards to heavy machineries (including power generation machine, communications machine, textile machine, mining machinery, transportation machine, motor power machine, metal processing machine, machine tools, chemical machinery, precision machinery, vehicle, automobile) and plants (including power plant, chemical plant, fertilizer plant, sugar plant, textile plant, mining plant, timber plant, machine tool plant), the current foreign-currency-denominated balance of deferred payment on export and the balance of oversea contract are estimated to be between 1 and 2 billion dollars. Thus, revaluation by 5% would result in a loss of about 36-54 billion yen ... With regards to chemical fertilizer, a buyer's market internationally, export ratio is 50%. The yen revaluation will make Japan even more difficult to compete with European fertilizer cartel ... Although the revaluation will lower the import price of naphtha (crude gasoline), the export of organic chemicals, which Japan began to pioneer, will be more difficult in the fierce international competition. Especially there will be a great impact on polyethylene goods of which 20% are exported. With regards to sundry goods and light industry products (toy, ceramic, paper, plywood, wood and bamboo goods, rubber, glass, musical instrument, sporting

¹²² *Asahi Shimbun*, 13 November 1969.

¹²³ Akiyama, Tetsu. "Susumu gyokai no en kiriage taisaku." *Ekonomisuto*, 8 December 1970, 37.

goods, miscellaneous personal goods, and smoking supplies), of which 70% are exported to the United States, there is a possibility of losing the market on a large scale unless the quality of their goods is improved and items are diversified, because of the double burden of the yen revaluation and America's preferential treatment of developing countries ... As for shipping and air cargo charges, 95% have been received in foreign currency. Expected foreign-currency-denominated revenues under the signed long-term contracts are 1.8 trillion yen, which is the same level as the shipbuilding industry. In addition, because those charges are regulated by international cartel, it is difficult for Japan to raise them alone. At a time like this when the shipping and air cargo industries' enhancement of international competitiveness is urgent, their revenue reduction will discourage their facility investment, and have an adverse effect on them.”¹²⁴

In addition, the Long-Term Credit Bank of Japan's industry workshop refers to possible economic damage to textile industry as follows: “Because the industry of synthetic fiber has heavy export dependence (38%), the impact [of revaluation] will be immense. Synthetic yarn will be less influenced because it has price competitiveness in Southeast Asian market, but the problem is the woven fabric and fabricated piece. Impacts on these goods will be huge because our competition with less developed countries is already fierce due to their labor cost and preferential tariff. The one that will be directly damaged will be the textile processing industry. If that industry suffers the impact of the revaluation, it could develop into a serious social problem because there are many small-and-mid-sized firms in the industry. Thus, there is a possibility that fiber producer lowers the fiber price in order to share the burden. Because of that, synthetic fiber producers will suffer a fall in income.”¹²⁵

Also, the Long-Term Credit Bank of Japan's industry workshop, after explaining possible impacts of revaluation on other areas in detail, distinguished between the industries that would benefit from the revaluation and industries that would suffer damage by it:¹²⁶

Positive impact (Large): Petroleum refinery, electric power

Positive impact (small): Steel, pulp and paper

Neutral: Petrochemistry, automobile, household electronic appliances

Negative impact (small): Synthetic fiber, chemical fertilizer, nonferrous metal, industrial machinery, trading company

Negative impact (large): Shipbuilding, shipping, end use textile product, sundry goods

If these are classified by causes,

Negative impact caused by lower export price:

End use textile product, sundry goods, chemical fertilizer, metallic products

Positive impact caused by lower cost of imported raw materials:

Petroleum refinery, steel, natural fiber

Positive impact caused by foreign exchange gain:

¹²⁴ Tsuda, Noboru. *Kokusai Kin'yu to en - Kiriage to denomi ni sonaeru*. Kogakusha, 1970, 255-257.

¹²⁵ Chogin Sangyo Kenkyukai ed. *En kiriage to nihon sangyo no jitsuryoku*. Toyo Keizai Shinposha, 1970, 105.

¹²⁶ *Ibid.*, 161.

Electric power, steel, petroleum refinery
Negative impact caused by foreign exchange loss:
Shipbuilding, industrial machinery, shipping, trading company

As academia and industries advanced their analysis of the impact of revaluation and deepened their sense of crisis, the government also had to examine the possibility of the revaluation. According to Yusuke Kashiwagi, then Vice Minister of Finance for International Affairs, there was a confidential research on the situation in the Ministry of Finance between November and December 1969. The research was led by Taizo Hayashi, then a deputy director of Research Division, and four secretary staffs under the name of Alpha project. After their research, they are said to have suggested that the yen revaluation was appropriate.¹²⁷ According to the nonfiction writer Ushio Shiota, they handled a wide range of issues, such as ① the outlook of Japan's international balance of payments. ② impacts of the yen revaluation on prices, growth, and international balance of payments. ③ the merit and demerit of implementing revaluation and not implementing it. ④ a simulation analysis of the yen revaluation. ⑤ grounds of the arguments for and against the yen revaluation. ⑥ a draft of Finance Minister's statement in the event of revaluation. ⑦ drawing up of anticipated questions and planned answers in preparation for reporters' questions.¹²⁸

But their opinion affirming the yen revaluation was not accepted by others in the Ministry of Finance. Yusuke Kashiwagi testifies the situation as follows: "At the time I was the Vice Minister of Finance for International Affairs, and I discussed with the deputy minister, director, and Mr. Hayashi concerning the issue. I was opposed to Hayashi's suggestion. In the International Finance Bureau, everybody including its director was opposed to the suggestion. They were against it because they thought that 'the level of national income was not yet high enough, and thus Japan needed to focus more on economic growth. For that to be achieved, it was natural for Japan to promote export and suppress import until the chronic shortage of foreign currency, which had been hampering our economic growth, is completely overcome.' They also thought that 'although Japan made trade surpluses, it did not reflect the power of the yen because the surpluses were made in a circumstance where there were import deregulations. The surpluses were partially artificial ones. Thus, what should be dealt first were the liberalization of import and other deregulations. To suddenly deal with the readjustment of the yen exchange rate is not a right order to do it.'" ¹²⁹ From this quotation, we can see that strong oppositions existed within the Ministry of Finance against the yen revaluation proposed by Taizo Hayashi.

Also, aforementioned Hisao Kanamori testified that, when the Bank of Yokohama President Takashi Ihara and an executive of Mitsui Bank publicly advocated yen revaluation, "there was administrative guidance from the Ministry of Finance that they

¹²⁷ Honda, Keikichi. and Hata, Tadao. *Kashiwagi Yusuke no shogen - Sengo nihon no kokusai kin'yushi*, Yuhikaku. 1998, 48.

¹²⁸ Shiota, Ushio. *Kasumigaseki ga furueta hi*. Saimaru Shuppankai, 1983, 71.

¹²⁹ Honda, Keikichi. and Hata, Tadao. *Kashiwagi Yusuke no shogen - Sengo nihon no kokusai kin'yushi*, Yuhikaku. 1998, 48.

should not make such an argument [in public].”¹³⁰ This shows that the government was very much against the pro-revaluation arguments.

The Bank of Japan was also examining the possibility of the revaluation in February 1970. Regarding the issue of the revaluation, there was a discussion among the mid-level executives of the Bank of Japan’s General Affairs Division (Somubu), Foreign Department, and Research Department. They concluded that it was desirable to avoid the revaluation and encourage import liberalization, because the revaluation would cause tremendous economic damage to the shipbuilding industry and others. Nevertheless, they added that it would be necessary to seriously examine the issue of the revaluation in the future if foreign pressures for yen revaluation continued to strengthen and if there to be a growing shortage of supply due to the high growth of the Japanese economy.¹³¹ Also, it is said that the top officials from the Ministry of Finance and the executives from the Bank of Japan had secret meetings from April through June 1970. These reflected the fact that the yen revaluation had become an important issue among currency authorities.¹³² However, from the below quotation of the interview of the Tadashi Sasaki, then the Bank of Japan Governor, we can see that the Bank of Japan too was just “examining” the possibility of the yen revaluation. They were not making specific plans to avoid revaluation, nor were they planning about measures that should be taken in the event of revaluation:

Question: You said that people generally and people in the Ministry of Finance and the Bank of Japan were not thinking about the yen revaluation at all, and that they all united for the maintenance of the yen exchange rate...

Sasaki: No, it was not that we did not think about it at all. I meant that they were opposed to the revaluation. There was a strong perception among us that it was still premature for Japan to revalue the yen.

Question: I heard that there were some people such as Mr. Taizo Hayashi who maintained that Japan should actively implement the yen revaluation ...

Sasaki: ... It is true that the Ministry of Finance and the Bank of Japan studied the issue, on the assumption that there eventually will be a yen revaluation someday. However, we studied it to understand what will happen in the event of the revaluation, not to assert that the yen should be revalued. I talked with Mr. Fukuda [Prime Minister Takeo Fukuda] about it. Neither the Ministry of Finance nor the Bank of Japan could say a word about the possibility of the revaluation [in public]. If we talk a little bit about it, foreign countries will interpret it as Japan’s intention to carry out the revaluation.¹³³

In the above, Sasaki says that “the Ministry of Finance and the Bank of Japan studied the issue, on the assumption that there eventually will be yen revaluation” but if they

¹³⁰ Kanamori, Hisao. “Dai 50-kai Nikkei, Keizai tosho bunkasho kinen ni yosete.” *Nihon Keizai Kenkyu Senta*, November 2007, 19.

¹³¹ *Nihon Ginko Hyakunenshi Hensan Iinkai ed. Nihon Ginko Hyakunenshi (6-kan)*. Nihon Ginko, 1986, 308.

¹³² Ito, Masanao. *Sengo nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 13.

¹³³ *Ekonomisuto henshubu. Sengo sangyoshi e no shogen 4. Kin'yu no saihensei*. Mainichi Shimbunsha, 1978, 209.

really had the assumption, they should have started to think about measures necessary in the event of revaluation. But all they did was to just examine the possibility of the revaluation. From the attitudes of the Ministry of Finance and the Bank of Japan, it is hard to think that they were considering the matter as an imminent real problem.

Meanwhile, among civilian scholars, there were some who had more sense of crisis than the government and the Bank of Japan had, and accurately pointed out the situation they were in. For example, Hitoshi Kuwano, a professor at Department of Commerce, Chuo University, explained the ongoing destabilization of the Bretton Woods System as follows: “What we learned from the experience of the devaluation of the franc and the revaluation of the mark ... is that no currency can maintain its exchange rate in the face of billions of dollars of international short-term capital migration. We learned the same lesson from the pound devaluation in November 1967. The conclusion we can derive from it is that, the SDR [Special Drawing Rights], which will be invoked from January 1st, will not be enough to withstand the sudden attack by short-term capital. For example, assuming that the total amount of SDR for allocation will be 3.5 billion dollars, the allocation for the U.S. will be only 850 million dollars and allocation for Britain will be only 400 million dollars. These amounts are not sufficient to prevent the deepening crisis of the dollar and the pound.”¹³⁴

With the destabilization of the fixed exchange rate system, more economic experts began to point out the real possibility of the yen revaluation. In late August 1970, the Research Institute of National Economy (Kokumin Keizai Kenkyu Kyokai) predicted when the revaluation would occur in its publication *Mid-term Forecasting*. According to their analysis, due to an increase in the U.S. government spending and facility investment, there will be an economic boom in the U.S. from 1971 to 1972. Because of the boom, the U.S. trade balance will deteriorate, and consequently it will begin to demand a readjustment of other countries' currency values. The institute predicted that the yen exchange rate will be appreciated to 340 yen to the dollar in the first half of 1972. In hindsight, the time that they predicted did not exactly coincide with the time when the appreciation of the yen really occurred (August 1971), and the extent of the revaluation they predicted did not coincide with the actual extent, but they were right in that the revaluation was an imminent problem. Also, Yukio Cho and Kiriro Morita, in their *The Yen's Future (En no shorai)*, stated that the revaluation will be an inevitable reality in 2 or 3 years, and suggested the Japanese government to stimulate domestic investment in order to support the industries that would be economically damaged by the revaluation.¹³⁵

As the yen revaluation came to be perceived as a real problem, there arose arguments on how the yen should be revalued and consequently the crawling peg system began to gain attention again. The advocators of the crawling peg system maintained that it would soften the damage of the revaluation because it would allow gradual a revaluation. For example, Kiyozo Miyata, then an emeritus professor at Kobe University, maintained that the crawling peg system, which allows gradual revaluation, must be adopted because there would be intensive exchange speculation if there was enough room for a drastic revaluation.¹³⁶

¹³⁴ Kuwano, Hitoshi. “Maruku kiriage to en kiriage mondai.” *Keizai*, February 1970, 111.

¹³⁵ Cho, Yukio. and Morita, Kiriro. *En no shorai*. Asahi Shimbunsha, 1970.

¹³⁶ Miyata, Kiyozo. “Kokizami kiriage an.” in *En no jitsuryoku*, Nihon Hoso Shuppan Kyokai, 1970.

On the other hand, there appeared a view that the yen revaluation was even good for Japanese economy. Especially many began to assert that the revaluation would subdue inflation. For example, Yasukichi Yasuba, a professor at Kyoto University, stated that the yen should be revalued to contain inflation because austerity measures has limit in preventing the inflation abroad from causing inflation in Japan through import.¹³⁷ Also, Mitsuaki Nakao from Mainichi Newspapers asserted in his *Much-expected yen revaluation - It is the decisive way to prevent inflation - (En kiriage taibo-ron - Inhure o husegu kimete wa koreda)* that, although the mark revaluation was not very effective in subduing inflation in Germany because timing was bad, the yen revaluation can be effective in subduing inflation because, if implemented at a right time, it will lower the price of imports, ease the supply shortage, and reduce trade surplus and foreign currency reserves as well as the excess liquidity.¹³⁸ Also, Takashi Murano, a professor at Kokugakuin University, noted that inflation, increases in Japan's surplus, foreign currency reserves, and the rate of the yen's undervaluedness (judged by comparing the purchasing power) are likely to continue, and that a deregulation of capital and trade would not be effective in solving those problems. He maintained that the yen revaluation will be the most effective way.¹³⁹ However, it was not only among researchers that the yen revaluation began to gain support. For example, according to the July 9th 1970 issue of *Nikkei Business*, 63.3% of 131 Japanese businessmen answered in a survey that they were willing to either support or accept a gradual revaluation. In late 1970, an economic commentator Morikuni Itabashi explained the merit of the yen revaluation as follows: "According to the calculation by Masahiro Tatemoto, a professor at Kyoto University, a revaluation by 10% will only slightly lower the economic growth rate to 11%, and it will only lower wholesale prices by 1.9%. It will increase consumer prices by 4.7%, and reduce the current-account surplus only by 3-4%. In theory, inflation will be moderate, surplus will be reduced, and real growth will be achieved. This is killing three birds with one stone."¹⁴⁰

Moreover, in late 1970, there were analyses that accurately predicted in what way the yen revaluation would occur. To the general opinion that speculation by foreigners (nonresidents) would not cause revaluation because there are regulations on foreigners in Japan, economic commentator Zenzo Tazawa responded that "It is not only foreigners (nonresidents) who do speculation. Japanese monopolist capital can also participate in it. Back in 1931, the Japanese were the major players in yen-selling and dollar-buying" (This incident is mentioned earlier in this chapter). He pointed out that the major player that brings about the yen revaluation could be the Japanese themselves, not foreign speculators.¹⁴¹ It was an accurate analysis, because the next year the yen revaluation actually occurred in the way he described.

The aforementioned Morikuni Itabashi explained such speculation in more detail: "If people think that the revaluation is imminent, [Japanese] exporters will try to accelerate

¹³⁷ Yasuba, Yasukichi. "En kiriage to bukka." *Boeki to Kanzei*, June 1970; Yasuba, Yasukichi. "En kiriage no chansu o ushinau - Yunyu infure boshi wa kidoteki ni." *Ekonomisuto*, 21 July 1970.

¹³⁸ Nakao, Mitsuaki. *En kiriage taibo ron - Infure o fusegu kimete wa koreda* -. Ēru Shuppansha, 1970.

¹³⁹ Murano, Takashi. "En heika mondai to sono mondai jokyo - En seisaku teisho no tame no Kenkyu noto -" (Recent Situation of the Problems of Par Value of the Yen - A Study Notes of the Proposals for the Foreign Exchange Policy of Japan), *Keizaigaku Ronshu*, Dai 36-kan, Dai 3-go, October 1970.

¹⁴⁰ Itabashi, Morikuni. "En e no kyokun." *Ekonomisuto*, 22 December 1970, 67-70.

¹⁴¹ Tazawa, Zenzo. "En kiriage rongi no mondaiten." *Keizai*, November 1970, 84.

their bill collection. Foreign importers will try to hasten the payment [for the imports from Japan]. And [Japanese] importers will try to delay the payment for imports, in order to prevent economic damages that the revaluation would incur [These methods are called “leads and lags”¹⁴²]. For instance, when West Germany implemented the mark revaluation in 1969, Germany newly gained foreign currencies amounting to as much as 6 billion dollars, and out of 6 billion, nearly 5 billion dollars were reportedly the outcome of leads and lags. The rest [1 billion] was short-term capital that moved in expectation of the mark revaluation. We should not neglect the fact that these speculative funds [leads and lags, short-term capital] accelerated the increase in [Germany’s] foreign currency reserves, and became the ultimate source of pressure for the revaluation ... Eurodollar intake or foreigners’ yen-denominated deposits could be the route of the short-term capital inflow. But our country has not been advancing the deregulation of foreign exchange control as much as West Germany ... Thus, an inflow of speculative short-term capital cannot happen in theory ... [But] Even if we can block the inflow of short-term capital, we cannot block leads and lags. People in the branches of Japanese banks and trading companies in Germany view that leads and lags alone will have enough power to bring about the revaluation.”¹⁴³ The Long-Term Credit Bank of Japan’s industry workshop also warned about the impact that leads and lags could have: “A temporary inflow of foreign currency by leads and lags could occur on a scale of around 3 billion dollars. It is necessary to be aware that such inflow of foreign currency could be intensive enough to work as an ultimate pressure for the yen revaluation.”¹⁴⁴ Such analyses were accurate in hindsight, because, as became apparent later, it was lead and lags that made Japan temporarily abandon the fixed exchange rate system in 1971.

And people did more than just argue. They actually took steps. Although more people began to expect or support the yen revaluation, the government and the Bank of Japan endeavored to maintain the status quo. In such a situation, rather than relying on the government, some private companies launched their own measures to prepare for the revaluation.

For example, as mentioned above, in early 1970 the shipbuilding industry had demanded that the government take measures to prevent revaluation, but by late 1970, shipbuilding companies had advanced their preparation on their own. For example, Ishikawajima-Harima Heavy Industries (later renamed IHI Corporation) began to receive orders on a yen basis. Earlier, the firm had received orders usually on a dollar basis, but 97% of the firm’s received orders from 1970 were orders on a yen basis. Including the earlier orders, only 33% of all the orders they had were on a yen basis but, for the orders that were quoted in foreign currency, the firm made contracts in a way that made trading companies bear the foreign exchange risk.¹⁴⁵

¹⁴² “Leads and lags” refer to the increase or decrease in the speed of payments received from foreign exchange transactions. An acceleration of transaction is known as leads. Leads occur when an increase in the exchange rate is expected. A deceleration of transaction is known as lags. Lags occur when a decrease in the exchange rate is expected. Leads and lags are used in an attempt to avoid foreign exchange losses and increase gains in case of a change in the exchange rate. See Investopedia. “Leads And Lags.” 2012. Web. 1 August 2012. <<http://www.investopedia.com/terms/l/leadsandlags.asp#axzz22IU42OyD>>.

¹⁴³ Itabashi, Morikuni. “En e no kyokun.” *Ekonomisuto*, 22 December 1970, 67-70.

¹⁴⁴ Chogin Sangyo Kenkyukai ed. *En kiriage to nihon sangyo no jitsuryoku*. Toyo Keizai Shinposha, 1970, 208.

¹⁴⁵ Akiyama, Tetsu. “Susumu gyokai no en kiriage taisaku.” *Ekonomisuto*, 8 December 1970, 36-37.

It was not only Ishikawajima-Harima Heavy Industries that prepared for the revaluation. According to the research by Japan Ship Exporters' Association (Nihon Senpaku Yushutsu Kumiai), out of 226 ships (1.75 billion dollars) for which Japanese shipbuilding companies made export contracts from April to late October 1970, contracts for 102 ships (1 billion and 133 million dollars) were on a yen basis, comprising 64.7% of the entire number. In November, yen-denominated contracts increased further, so that, out of 38 export ships, contracts for 27 ships were on a yen basis, whereas 3 were cash-based, and only 8 were quoted in foreign currency. And even the 8 contracts quoted in foreign currency were made on favorable terms; there was an improvement in the ratio of down payment, and a shortening of deferred payment period, or inclusion of a yen clause.¹⁴⁶ In such a manner, shipbuilding industry was rapidly advancing their preparation for the yen revaluation.

Meanwhile, in the automobile industry, although being an exceptional case, Nissan made yen-denominated contracts in 1970 with British dealers for the export of finished cars. For the export of auto parts to India, Nissan made a yen-denominated contract with the Indian government.¹⁴⁷

Also, in the camera industry, Nikon accumulated an exchange fluctuation fund in September 1970, which amounted to 200 million yen. The firm implemented a transition from foreign-currency-denominated to yen-denominated contracts. Minolta succeeded in making a yen-denominated contract (about 1 billion yen) with Agfa (Belgium) for 8mm cameras. Also, from 1971, Canon began to add an escalator clause when they made contracts. However, a transition to yen-denominated contracts was not a smooth process because the success of the transition depended on the power relationship between the Japanese companies and the export destinations.¹⁴⁸

We cannot look at every industry, but generally speaking, industries with a seller's market found it relatively easy to make yen-denominated contracts. In non-seller's market, such as plant manufacture, it was relatively difficult.¹⁴⁹ Because there were many industries that could not take effective measures to prepare for the yen revaluation, there still was strong opposition to it in the early 1970s. Such opposition viewpoints are quoted below. They were more or less similar but I quote them all to demonstrate that there really were many opponents.

For example, Yoshio Miyake, a professor at Rikkyo University, noted, "The strength of the yen is based on the protection of residual import restriction, regulations on capital transaction, and the strict foreign exchange control (Japanese residents cannot freely deposit their money in foreign banks or invest in foreign securities). Thus, the real power of the yen will not be clear unless we get rid of those protections."¹⁵⁰

Also, Japan Economic Research Council (Nihon Keizai Chosa Kyogikai) expressed its view that, despite constant surpluses that Japanese industries were making, it was difficult to judge whether or not those industries could withstand the revaluation because

¹⁴⁶ Saito, Yoshio. "Kigyo no en kiriage taio senryaku." *Boeki to Kanzei*, June 1971, 157.

¹⁴⁷ Shimazaki, Eiji. *En kiriage no kenkyu*. Foto Nipponsha, 1971, 289.

¹⁴⁸ *Ibid.*, 291.

¹⁴⁹ Akiyama, Tetsu. "Susumu gyokai no en kiriage taisaku." *Ekonomisuto*, 8 December 1970, 37–38; Shimazaki, Eiji. *En kiriage no kenkyu*. Foto Nipponsha, 1971, 295.

¹⁵⁰ Miyake, Yoshio. "En kiriage ni tsuite no kosatsu." *Boeki to Kanzei*, January 1970, 35.

they had been supported by the protective system. Thus, the Council maintained, what should be dealt first were the liberalization of trade and foreign exchange, tariff reductions, and the expansion of foreign investment. They said, if Japan's surplus continued to grow despite such measures and if international troubles emerged because of the surplus, and then it was necessary to implement the yen revaluation.¹⁵¹

Takeo Kajiyama, a professor at the University of Kitakyushu, also opposed the revaluation as follows: "When discussing the status of the yen, the most important thing is to unveil the real value of the yen in order to evaluate it. Of course, the veil refers to numerous overprotection policies such as the lingering capital restrictions, strict residual import restriction, foreign exchange control, and the protection of exports. The target of residual import restriction is going to be reduced to 98 items from this April [1970], but it is still more than twice the number of restricted items in West Germany. Moreover the process of capital deregulation is lagging far behind. This year, the pressure for liberalization is increasing across many industries."¹⁵²

Also, Osamu Shimomura warned that a revaluation could invite another revaluation, instead of bringing an end to the issue. He thus maintained that a series of liberalization measures should be taken instead of the revaluation. He noted, "It is because we maintain the rate of 360 yen to the dollar that Japanese economy is making a constant and strong current account surplus, and achieving rapid economic growth."¹⁵³

Also, Kamekichi Takahashi, then a professor at Takushoku University, opposed the revaluation for the following reason: "Because heavy and chemical industries are newly-risen industries, the industries' profit margin is small ... While companies of West Germany have small ratio of debt loan, the ratio is 80% as for Japanese companies. In that situation, the revaluation will cause much damage to the Japanese economy because the interest and principal of their debt loan will increase due to the revaluation. In other words, there is a high possibility that damages deriving from the revaluation could weaken the momentum of industrial development, and significantly lower their ability to increase the amount of loans. Especially, there will be huge damage to small and medium firms in primary product industries such as agriculture, forestry and fisheries as well as small and medium firms in light industry, because many of them are weak and already close to break-even point."¹⁵⁴

There also were opinions that skeptically viewed the revaluation's potential effect on subduing inflation. For example, Jiro Yao, a professor at Kobe University, maintained that the alleged effect of the revaluation on price suppression was not certain in places like Japan where there was strict import restriction: "There is a view that the revaluation would lower the import prices, and then the lower import prices would lower the domestic prices. But such price effect cannot be fully realized under the import restrictions and domestic market competition. In a circumstance where trade deregulation is incomplete and imports are restricted, the reduced import prices will only contribute to the importers' profit margin and not contribute to a lowering of domestic prices. In

¹⁵¹ Nihon Keizai Chosa Kyogikai. "Kokusai tsuka oyobi kokusai kin'yu mondai ni kansuru teigen." *Ekonomisuto*, 18 August 1970.

¹⁵² Kajiyama, Takeo. "En no kashohyoka wa honmono ka." in *En no ronri*, Best Books, 1971, 110.

¹⁵³ Shimomura, Osamu. "360 en reito o kenji subeshi." in *En no jitsuryoku*, Nihon Hosho Shuppan Kyokai, 1970, 123.

¹⁵⁴ Takahashi, Kamekichi. "Kokuminteki mainasu." in *En no jitsuryoku*, Nihon Hosho Shuppan Kyokai, 1970, 87.

addition, if there is cartel-like price maintenance through price control, commodity prices will not necessarily reflect the reduced prices of imported raw materials. Trade liberalization and an increased competition in domestic market are prerequisites for achieving the desired price effect of the revaluation.”¹⁵⁵

Also, Makoto Hatano, a professor at Musashi University, stated, “If the yen is revalued, the prices of imported raw materials would decrease, and thus there will be an incentive for lowering the domestic prices. But at the same time, the revaluation will force exporters to lower the price of their exports. Because of it, a recession and rationalization will be unavoidable, and we can predict a drop in the national income as well. Just as the effect of currency devaluation is only temporary, the effect of currency revaluation is also temporary. In our time when the oligopolistic system is keeping prices from falling, the revaluation’s effect on price stability is doubtful. The experience of the mark of West Germany demonstrated it.”¹⁵⁶

Meanwhile, the Japanese government was continuing its opposition to yen revaluation, and the government and the Bank of Japan were only reviewing the possibility of the revaluation, as explained above. Because their reviews were meant to be internal and secret, even the aforementioned Taizo Hayashi, who suggested that the Ministry of Finance implement the revaluation, criticized those who publicly expressed their support for the revaluation, as journalist Nobuhito Kishi illustrates: “Toshio Shishido, who retired as the head of Research Bureau of the Economic Planning Agency and then became the director of Nikko Research Center, was invited by the Association for Investment Management and Research (United States) to give a lecture in New York on New Year’s Day in 1971. There, he expressed his own view that a yen revaluation can happen in the end, even though the Japanese government stated that the revaluation was out of the question. When he returned to Japan, there was a call from Taizo Hayashi, then the Deputy Director of International Finance Bureau. Shishido was told by Hayashi in an emphatic tone that he should not talk in public as he did even outside Japan.”¹⁵⁷ In short, it was not only that there were many who were opposed to the yen revaluation in the Ministry of Finance and the Bank of Japan. Even someone like Taizo Hayashi who suggested within the circle of the Ministry of Finance the implementation of the yen revaluation was opposed to those who publicly expressed their support for the revaluation.

Although there were some supporters of the revaluation in the government as mentioned above, it was taboo to make statements about the yen revaluation in public space. According to the recollections of Toshihiko Yoshino, “It was not that there was no one within the government or the Bank of Japan who saw the inevitability of the yen revaluation. But until the Nixon Shock, such view was treated as strictly confidential and controlled strictly to prevent it from leaking. Moreover, both executives and regular employees were agreeing that they show a consistent anti-revaluation stance externally.”¹⁵⁸

But, as the U.S. international balance of payments worsened and the credibility of the dollar fell, the pressure for yen revaluation gradually heightened. The U.S. trade balance

¹⁵⁵ Yao, Jiro. “Bukka mondai e no koka.” in *En no jitsuryoku*, Nihon Hoso Shuppan Kyokai, 1970, 140.

¹⁵⁶ Hatano, Makoto. “En kiriage ron no kongen o tou.” *Boeki to Kanzei*, January 1971, 24.

¹⁵⁷ Kishi, Nobuhito. *Keizaihakusho monogatari*. Bungei Shunju, 1999, 157-158.

¹⁵⁸ Yoshino, Toshihiko. *En to doru - Endaka e no kiseki to haikai*. Nihon Hoso Shuppan Kyokai, 1987, 169-170.

surplus gradually dropped from the mid-1960s and it finally fell into the red in 1971. Capital balance was in good shape in 1969 because of the strong dollar policy, which invited capital inflow into the United States, but intensive capital outflow occurred in 1970 when the Nixon administration stopped its strict monetary policy in order to take an aggressive fiscal policy. On the other hand, Japan's trade balance surplus inflated as follows: Trade surplus was 377 million dollars in 1964, 1.91 billion dollars in 1965, 2.275 billion dollars in 1966, 1.15 billion dollars in 1967 (temporarily reduced), 2.529 billion dollars in 1968, 3.699 billion dollars in 1969, and 3.963 billion dollars in 1970. With the improvement of the international balance of payments, Japan's foreign exchange reserves, which used to be about 2 billion dollars between the second half of 1960 and the first half of 1968, began to rapidly increase from fall 1968, and soared to 2.935 billion dollars in January 1969, 3.617 billion dollars in January 1970, and 4.532 billion dollars in January 1971.

As the U.S. international balance of payments worsened and the Japanese economy continued its good performance, the U.S. government and business community's complaints about Japan and their pressure for yen revaluation increased. For example, looking back at the year 1970, Paul Volcker, later Chairman of the Federal Reserve, commented as follows: "The official American government brochure about the Japanese economy described it as fragile, vulnerable, and prone to recurrent balance of payments difficulties. That description plainly no longer fit the facts, although it had probably been written only two or three years earlier. Certainly, the American businessmen knew it didn't fit what they were seeing in the marketplace. I was not at all sure, however, that the Japanese representatives comprehended the complaints all that well."¹⁵⁹ In 1971, such complaints grew bigger. For instance, *Annual Report of the Council of Economic Advisers*, announced with *the Economic Report of the President* in February 1971, stated that "No matter what constraints the Government imposes on the domestic economy, and no matter how many measures it adopts to alter or control individual categories of international transactions, the United States will not be able to abolish its balance-of-payments deficits if most of its major trading partners establish exchange rates and follow other balance-of-payments policies that enable them to run surpluses over and above their SDR allocations."¹⁶⁰ Although neither Japan nor the yen were referred to, the content of the sentences fit the situation of Japan the most, and thus we can see that it was an indirect criticism of Japan's adherence to the exchange rate of 360 yen to the dollar.

However, the Japanese government did not change its anti-revaluation stance. For example, on February 23rd 1971, Prime Minister Eisaku Sato clearly stated in the general meeting of Economic Council (an advisory body to the Prime Minister) that, "We will deploy our domestic policies on the assumption that we will not consider the possibility of yen revaluation." Finance Minister Takeo Fukuda also stated in the Upper House Committee on Finance that "We will not consider yen revaluation even if our foreign currency reserves increase more."¹⁶¹

Also, when David M. Kennedy, a former Secretary of the Treasury, visited Japan as the President's special envoy, he reportedly suggested that Japan widen the range of

¹⁵⁹ Volcker, Paul. and Toyoo Gyohten. *Changing Fortunes*. Times Books, 1992, 70-71.

¹⁶⁰ Economic report of the President: transmitted to the Congress February 1971, 151
(See the online resource Fraser Federal Archive <http://fraser.stlouisfed.org/publications/ERP/issue/1214>).

¹⁶¹ Kishi, Nobuhito. *Keizai hakusho monogatari*. Bungeishunju, 1999, 157.

foreign exchange fluctuation. But it is said that Finance Minister Fukuda rejected the suggestion.¹⁶²

The reason the Japanese government firmly adhered to the anti-revaluation stance was that it was afraid of economic losses that would result from a revaluation. Toyoo Gyohten, who later became the Vice Minister of Finance for International Affairs, explained the situation as follows: “On the Japanese side, we now realize in hindsight that the underlying structure of our balance of payments had become very solid by the middle of 1960, although we were still subject to fluctuations and in fact ran a rather serious current account deficit in 1967. We therefore still believed ourselves to be very vulnerable, and when our external accounts started yielding large surpluses in 1970 and 1971, we thought it was the result of the cyclical domestic slowdown during those years. Corporate profits were deteriorating, stock prices were falling, and production was very stagnant. The shift to a policy of domestic expansion in the United States raised a strong demand for our exports, while peculiar factors such as a long dock strike in the United States blocked American exports while Japanese textile producers were rushing shipments to the United States in anticipation of the voluntary export restraints. With the underlying situation thus disguised, we thought the appropriate countermeasure was not to revalue the yen, because that only would have aggravated our domestic slowdown ... a majority of Japanese lacked confidence in our balance of payments structure and feared that revaluation would dampen the economy.”¹⁶³

Yoshiharu Kitada, a professor at Tokyo Keizai University, stated the same point. According to him, the Japanese government and business leaders had the following perception: “They were aware that one of the major causes of Japanese economic growth was the maintenance of the fixed exchange rate of 360 yen to the dollar. Japan just got out of its chronic balance of payments difficulties. Since Japanese exports rely largely on their price competitiveness, there is a view that revaluation would cause more damage to Japan than it did to West Germany. Because Japan just got out of its recession, they think that Japan can fall into a serious recession, if the yen is revalued at this important moment.”¹⁶⁴

In short, because the Japanese government and business leaders thought that Japan’s surplus was not quite based on a solid strength of the Japanese economy but that it was very much dependent upon international economic circumstances and Japan’s protection policies, they feared that a yen revaluation might expose Japan’s economic vulnerability, and bring about a collapse of what they had so far accumulated.

But, in the private sector, there was a heightening sense of crisis that yen revaluation may eventually happen, and economic experts argued that there was an urgent need for reducing Japan’s foreign currency reserves in order to avoid yen revaluation. For example, we can see from the title of the article “Rapidly increasing foreign currency accelerates the yen revaluation” (*Ekonomisuto*, April 13, 1971) that the issue of foreign currency reserves was emerging as a focal point. Moreover, in the face of foreign pressures that demanded Japan’s surplus reduction, some began to emphasize more the need to provide measures that would contain the damage in the event of revaluation. For example, Hamao Okura, an economic critic, warned that “Considering the status of the

¹⁶² Kitada, Yoshiharu. “Maruku no doyo to en.” *Keizai*, July 1971, 204.

¹⁶³ Volcker, Paul. and Toyoo Gyohten. *Changing Fortunes*. Times Books, 1992, 91-92.

¹⁶⁴ Kitada, Yoshiharu. “Maruku no doyo to en.” *Keizai*, July 1971, 208.

yen within the IMF currency system, and comparing the views that consider the yen as overvalued and undervalued, an adjustment of the yen exchange rate is a ‘real possibility’ and we should not close our ears to its approaching footsteps.”¹⁶⁵ Shigeo Horie, the former chairman of the Bank of Tokyo, stated that “The yen revaluation will inevitably occur in one or one and a half years. In order to avoid friction, it is desirable to adopt the wideband system, which allows a widening of the range of foreign exchange fluctuation, rather than simply implement [sudden] revaluation.”¹⁶⁶

On the other hand, there were some who held that the implementation of yen revaluation should be positively reviewed, considering its inevitability. For example, concerned over the intensifying conflicts among countries, Kazutaka Kigawada, then the chairman of Japan Association of Corporate Executives, stated on April 14th 1971 that “Yen revaluation, which has become a focal point, is becoming more and more a reality. Thus it is worth carefully examining the necessary conditions of revaluation, and we should proactively judge the matter from a standpoint of international cooperation.” However, the Ministry of Finance and the Bank of Japan countered that “it gives us trouble when a responsible business leader like him speaks about the important issue [in public].”¹⁶⁷ Reportedly, “both political and business circles almost unanimously criticized his statement.”¹⁶⁸

Thus, there were strong concerns about and opposition to revaluation within the government and business community in 1971, and such an atmosphere suppressed the possibility of realistic arguments and policies regarding the issue.¹⁶⁹ Instead of providing measures that would reduce economic damage in the event of revaluation, the Japanese government moved on to provide measures for ‘preventing’ the revaluation. As one such measure, the Ministry of Finance loosened its foreign exchange control on May 1st, 1971 in order to escape foreign pressures for revaluation, and announced that it will extend the holding period for claimable assets in foreign currency, relax restriction on trading company’s foreign currency deposits, and raise the maximum amount of foreign currency that travelers could take out of the country.¹⁷⁰ It was decided that these measures would be implemented the following June.

However, regardless of these measures taken by Japan, the global economic situation shifted in a way that increased the pressure for yen revaluation. Because of the growing global distrust of the dollar, there began an intensive inflow of speculative capital into West Germany in early May 1971, and massive dollar-selling and mark-buying occurred. Speculation targeted other European currencies as well. Reportedly, speculative capitals that flowed into West Germany immediately before the mark revaluation in 1969 were 5 billion dollars, whereas speculative capital inflow between the early 1971 to May 1971 reportedly exceeded 10 billion dollars (During the three days of massive speculation in early May, capital inflow amounted to over 2 billion dollars). As a result of such overwhelming scale of speculation, the Bundesbank decided to abandon its mark-selling

¹⁶⁵ Okura, Hamao. “En kiriage no taisaku o isoge.” *Ekonomisuto*, 20 April 1971, 44.

¹⁶⁶ *Ekonomisuto*, 27 April 1971, 3.

¹⁶⁷ *Nihon Keizai Shimbun*, 15 April 1971.

¹⁶⁸ Tagami, Kyoji. “Zaikai, seifu no en taisaku hihan.” *Keizai*, November 1971, 58.

¹⁶⁹ Kojo, Yoshiko. “Baburu keisei, hokai no haikai toshite no nichibei keizai kankei” in Muramatsu, Michio and Okuno, Masahiro eds. *Heisei Baburu no Kenkyu (ge) Hokai hen*, Toyo Keizai Shinposha, 2002, 349-51.

¹⁷⁰ Zenkoku ginko kyokai rengokai. *Kin'yu*, dai 291-go, June 1971, 55-56; requoted from Ito, Masanao. *Sengo nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 251.

and dollar-buying interventions. On May 10th, Germany and the Netherlands made decisions to temporarily shift to the floating exchange rate system. At the same time, the Swiss franc and the Austrian Schilling, attacked by the speculation, were upwardly revalued by 7.07% and 5.05% respectively.

Looking back those days, Yusuke Kashiwagi noted, “In May ... I happened to be in Paris, and witnessed the fierce speculative mark buying. Because it reflected a crisis of the dollar, I had an intuition that it would inevitably have an impact on the yen as well.”¹⁷¹ In fact, the speculation in Europe led to speculative buying of the yen. On May 6th 1971, the interbank spot trading of the dollar in Tokyo foreign exchange market showed a record high 349 million dollars, and on May 8th, there were 66 million dollars of spot trading, which was 6.7 times more than the usual trading amount. On May 10th, as West Germany shifted to the floating exchange rate system, yen-buying rapidly increased in European foreign exchange markets, and in London, Japanese banks went as far as to stop yen trading.¹⁷²

However, amid the heightening threat caused by speculation, the Japanese government did not alter its attitude. Finance Minister Takeo Fukuda stated that “[In Japan] the short-term inflow of capital is checked under the foreign exchange control, and thus there is no possibility of yen speculation,” and also that “we will adhere to the current international currency system. Japan does not need to change its attitude.”¹⁷³ On the other hand, the Bank of Japan lowered the official bank rate on May 8th from 5.75% to 5.5% in an attempt to assist the government’s intention to prevent yen revaluation.¹⁷⁴ The lowering of the official bank rate was meant to stimulate imports and reduce an embarrassingly large excess in exports over imports.¹⁷⁵ Also, Tadashi Sasaki, the Bank of Japan Governor, denied the possibility that foreign pressures would cause yen revaluation: “Because it is the sovereign right that decides a change of its exchange rate, it is a matter in which foreign countries do not intervene.”¹⁷⁶ On May 14th, Keidanren (Japan Business Federation) in its council made clear its agreement with a report submitted by the Advisory Committee of the Council of Economic Research, which stated that “The yen revaluation in the midst of recession will invite a panic,” and announced its anti-revaluation stance. On May 17th, Prime Minister Eisaku Sato stated in a Keidanren meeting that “We would like to maintain the current yen exchange rate, and achieve stable economic growth through appropriate policies. For that, we should make further efforts to promote liberalization, economic cooperation with foreign countries, and well-ordered exports.” Also, in the forth meeting of the Pacific Basin Economic Council that was held in Vancouver in May, Yoshizane Iwasa, then the chairman of the Fuji Bank and one of the top business leaders, stated that “Yen revaluation is an issue that should be examined only after we see a progress in the loosening of import restrictions and capital liberalization.” Another participant in the meeting from Japan, Shigeo Nagano, then the president of the Japan Chamber of Commerce and Industry (Nihon Shoko Kaigisho), also

¹⁷¹ Honda, Keikichi. and Hata, Tadao. *Kashiwagi Yusuke no shogen - Sengo nihon no kokusai kin'yushi*, Yuhikaku, 1998, 48-49.

¹⁷² Ito, Masanao. *Sengo nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 251.

¹⁷³ *Nihon Keizai Shimbun*, 7 May 1971.

¹⁷⁴ “En mondai ni tsuite no sosai no kenkai.” (internal document of the Bank of Japan)

¹⁷⁵ Ofusa, Junnosuke. “Japan Pushed Near Yen Choice.” *The New York Times*, May 12, 1971.

¹⁷⁶ *Nihon Keizai Shimbun*, 11 May 1971.

said that “The majority view within the Japanese government and business circles is that it is premature to discuss yen revaluation in the current situation.”¹⁷⁷

From its anti-revaluation stance, the Ministry of Finance announced on May 17th that it would implement following measures immediately: The first measure was a regulation on the amount of export prepayment.” In other words, it was a regulation on ‘leads and lags,’ which Japanese companies overseas were beginning to carry out. That is to say, anticipating that the yen would be revalued after the revaluation of the mark, they borrowed dollars from the Japanese exchange banks and foreign banks in the foreign countries where their branches were, and sent those dollars to Japan in the form of advance payment for imports, so that they could convert dollars to yen before revaluation took place. Because intensive leads and lags could invite a yen revaluation, the above measure was taken to regulate their funding sources.¹⁷⁸ Another measure was a regulation on non-residents’ investment in public bonds. In the United States, if an investor invested in foreign securities for less than one year, interest equalization tax was exempt, and thus Americans tended to make short-term external investment. But the above measure in principle prohibited such investment in Japan.¹⁷⁹ This measure was taken because foreigners were actually increasing their purchase of Japanese public bonds. According to *Ekonomisuto*, “It is said that the Western shipowners, who made contracts with Japanese shipbuilding companies on a yen basis, are buying Japanese bank debenture bonds as a hedge against yen revaluation. During the two days of [May] 14th and 15th, which was immediately before the announcement of the above measures by the Ministry of Finance, foreigners bought an enormous volume of Japanese public bonds amounting to 55 million dollars. In March and April, the buying was around 100 million dollars per month, but we expect that it would jump to 200 million dollars in May.”¹⁸⁰

In this way, the government attempted to cut off the route of speculation in advance, in order to prevent speculative capitals from causing a yen revaluation. But, as later became clear, the above measure was not sufficient for achieving the goal. The government, the Bank of Japan, and some economic experts were underestimating Japanese exchange banks’ and trading companies’ ability to finance themselves in foreign countries and transfer capitals. For example, in the magazine *Ekonomisuto*, an anonymous commentator under the pen name of Y stated, “The potential major route of yen speculation was leads and lags as well as public bonds, but the Ministry of Finance and the Bank of Japan just made a decision that left little room for speculative capitals to enter. They basically put a lid on them. Capital inflow on a scale that West Germany experienced is almost unthinkable [in Japan], because there are double and triple layers of barriers. Because of measures such as the Bank of Japan’s regulation on short-term funds, which had been implemented from July 1964, the Bank of Japan’s regulation on yen conversion, which had been implemented from February 1968, and its indirect measures related to foreign exchange reserves, there is almost no room for speculative short-term capitals to enter Japan beyond the scale intended by the Ministry of Finance and the Bank of Japan. The leaders of the Bank of Japan are very pleased with the fact that the

¹⁷⁷ Tagami, Kyoji. “Zaikai, seifu no en taisaku hihan.” *Keizai*, November 1971, 58.

¹⁷⁸ Ito, Masanao. *Sengo nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 252.

¹⁷⁹ *Ibid.*

¹⁸⁰ Y (pen name). “Okurasho, en toki kisei ni ugoku.” *Ekonomisuto*, 1 June 1971, 9.

regulatory actions taken by the Ministry of Finance had an immediate effect: On the 18th, the day after the above regulatory measures were announced, dollar-buying increased in the Tokyo foreign exchange market, and consequently the Bank of Japan did not need to implement its intervention purchase after 45 days of consecutive interventions. A leader of the Bank of Japan showed a high-handed attitude, stating ‘Even if one criticizes these measures as against the trend of capital liberalization, we are not in a situation to consider such thing.’”¹⁸¹ However, as we will discuss in the next chapter, the government’s regulation on leads and lags, after all, was insufficient in preventing the huge scale capital transfer that Japanese companies were capable of carrying out.

The above commentator at least mentioned leads and lags, but most monetary authorities and economic experts did not consider the issue of leads and lags at all. For example, Yasutsugu Kodama, a division manager of business planning of the Sanwa Bank, stated, “Because foreign exchange control remains in Japan, and Japan is far from Europe and the U.S., there is no need to stir up a great fuss about the possibility of revaluation right now. On the occasion of the mark revaluation in 1969, I was asked to explain how foreigners view [the possibility of yen revaluation] but it almost did not become an issue. Back then, there were some articles on newspapers and magazines about the yen, but serious-minded people in financial industry did not consider it as a real issue. I think we can say the same thing about the impact [of the recent dollar-selling in Europe]. Japan has safe foreign exchange control and thus yen speculation cannot occur, although stock and bond investment on a small scale may be possible. I do not think it is good to argue about yen revaluation among the Japanese ... It is a leap of logic to think that the yen will be the next after the mark.”¹⁸² From this statement, it is clear that he missed the possibility that Japanese companies’ leads and lags could be the cause of yen revaluation.

Osamu Shimomura, formerly of the Ministry of Finance and later an influential economist, also missed the point. He said, “There was instability in the foreign exchange market of West Germany. As a result of discussions in the EC, West Germany decided to allow more flexible fluctuation of its exchange rate, although with some restrictions. That stimulated people’s idea that the issue of revaluation was something unavoidable and that the yen would be the next currency to revalue. But that is a misunderstanding. West Germany had already been completely abolishing foreign exchange control. A currency in such a situation is vulnerable to exchange speculation, and thus wide band system could be the only choice for withstanding the speculation. But speculation cannot occur in a country where there is foreign exchange control on short-term capitals. Thus it is wrong to say that Japan will be the next country to revalue after West Germany.”¹⁸³ Here again, there was no caution about leads and lags.

But, while monetary authorities and economic experts expressed their skeptical views of yen revaluation and endeavored to prevent it, foreign pressure for yen revaluation was in fact becoming stronger after West Germany’s temporary shift to the floating exchange rate system.

¹⁸¹ *Ibid.*

¹⁸² Araki, Nobuyoshi. and Kodama, Yasuji. “Tsuka kiki judai na kyokumen ni.” *Ekonomisuto*, 18 May 1971, 36-37.

¹⁸³ Shimomura, Osamu. “Honshitsu o kaku en kiriage ron.” *Ekonomisuto*, 8 June 1971, 16.

For example, Senator Jacob Javits stressed the need for a revaluation of the yen in a Senate speech on May 12th 1971.¹⁸⁴ On May 17th 1971, in the Subcommittee on International Trade, Senate Finance Committee, the Secretary of the Treasury John Connally also stated that the yen was an undervalued rate. At a press conference in Japan on May 24th, the U.S. Assistant Secretary of State Philip Trezise added to the pressure for yen revaluation by stating that, although yen revaluation was a matter that should be decided by the Japanese government, his personal view was that the yen exchange rate was an undervalued one. He also noted that the Japanese government should examine the yen issue, because Japan's international balance of payments and foreign currency reserves were in good conditions.¹⁸⁵ Also, on May 24th, The New York Times reported about growing pressures for yen revaluation: "The seemingly radical idea of imposing a special tariff on all goods from Japan unless the yen is revalued upward is now being taken seriously in the United States Government ... The idea is far from being adopted. But ... One very high official made known his belief this month in the wake of the brief international monetary crisis that the yen is probably 'undervalued' by as much as 20 per cent ... The view that is held widely throughout the Government - and in many foreign countries as well - is that the yen is the only important currency in the world whose international exchange value, its 'parity,' is clearly and seriously out of line. This is particularly the case now that several European countries have increased the value of their currencies."¹⁸⁶ In addition, at the International Monetary Conference in Munich in late May, where the central issue was on how to deal with the floating exchange rate of the mark, the participating representatives reportedly shared the perception that Japan would be the next target after Europe. Thus, after they discussed the issue of the mark, they began to criticize Japan for doing nothing while other countries whose currencies had become strong against the dollar already took some sort of measures for [maintaining the status of] the dollar. Only Japan, they noted, had no concrete policy on the matter and that Japan was even heading in an opposite direction, continuing import restriction and export promotion.¹⁸⁷

Meanwhile, some economic experts in Japan suggested that yen revaluation may not be avoided just by promoting liberalization on a small scale. For example, in the article "The current exchange rate and national profit - Responsibility for the risk of an exchange rate change-" written on May 15th (published in the July 1971 issue of the magazine *Boeki to Kanzei*), Yoshio Saito, then an assistant professor at Chuogakuin University, stated his criticism as follows: "Either because policymakers lack the understanding that Japan's rapidly increasing international balance of payments surplus and foreign currency reserves could invite strong pressures for yen revaluation, or because they have not overcome the fear of poverty, which they experienced during the period of chronic foreign currency shortage, and want to have the peace of mind that comes from sufficient foreign exchange reserves, they are just making makeshift responses and taking superficial measures for preventing the increase in foreign currency reserves. They are

¹⁸⁴ *Nihon Keizai Shimbun*, 13 May 1971.

¹⁸⁵ Sato, Sadayuki. "Kokusai tsuka kiki to amerika." *Keizai*, July 1971, 189.

¹⁸⁶ Dale, Edwin L. "A Special Tariff on Japan Wiegthed." *The New York Times*, May 24, 1971.

¹⁸⁷ Okurasho. "Kanbocho shusai somukacho kaigi." 10 June 1971; requoted from Ito, Masanao. *Sengo nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 253.

not showing a firm determination for a drastic and proactive policy. Instead, they give an impression that they are just trying to delay things until they finish their preparation for yen revaluation. The fundamental problem lies in these attitudes.” And he suggested that they start “① wide-ranging liberalization of residual import restriction, which would have strong effect of price stabilization. ② specific measures for import promotion, including tariff reductions. ③ long-term low interest rate loan of the accumulated foreign currencies, for the import of goods related to pollution control and welfare. ④ flexible monetary policy linked to the level of interest rates in other countries ⑤ clarification of specific policies, such as using foreign currencies for external cooperation.”¹⁸⁸

Japanese ambassador to the United States, Nobuhiko Ushiba, also stated at a press conference on May 18th that “the Japanese government is trying to cope with the revaluation pressure from the U.S. and other countries by further promoting the liberalization and foreign aid, but the U.S. does not seem to be willing to accept such reasoning by Japan. It seems that our trade negotiation will be in the end a negotiation about the yen.”¹⁸⁹

Japanese business communities were also examining a way to cope with the yen issue. Japan Association of Corporate Executives (Keizaidoyukai) decided at their executive board meeting on May 21st to tackle the issue of the yen and international currency problems. Japan Economic Research Institute (Nihon Keizai Chosa Kyogikai), a research institute of the business community, also announced in their general meeting on May 27th that they would formally start working on the yen issue, as a voice representing the whole business circle.¹⁹⁰

In the same month, Yoshio Matsunaga, an assistant professor at Nagoya City University, recommended Japan’s voluntary yen revaluation at an early stage, explaining that, if Japan continued to resist the foreign pressure, the pressure would increase, and with it Japanese companies, expecting a yen revaluation, would practice leads and lags on a large scale. The pressure of capital transfer [caused by leads and lags] would bring about more radical yen revaluation than if Japan voluntarily revalued it at an early stage.¹⁹¹ In hindsight, he accurately predicted that leads and lags by Japanese companies, which came to have large trade volume, would be the real pressure for revaluation, not overseas hot money.

Eiji Shimazaki, an economic critic, also predicted that leads and lags would work as a pressure for revaluation, by pointing out the following fact: “Regarding import and export settlement, ‘standard method of payment’ is applied under the ordinance of the Ministry of Finance and the Foreign Exchange and Foreign Trade Control Law. If companies use this standard method of payment, they do not need to be restricted by administrative procedures. The standard method of payment was introduced during the postwar recovery period, when there was a [chronic] shortage of foreign currency. Thus, it was designed in a way that allowed companies to ‘receive export proceeds as early as possible and pay import bill as late as possible.’ For example, it allowed companies to receive export proceeds one year prior to export validation and limited them to receive

¹⁸⁸ Saito, Yoshio. “Genko heika to kokumin teki rieki - Heika henko risuku no futan sekinin -.” *Boeki to Kanzei*, July 1971, 21-23.

¹⁸⁹ *Nihon Keizai Shimbun*, 19 May 1971 (Evening edition).

¹⁹⁰ Tagami, Kyoji. “Zaikai, seifu no en taisaku hihan.” *Keizai*, November 1971, 59.

¹⁹¹ Matsunaga, Yoshio. “En kiriage no taimingu.” *Ekonomisuto*, 25 May 1971.

export proceeds within 6 months after shipment at the latest. Thus the current standard method of payment is making an environment where yen speculation through leads and lags could be easily done. Especially, early reception of export proceeds accelerates intensive foreign currency inflow and yen speculation.”¹⁹² This analysis by Shimazaki later turned out to be correct. With the increase in trade volume and capital transfer, the payment method designed to protect Japan’s currency system had become, ironically, the very source of a threat to the system.

In the meantime, industries other than the above-mentioned shipbuilding industry were also launching their own measures to cope with yen revaluation. According to Yoshio Saito, mentioned above, some of the measures taken by industries were as follows: “The shipping industry is increasing yen-denominated contracts with ... tramp steamers that began to be built from 1971. It has been the custom of international maritime trade that ocean freight is paid in foreign currency. If that custom continues, the owners of tramp steamers who made long-term (more than 10 years) contracts for ocean freight will be exposed to risk in the event of yen revaluation. Because the foreign-currency-denominated long-term contracts on hand amount to 1.8 trillion yen, yen revaluation by 5% would generate the foreign exchange loss of 90 billion yen. Unlike industries such as shipbuilding that have seller markets, it is difficult for the shipping industry to shift to yen-denominated contracts. But, regarding the import of ore, the shipping industry could get help from steelmakers that were expected to gain profit from ore price reduction in the event of yen revaluation; Nippon Yusen Kaisha (NYK) could make yen-denominated contract with Nippon Kokan (Nippon Steel Tube Company) for the ocean freight of ore/coal carrier of 115400 deadweight tons; Osaka Shosen Mitsui Senpaku (now Mitsui O.S.K. Lines, Ltd.) could make yen-denominated contract with ... Nippon Steel Corporation (Shin Nippon Seitetsu Kabushiki Kaisha) for the ocean freight of ore carrier of 160000 tons ... On the other hand, machine industry is also advancing negotiations to make yen-denominated contracts, but the situation seems not easy for them, because their choice is limited by international competition. However, above-mentioned Ishikawajima-Harima Heavy Industries (later renamed as IHI Corporation) made a yen-denominated contract with Argentina’s state-owned steel maker Somisa [Sociedad Mixta Siderurgia Argentina]. Out of 3.2 billion yen for the cargo work of steel making raw materials, storage facility, and others, 2.4 billion yen for equipment export were yen-denominated. Mitsubishi Electric also made a yen-denominated contract with Argentina’s hydroelectric power plant El Chocón for six high-voltage transformers, which amounted to 1 billion yen.”¹⁹³

In short, in the early 1970s, we can see a mixture of different attitudes: the Japanese government’s stubborn resistance to yen revaluation, the U.S. criticisms of that resistance, business circles and scholars’ sense of crisis about the possibility of revaluation, and industries’ own efforts to cope with revaluation.

In the midst of such development, the situation of the U.S. continued to get worse, and its currency policy began to change significantly. As it became obvious that the U.S. trade balance deteriorated further during the second quarter (spring quarter) of 1971, a

¹⁹² Shimazaki, Eiji. *En kiriage no kenkyu*. Foto Nipponsha, 1971, 232.

¹⁹³ Saito, Yoshio. “Kigyo no en kiriage taio senryaku - Giron no dankai oeta to handan -.” *Boeki to Kanzaei*, June 1971, 36-37. In this article, there are detailed descriptions on measures taken by other companies.

concern over the sustainability of dollar-gold conversion arose. The amount of gold in the U.S. had been declining over the years, and other countries' requests for dollar-gold conversion continued in 1971.

Thus, from late May 1971, Paul Volcker, then Under Secretary of the Treasury for International Affairs, John Petty, Assistant Secretary for International Affairs (Department of Treasury), and William Dale, the Treasury representative at the IMF, started unofficial planning for a suspension of dollar-gold convertibility.¹⁹⁴ The 'plan' that was written in early June was circulated to the Secretary of the Treasury John Connally, and then he explained the plan to George Shultz, then the first director of the Office of Management and Budget, and President Nixon.¹⁹⁵

Such a move toward a suspension of dollar-gold convertibility implied the possibility of dollar devaluation and other currencies' upward revaluation. Although the Japanese government did not know about the plan at the time, it was already obvious that the credibility of the dollar was falling and yen-buying pressure was growing. There also were economic commentators inside and outside Japan who warned of the possibility of dollar devaluation and supported a transition to the floating exchange rate system. However, the Japanese government, the Bank of Japan, and many business leaders did not change their anti-revaluation stance.

For example, on June 1st 1971, Finance Minister Fukuda and the Bank of Japan Governor Sasaki emphasized that the yen exchange rate will remain the same. Fukuda even stated that there would be no widening of the range of foreign exchange fluctuation. Also, Japan Foreign Trade Council (Nihon Boeki Kai) drew up "Demand for an absolute adherence to the yen exchange rate" in their President and Vice-President meeting on June 2nd.¹⁹⁶ In such a manner, the Japanese government, the Bank of Japan, and export business circle were strongly opposed to yen revaluation, amid the growing international criticism toward Japan's currency policy.

Because of its anti-revaluation stance, the Japanese government made a decision to alleviate foreign demands for yen revaluation by promoting liberalization and reducing surpluses. On June 4th 1971, Finance Minister Fukuda, Minister of Foreign Affairs Kiichi Aichi, Minister of International Trade and Industry Kiichi Miyazawa, Minister of Agriculture and Forestry Tadao Kuraishi, Director of Economic Planning Agency Ichiro Sato, and Chief Cabinet Secretary Shigeru Hori made a cabinet decision to implement "Eight-Point Program to Avoid Yen Revaluation." The eight points were (1) Import liberalization (2) Early implementation of preferential tariff (3) Tariff reduction (4) Capital liberalization (5) Removal of non-tariff barriers (6) Promotion of economic cooperation (7) Abolition of preferential tax for exports (8) Fiscal and monetary policies for the expansion of domestic demand. In short, it was a program intended to alleviate revaluation pressure through a promotion of economic liberalization, as well as to sustain through the expansion of domestic demand the profits of companies whose income could be diminished by liberalization and an increase in import. Yusuke Kashiwagi, who was involved in drafting the Eight-Point Program, referred to that aspect, noting "The basic

¹⁹⁴ Odell, J. S. *U. S. International Monetary Policy - Markets, Power, and Ideas as Sources of Change*, Princeton University Press, 1982, pp.252-7.

¹⁹⁵ Ito, Masanao. *Sengo nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 221.

¹⁹⁶ Tagami, Kyoji. "Zaikai, seifu no en taisaku hihan." *Keizai*, November 1971, 58.

stance [of the Eight-Point Program] was anti-revaluation. The program included such things as the expansion of total demand through macroeconomic policies, liberalization of imports, deregulation, and others, but all of those were for avoiding yen revaluation.”¹⁹⁷

Reflecting the urgency of the situation, the Eight-Point Program was rapidly carried out. Nevertheless, it was not something that offered a fundamental solution. Regarding the issue, Mitsuaki Nakao from Mainichi Newspapers said, “According to the Japan-U.S. Business Council ... the Eight-Point Program is expected to reduce Japan’s trade surplus with the U.S. only by 200 million dollars in 1971. Even if its influence lasts for a year, the surplus will be reduced only by 1 billion dollars. Even the government itself, which is launching the program, is expecting no more than that. However, the United States’ trade deficit with Japan during the first half of 1971 is already reaching 1.38 billion dollars ... The effect of the Eight-Point Program is like a drop in the bucket, and it is obvious that the U.S. will be pushed into a corner. But Japan reasoned that ‘Japan was doing what it could do. If the problem persisted, then it is the responsibility of the United States. What should be implemented is not yen revaluation but dollar devaluation’.”¹⁹⁸

Takashi Murano, a professor at Kokugakuin University, also criticized the Eight-Point Program as follows: “I don’t think that the program is going to make us avoid the revaluation. With the Eight-Point Program, it is impossible to correct the fundamental disequilibrium reflected by the abnormal balance of payments surplus and the excessive accumulation of foreign currency reserves. If the drastic program as such is carried out, it will even cause more than 10% damage to weak industrial sectors [It is not clear what “more than 10% damage” specifically means]. If we consider the temporal element, the issue is not whether we choose the Eight-Point Program or yen revaluation, because the time for a revaluation seems imminent, considering the internal and external situations that are demanding it.”¹⁹⁹ In hindsight, this was an acute criticism, given the fact that the Nixon Shock occurred right after the publication of this article (the article was in the September issue of *Boeki to Kanzei*, but the September issue was published and circulated before the Nixon Shock in August).

But the Japanese government did not change its stance and endeavored to avoid yen revaluation through the Eight-Point Program. To the Japanese efforts as such, the Secretary of State William Rogers expressed the stance of the U.S. in the OECD ministerial council and at a press conference that, although the Eight-Point Program was welcomed, the issue of the trade and capital liberalization and the issue of yen revaluation were two separate matters, and thus that the issue of revaluation would not dissolve even if the liberalization policy was implemented. In the Japanese government’s interpretation, the U.S. was not actually pressing for yen revaluation but was simply showing irritation at the delay of Japan’s trade and capital liberalization. Based on that interpretation, the Japanese government hurried the implementation of the Eight-Point Program.²⁰⁰

In June 1971, regarding the issue of the yen revaluation, reportedly the following conclusions were made within the Ministry of Finance: 1. Yen revaluation is not a simple

¹⁹⁷ Honda, Keikichi. and Hata, Tadao. Kashiwagi Yusuke no shogen - Sengo nihon no kokusai kin’yushi, Yuhikaku. 1998, 49.

¹⁹⁸ Nakao, Mitsuaki. “Nikuson shokku to nihon Keizai.” *Ekonomisuto*, 31 August 1971, 28.

¹⁹⁹ Murano, Takashi. “Kokusai tsuka to en mondai.” *Boeki to Kanzei*, September 1971, 53.

²⁰⁰ M (pen name). “Hakkomoku no en kiriage kaihisaku.” *Ekonomisuto*, 22 June 1971, 9.

economic issue. It is social and political issue as well. It has too much impact. 2. The problem originates from the weakening of the U.S. economy and the dollar. A slight revaluation would only have poor effect. It is also difficult to determine to what extent the range of foreign exchange fluctuation needs to be widened. 3. The effect of revaluation is dubious, considering the case of West Germany. 4. It is not certain whether Japan's continuous surpluses reflect the strength of the Japanese economy. It should be naked first [restriction should be relaxed first].²⁰¹

In June, the Bank of Japan also expressed its anti-revaluation view. According to the bank's official history, "Inside the Bank, the majority held that the rate of 360 yen must be maintained. The booklet named 'Governor's opinion on the issue of the yen,' which was drawn up by the General Affairs Division (Somubu) in June 1971 and circulated among the Bank's executives, demonstrates such a view of the majority. The booklet was based the Governor Sasaki's comments that were made during his conversation with leaders from Kansai [western Japan] ... His comments frankly expressed the Bank of Japan's viewpoint at the time. The crux of the comments was as follows: It is true that the yen had become a strong currency but the yen showed the strength only from 2 to 3 years ago, especially from the fall of last year [1970]. Thus, the strength of the yen is fundamentally different from the strength of the Deutsche mark ... The essence of the problem ... lay in foreign industries' complaints about the Japanese goods that flooded in. They had complaints about the exports from Japan that showed 30% annual increase rate ... Yen revaluation could be a quick way to decelerate the increase rate of export, but unlike West Germany, 90% of Japanese exports are quoted in foreign currencies, and therefore a revaluation will give huge damage to the Japanese industries. Damages to shipping industry, textile industry, small and medium-sized exporters, and especially the shipbuilding industry will be fatal ... What is necessary now for avoiding yen revaluation is to carry out the Eight-Point Program, which was decided in June, as soon as possible. Monetary policy should be implemented in a way that stabilize the domestic growth, remove the incentives for exports, and increase the imports. The official bank rate was lowered on May 8th for that purpose."²⁰²

Governor Sasaki, in an interview that he gave years later, reconfirmed the fact that the Bank of Japan had the stance illustrated above:

Question: ... On August 15th 1971, there was the announcement of Nixon's dollar defense measures ... Did the Bank of Japan expect that something like that would happen?

Sasaki: Yes we expected it ... When we talked with foreign financial and monetary authorities, they often referred to the issue of yen revaluation. Of course, our cardinal rule at the time was to maintain the rate of 360 yen to the dollar. We believed that there would be an overwhelming consequence if we deviated from the 360 yen rate. So, we policy makers had to absolutely refrain from stating that there was a possibility of yen revaluation ... The 'mood' at the time did not allow such thing. For instance, before the implementation of yen revaluation, Finance

²⁰¹ Okurasho. "Kanbocho shusai somukacho kaigi." 10 June 1971; requoted from Ito, Masanao. *Sengo nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 257.

²⁰² Nihon Ginko Hyakunenshi Hensan Iinkai ed. *Nihon Ginko Hyakunenshi* (6-kan). Nihon Ginko, 1986, 308-9.

Minister Fukuda stated in the diet that “[a plan for] yen revaluation does not exist even at the back of my mind” ...

Question: The rate of 360 yen to the dollar is like a point of origin for the postwar Japanese economy, and thus it is understandable that people could not imagine its collapse. But didn't you think about what would happen in the event of yen revaluation and how to deal with it? Didn't you think it as a real problem?

Sasaki: Of course, we thought about those things ... Should a yen revaluation occur, export was expected to fall and import was expected to increase. We were really fearful of the possibility that a revaluation could severely worsen Japan's international balance of payments, and that Japan, which had no natural resources, could suffer the pain of payments imbalances. At the time the media had absurd assertions. For example, they said that revaluing the yen was like losing Hokkaido. In the diet, people in the opposition party scolded me that a yen revaluation would be a national loss. Because of the unusual mood, we felt and worried that a yen revaluation would bring about overwhelming consequences, although we knew in theory that, considering the international environment, the yen had to be revalued, reflecting the strength of the Japanese economy. Thus, even when the issue of yen revaluation was actually put on the table, Japan endeavored to minimize the rate of revaluation.²⁰³

Looking back those days, Sasaki recollected, “I think that we should reflect on the possibility that we overestimated the potential impact of yen revaluation and used wrong evaluation methods. We had to have a sufficient understanding of how far the Japanese economy had come.”²⁰⁴

From these statements, it can be pointed out that it was not because of a simple technical mistake or miscalculation that they made a wrong evaluation. From the statements above, we can see that the fear of losing what Japan had achieved on the basis of the 360 yen rate led to their doubt if the Japanese economy would survive without the 360 yen rate. And we can see that the fear and doubt as such in turn invited a wrong evaluation.

As illustrated above, amid the increasing foreign pressures for yen revaluation, the Japanese government and the Bank of Japan continued to defend the yen exchange rate. However, the pressure from Western countries did not disappear.

For example, after participating in bankers' meeting held in West Germany in early June, Shigeo Kurebayashi, an auditor of the Fuji Bank, stated his impression that yen revaluation had become a commonly expected thing [among other countries].²⁰⁵ Also, Eiji Shimazaki, an economic critic, warned that there was a high possibility that the period of yen revaluation would be between late 1971 and spring 1972, considering the situations of the trade balance of Japan and the U.S., domestic economy, the overheating speculation, as well as Japan's political circumstances.²⁰⁶

²⁰³ Ekonomisuto henshubu. *Sengo sangyoshi e no shogen 4. Kin'yu no saihensei*. Mainichi Shinbunsha, 1978, 204-206.

²⁰⁴ *Ibid.*, 215.

²⁰⁵ *Asahi Shimbun*, 30 June 1971.

²⁰⁶ Shimazaki, Eiji. *En kiriage no kenkyu*. Foto Nipponsha, 1971, 280.

Against this backdrop, pro-revaluation views began to be shared among some scholars. For example, in the book *Yen Revaluation and the Japanese economy (En kiriage to Nihon keizai, 1970)*, Yoshitomi Ishimaru, Nobuyoshi Araki, and Eiichi Omiya supported yen revaluation because they considered it as an effective means of reforming the structure of Japanese industries. The Long-Term Credit Bank of Japan's industry workshop also stated that "we need to consider the developmental stage of Japanese economy and the yen's international status as well as the merit of structural enhancement which a revaluation would bring."²⁰⁷ The workshop viewed the revaluation as a means of accelerating the transition from an industrial structure based on low priced goods into an industrial structure based on upscale goods and services.

Moreover, the crawling peg system was gaining support as a method of revaluation. For example, Chiaki Nishiyama, a professor at Rikkyo University, suggested in an article issued in June 1971 a gradual revaluation: "taking into account the possibility of the resurgence of inflation in the U.S., yen revaluation is inevitable in order to maintain the international monetary order. The more the revaluation is delayed by the resistance from industry, the larger the range of revaluation will be. The larger the range of revaluation, the more economic damage will be inflicted ... Thus, rather than resisting it, we should immediately adopt the trotting peg system (crawling peg system) that raises the exchange rate by 0.25% every month, so that we can adjust the parity of the yen gradually, systematically, and with sufficient preparation."²⁰⁸

In the following month, July 1971, Ryutaro Komiya, a professor at the University of Tokyo, advised the government to adopt the crawling peg system in his article "The Crawling Peg: A Survey" (*Kuroringu peggu: Tenbo*).²⁰⁹ And, on July 10th 1971, the Research Group on Foreign Exchange Policy (*Kawase seisaku kenkyukai*), which consisted of 36 economists including Komiya, announced "A suggestion for yen adjustment based on the crawling peg" (*En rēto no kokizami chōsei ni tsuite no teigen*) and stressed the urgent necessity of having the crawling peg.²¹⁰ Specifically they suggested the government to revalue the exchange rate within 1% at a time, although the frequency and the range of revaluation may change depending on the situation. They suggest an annual adjustment of 2.4% to 4%. They advised it because, despite the Eight-Point Program, Japan's trade surplus was expected to increase further and the foreign currency reserves were expected to be over 10 billion dollars. The increases in trade surplus and foreign currency reserves were expected to bring about a drastic revaluation. To prevent it from happening, they asserted that it was desirable to gradually reduce Japan's excessive foreign currency reserves and soften the impact of revaluation by implementing the crawling peg system in advance.

Toshimasa Tsuruta, then a senior researcher at Kokumin Keizai Research Institute (Research Institute of National Economy), supported yen revaluation as follows: "First of all, the backbone of Japan's exports is the industries that have economies of scale and comparative advantage in the international market as well as the industries that have achieved excellent R&D [research and development]. It is reasonable to think that these

²⁰⁷ Chogin Sangyo Kenkyukai ed. *En kiriage to nihon sangyo no jitsuryoku*. Toyo Keizai Shinposha, 1970, 165.

²⁰⁸ Nishiyama, Chiaki. "Kokumin fuzai no nichibei keizai kincho." *Ekonomisuto*, 22 June 1971, 61.

²⁰⁹ Komiya, Ryutaro. "Kuroringu peggu: Tenbo." *Keizaigaku Ronshu*, dai 37-kan dai 2-go, July 1971.

²¹⁰ *Kin'yu zaisei jijo*, 19 July 1971.

industries would not be damaged much in case of a 5-10% revaluation. Second, the economic sectors that will be affected by a revaluation are going to be the sectors that have low productivity and poor achievement of R&D. Because, in Japan, labor shortage is conspicuous and the wage level is approaching that of the West, it is desirable to leave these sectors to the developing countries, and promote the international division of labor. Third, as a result of a revaluation and a consequent increase in import, economic sectors that have low productivity and poor achievement of R&D can lose the foundation of their existence. But, considering the national economy as a whole, it would work as a factor that reduces the inefficient use of labor in Japan and shifts the Japanese economy to a more efficient economy. We need to change our preexisting policy of protecting the low-productivity sectors. Fourth, considering the fact that approximately 15% of Japan's imports are food imports, a yen revaluation will work to lower the domestic food prices. However, in the current food distribution system, there is a possibility that distributors simply absorb the potential profit for consumers [in other words, rather than lowering the food prices, they may maintain the prices and just increase their margin]. Thus, some kind of measure is necessary to prevent it."²¹¹

However, unlike the economists mentioned above, the government, export industries, and no small numbers of economists continued to position themselves against revaluation. For example, the government was continuing its attempt to overcome the pressure from the U.S. through the aforementioned Eight-Point Program, instead of revaluation; Osamu Shimomura, then an economist and a former bureaucrat at the Ministry of Finance, criticized the aforementioned "A suggestion for yen adjustment," stating that, instead of demanding a yen revaluation, the U.S. must devalue their own currency because the U.S. was responsible for the dollar crisis; the business community also showed their opposition to revaluation, claiming that it would reduce Japan's exports.²¹² Moreover, on July 5th 1971, the newly appointed Finance Minister Mikio Mizuta stated that "I think that it is most desirable to achieve stabilization under the fixed exchange rate system. I cannot actively support the wider band system yet."²¹³ Also, according to the July 1st issue of *Nihon Keizai Shimbun*, questionnaires on yen revaluation directed to 222 people including scholars, business people, politicians, labor union leaders, and consumer group leaders revealed that 72% of them were basically against the revaluation (91% of the business people and 36% of scholars and economists were against it).²¹⁴

The government hurried the implementation of the Eight-Point Program in order to avoid revaluation. A critic Kyoji Tagami summarized the actions by the government as follows: "After the first cabinet meeting on July 6th, Prime Minister [Eisaku Sato], Foreign Minister Fukuda [Takeo Fukuda], Minister of International Trade and Industry Tanaka [Kakuei Tanaka] had a trilateral talk and agreed, from a 'high standpoint,' to politically resolve problems that could not be resolved by negotiations among ministries until late August, which was the deadline for the preparation of the plans for the Eight-Point Program. They agreed it in order to get rid of a potential cause of external friction (= complaints by the U.S.) ... On July 27th, the government decided to implement an

²¹¹ Tsuruta, Toshimasa. "Sangyo kiban no henka to en mondai." *Boeki to Kanzei*, July 1971, 33.

²¹² Kawakami, Masamichi. "En, doru mondai to nihon no 'kindai keizaigaku' - Komiya Ryutaro, Shinohara Miyoei shi ra no machigai -." *Keizai*, December 1971, 32.

²¹³ Okurasho. *Fainansu*. Dai 69-go, August 1971, 102.

²¹⁴ *Nihon Keizai Shimbun*, 1 July 1971.

additional injection of 220 billion yen for its fiscal investment and loan program, a lowering of the loan rates of Japan Development Bank and Hokkaido-Tohoku Development Finance Public Corporation (This was aiming at lowering the long-term loan rate of private banks), and a lowering of the provisional payment rate for the subsidized projects of local governments. Because of these measures the official bank rate lowered to 5.25% ... which was the lowest level since Japan abolished the higher interest rates application system and shifted to the current system. Because the official bank rate had been ... lowered three times already, the Bank of Japan did not think that a further lowering would have any stimulus effect on the domestic economy, and thus the Bank of Japan was showing its reluctance to implement it. But the reason why the government forcefully demanded a lowering of the rate for the fourth time was to avoid yen revaluation by externally showing that Japan was working on comprehensive economic measures ... On July 29th, Foreign Investment Council (Gaishi Shingikai) submitted a plan for the fourth capital liberalization, and the plan was adopted at a cabinet meeting on August 3rd and was put into practice ... Because the fourth capital liberalization was originally scheduled to be implemented in autumn, the process was one to two months earlier than the schedule. As a result of the fourth liberalization, the number of the non-liberalized sector reduced from 350 (the number at the point of the third liberalization) to only 7. It was a tremendous ‘effort’ ... considering the fact that people in autumn last year expected that at least 50 sectors would remain non-liberalized by this time.”²¹⁵

Tagami summarized the actions by the business community as well: “Compared to the government’s efforts for the Eight-Point Program, the attitude of the business community was even more aggressive. On July 12th, Keidanren (Japan Business Federation) decided in its chairman and vice-chairman meeting to support and carry out the Eight-Point Program. After examining the role of the business community in the program, Keidanren summarized its ‘opinion on the promotion of the Eight-Point Program’ on July 27th and submitted it to Prime Minister Sato and others. In it, they requested more aggressive liberalization and more stimuli for domestic economy, such as an earlier implementation of import liberalization that was scheduled to be carried out in late September as well as an extra issuance of national bonds amounting to approximately 1 trillion yen.”²¹⁶ In such a manner, the business community worked together with the government to avoid revaluation, while suggesting more radical measures than the government intended to take.²¹⁷

Of course, as explained earlier, there were people in the government and the Bank of Japan who had foresights: Taizo Hayashi suggested within the circle of the Ministry of Finance the implementation of yen revaluation; Toshio Shishido, who was reprimanded by Hayashi for publicly stating the possibility of revaluation, was the head of Research Bureau of the Economic Planning Agency before it happened. The Bank of Japan Governor Sasaki was also sensing the trend toward revaluation, although he did not support it.

²¹⁵ Tagami, Kyoji. “Zaikai, seifu no en taisaku hihan.” *Keizai*, November 1971, 62.

²¹⁶ *Ibid.*, 64.

²¹⁷ Ito, Masanao. *Sengo nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 254.

But the problem was that the anti-revaluation atmosphere at the time suppressed the opinions that expected a revaluation. We have seen the examples of the suppression earlier, but there were more. Another example was the Economic White Paper (Keizaihakusho), which was the official document of the government on the Japanese economy. The people in the Economic Planning Agency, who were in charge of drafting the Economic White Paper, could not write about yen revaluation although they expected it to happen. In the 222 pages long Economic White Paper submitted on July 30th 1971, even the term “yen,” let alone “yen revaluation” did not appear, although there were lively discussions on yen revaluation outside the government. According to the journalist Nobuhito Kishi, Hidetoshi Kojima, then the head of Research Bureau of the Economic Planning Agency, later looked back those days and stated as follows: “I was pro-revaluation. I believed that it was necessary to revalue the yen to a certain degree. But, because the Economic White Paper was the official document of the government, I gave up writing about it. During the postwar recovery period, anything could be written in the Economic White Paper, but the process became more bureaucratic from the mid-1960s. Without the approval of other ministries, the draft could not pass the Vice Minister meeting. Thus, I gave up writing about it, expecting that it would be erased after all.” For that reason, Kojima ordered his assistant general Yutaka Kosai not to write about yen revaluation. Kosai responded, “If I cannot write about yen revaluation, I will not even use the word ‘yen’ ... If I use the word, I will be only allowed to write about the defense of the yen. If I use the word, it will end up being a compromised sentence.” Kosai then advised Tatsuro Uchino, then a director of the Domestic Research Division, to “give up [writing about the revaluation] this time.” Uchino resisted it and wrote about yen revaluation, but Kosai erased them all and the word “yen” disappeared from the Economic White Paper.²¹⁸

As seen above, Kojima, Kosai, and Uchino were all sensing the trend toward the revaluation, but they could not express it because of the atmosphere of other ministries that did not allow it to be expressed. In short, it was not possible to write about the possibility of yen revaluation in the Economic White Paper at the time.

Another example of the suppression was the case of Miyoehei Shinohara, who assumed the Director of the Economic Research Institute, the Economic Planning Agency (Keizai Kikaku Cho Keizai Kenkyujo) from 1970. According to the journalist Nobuhito Kishi, Shinohara looked back those days and stated as follows: “In the Economic Planning Agency, only I and the deputy director supported the floating exchange rate system. Others were mostly the supporters of the fixed exchange rate system. The staff of the Domestic Research Division were also strongly opposing to the floating exchange rate system. The reason why I supported the floating exchange rate system was because I understood its necessity from early on, by reading [Milton] Friedman’s book,” “Structurally, Japan’s excess of export was beginning to be a constant trend. But the Ministry of Finance tried to offset the imbalances in international payments by domestic inflation. Therefore, in the study group within the Ministry of Finance, I was the only one who asserted the validity of the floating exchange rate system. The Administrative Vice Minister of Finance Ichiro Hatoyama criticized me for this, saying that ‘it is not appropriate for a government employee to say such thing’.” Shinohara also said, “If we calculate based on the real exchange rate in 1945, today’s rate of 360 yen is undervalued

²¹⁸ Kishi, Nobuhito. *Keizai hakusho monogatari*. Bungeishunju, 1999, 168-169.

by 20%. The real exchange rate today is about 290 yen to the dollar. If this situation continues, we will have to have adjustment inflation, which is not desirable.”²¹⁹

Shinohara did more than support yen revaluation. He had the foresight to suggest even the floating exchange rate system. Hisao Kanamori highly evaluates him for it, stating that “At the time, we were under the IMF’s fixed exchange rate system, and thus the floating exchange rate system sounded unrealistic. But, when we look at the results, Shinohara’s theory was the most correct one.”²²⁰ However, the government and the Bank of Japan refused to consider the claims by Shinohara and others who supported revaluation.

While the Japanese government and the business community continued to resist yen revaluation and a transition to an alternative currency system, the U.S. was making an important decision. It was mentioned earlier that Paul Volcker, then Under Secretary of the Treasury for International Affairs, and others drew up a plan for a suspension of dollar-gold convertibility, and that the plan was circulated to the Secretary of the Treasury John Connally in June 1971. Reportedly, at some point in July, President Nixon accepted Connally’s advice about a new domestic economic policy and the suspension of gold-dollar convertibility. It paved the way for the actual suspension of gold-dollar convertibility announced on August 15th 1971 (the 16th in Japan).²²¹

At the time, the Nixon’s decision was not announced publicly, and thus Japan was not aware of it. However, it was apparent that the situation was worsening. For example, in the Joint Economic Subcommittee on International Exchange and Payments (under the U.S. Congress Joint Economic Committee), the chairman of the subcommittee Henry S. Reuss reported that the dollar was overvalued, that the gold-convertibility pledge should be withdrawn, and that the United States currency should be allowed to float downward in value against other major currencies.²²² It implied a relative appreciation of the yen and other currencies against the dollar. On the other hand, global distrust of the dollar was deepening. Gold price that had soared to 42 dollars per ounce in the London Bullion Market in July rose even more to 44 dollars 10 cents per ounce on August 9th.

In Japan, a counterargument against Reuss’s statement was made in the August 24th 1971 issue of *Ekonomisuto* (although it was the August 24th issue, it was published and circulated before the Nixon Shock, August 16th). In it, an unknown commentator under the pen name of Y noted, “In reality, it is impossible to suspend the dollar-gold convertibility. If it happens, the Netherlands, Belgium, Switzerland, and France, which have strong preference for gold, would stop buying and sustaining the dollar and instead go to acquire gold or strong currencies such as the mark. As a result, the IMF regime could be shaken to its very foundation. There is no way the U.S. government would take such a dangerous gamble.”²²³ Soon it became apparent from the Nixon Shock that this opinion was wrong.

On the other hand, there were experts who had an accurate foresight, such as Takeo Kajiyama, a professor at the University of Kitakyushu. He noted, “In case the position of

²¹⁹ *Ibid.*, 160-161.

²²⁰ Kanamori, Hisao. *Watashi no sengo keizaishi Ekonomisuto no 50 nen*. Toyo Keizai Shinposha, 1995.

²²¹ Ito, Masanao. *Sengo nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 221.

²²² “Friedman Differs with Reuss Panel.” *The New York Times*, August 11, 1971.

²²³ Y (pen name). “En kiriage ito no roisu hokoku.” *Ekonomisuto*, 24 August 1971.

the dollar gets worse and does not improve, a suspension of the dollar-gold convertibility could occur earlier than expected.”²²⁴

However, the Japanese government and the Bank of Japan could not see that the suspension was imminent, and they had to face the Nixon Shock without sufficient preparations for the revaluation.

In the morning of August 16th, a day of Nixon’s announcement of the suspension of dollar-gold convertibility, a discussion for avoiding revaluation was going on in the government. The journalist Nobuhito Kishi reports the story as follows: “In the morning of August 16th, Takehiro Sagami, then a director of Research and Planning Division (Kanbo Chosa Kikaku Ka) was having a heated debate with a top official from the Trade Promotion Bureau, the Ministry of International Trade and Industry. Sagami stated, ‘it is now imperative to prevent yen revaluation by promoting the liberalization of trade and capital. In order to solve the yen issue, it is urgent to contain the increasing export volume. We request that you examine an introduction of export surcharge as a drastic measure to solve the issue.’ The official from the Ministry of International Trade and Industry responded, ‘Export promotion is the inevitable path of Japan because it has poor resources. We cannot impose ‘penal fines’ such as the export surcharge, just because the trade surplus soared.’ They did not reach a conclusion but a stalemate. And then there was a phone call from a newspaper reporter to Sagami, informing them that Nixon was announcing a new economic policy.”²²⁵

At the time, President Nixon was announcing his dollar-defense measures, including the suspension of the dollar-gold convertibility. The specific content was the following: “... In the past seven years, there's been an average of one international monetary crisis every year. Now who gains from these crises? Not the working man, not the investor, not the real producers of wealth. The gainers are the international money speculators: because they thrive on crises, they help to create them. In recent weeks, the speculators have been waging an all-out war on the American dollar ... Accordingly, I have directed the Secretary of the Treasury to take the action necessary to defend the dollar against the speculators. I directed Secretary Connally to suspend temporarily the convertibility of the dollar into gold or other reserve assets except in amounts and conditions determined to be in the interest of monetary stability and in the best interests of the United States ... Let me lay to rest the bugaboo of what is called ‘devaluation’ ... I am taking one further step to protect the dollar, to improve our balance of payments and to increase jobs for Americans. As a temporary measure I am today imposing an additional tax of 10 per cent on goods imported into the United States ... This import tax is a temporary action. It isn’t directed against any other country. It’s an action to make certain that American products will not be at a disadvantage because of unfair exchange rates. When the unfair treatment is ended, the import tax will end as well. As a result of these actions the product of American labor will be more competitive and the unfair edge that some of our foreign competition has will be removed. This is a major reason why our trade balance has eroded over the past 15 years. At the end of World War II, the economies of the major industrial nations of Europe and Asia were shattered. To help them get on their feet and to protect their freedom, the United States has provided over the past 25 years \$143-

²²⁴ Kajiyama, Takeo. “Kin, doru, en no yukue.” *Boeki to Kanzei*, September 1971 (Although this is the September issue, the draft was completed on July 11th, which was before the Nixon Shock on August 16th)

²²⁵ Kishi, Nobuhito. *Keizai hakusho monogatari*. Bungeishunju, 1999, 161-162.

billion in foreign aid. That was the right thing for us to do. Today, largely with our help, they have regained their vitality. They have become our strong competitors, and we welcome their success. But now that other nations are economically strong, the time has come for them to bear their fair share of the burden of defending freedom around the world. The time has come for exchange rates to be set straight, and for the major nations to compete as equals. There is no longer any need for the United States to compete with one hand tied behind her back ...”²²⁶

What we can understand from this announcement is that the international currency system was losing stability because of increased speculation in global capital, that the exchange rates of several countries needed to adjust in order for the global economy to overcome the crisis, and that the U.S. policy was to reject dollar devaluation and demand upward revaluation of the currencies of other countries that have been competing with the U.S. with their unfairly advantageous exchange rates.

Since Nixon and others planned this announcement behind the curtain, it was a surprise not only to Japan but also to the whole world. Nevertheless, there were clear signs that foreign pressures for yen revaluation were increasing, and that an increase in the potential scale of capital transfer caused by leads and lags was making a yen revaluation inevitable. But the Japanese government, the Bank of Japan, and many business leaders in Japan did not devise measures that would be necessary in the event of yen revaluation (their measures were for the “prevention” of revaluation). They only continued to resist yen revaluation.

In the above, we have seen developments surrounding currency problems in Japan and the global economy. Our findings can be summarized as follows (although already mentioned in the beginning of the chapter):

- ① The Bretton Woods system (the fixed exchange rate system in the form of the dollar-gold standard system) succeeded in preventing all-out currency devaluation race that occurred in the prewar period and functioned as a stable international currency system in its early phase.
- ② As the stabilization and liberalization of the global economy advanced, the transaction of goods and capital as well as wealth expanded. However, as the international capital grew, its speculation reached a scale that could not be easily contained by any state’s interventions, destabilizing the Bretton Woods System.
- ③ Because the Bretton Woods System allowed a country to continuously maintain its fixed exchange rate (although pressures for devaluation or revaluation existed) even if there had been a drastic change in the country’s economic capacity, there emerged a country like Japan whose currency’s fixed exchange rate gradually worked to the advantage of its trade, while there was a country like the U.S. whose currency exchange rate gradually worked to the disadvantage of its trade. This factor accelerated the capital transfer from a country of bad trade performance to a country of good trade performance, and thereby caused a further destabilization of the Bretton Woods System.

²²⁶ “Transcript of President’s Address on Moves to Deal with Economic Problems.” *The New York Times*, August 16, 1971.

- ④ As the productivity and quality of Japanese traded goods improved, the exchange rate of 360 yen to the dollar gradually worked to the advantage of its trade. However, as this factor invited an increase in export-oriented industry which relied heavily on export for their survival, as well as an increase in the size of wealth that depended upon export performance, along with these increases there also increased the scale of potential economic damage and loss that could be inflicted in the event of yen revaluation.
- ⑤ The increase in the scale of potential economic damage aroused people's fear, and fear in turn led to their active support for the 360 yen rate and active resistance to any currency system other than the fixed exchange rate system because any other system was expected to cause a yen revaluation.
- ⑥ Because monetary authorities' decisions and judgments had been affected by fear, they became unable to see the objective fact that the Japanese economy had grown to a level that it would not be much damaged by a revaluation of a modest degree. There were some experts who could objectively evaluate the strength of the Japanese economy, but many business leaders and the majority of government officials and bank executives were driven by the fear of losing the 360 yen rate and thus attempted to postpone yen revaluation. Because it was postponed, it led to a drastic revaluation later.
- ⑦ Out of fear, in an attempt to maintain the yen exchange rate and the fixed exchange rate system, a transformation of economic structure advanced in Japan, such as the rapid liberalization of trade and capital as well as the promotion of domestic demand. In other words, an increase in potential damage and fear had a function to strengthen or transform the preexisting economic system.

Through the above description, this chapter explained the cycle of: An increase in wealth/transaction based on a stable system = an increase in potential damage → Increase in Fear → A strengthening or transformation of the preexisting system in order to contain potential damage → An increase in wealth/transaction based on a new stable system = an increase in potential damage. We have seen this cycle through the cases of both Japan and the Bretton Woods System.

CHAPTER 2

The Deepening Contradictions of the Fixed Exchange Rate system and the Expansion of Potential Economic Damage

In Chapter 1, we saw that the Bretton Woods System (a fixed exchange rate system based on the dollar-gold standard) prevented the world from reverting to bloc economies, stabilized the trade environment, and contributed to the expansion of trade and international capital transactions. The chapter also demonstrated that Japan's heavy dependence on its fixed yen rate for its export expansion increased the potential damage that a rise of the yen would cause. In turn, this spread fears of a yen revaluation, propelled people's support for the fixed-rate system, and led to the development of policies and measures for the fortification of the system.

Here in Chapter 2, we will look at the process by which such advantages of the fixed-rate system turned out to cause problems as the scale of the international economy expanded further. In other words, we will look at **the process by which growing international trade and international capital transactions, both of which expanded with the help of the fixed exchange rate system, made it impossible for the system to persist as they grew.** Of course, the expansion of the international economy alone did not create contradictions in the fixed-rate system, and there were a number of different factors that led to them. However, as will be discussed below, such factors became serious problems as the scale of the economy expanded, and in that sense, expansion of the economy played a central role.

In this chapter, we will also look at how **monetary authorities' fears of a collapse of the fixed exchange rate system worked to delay changes in the currency system necessary for solving the contradictions.** Although we examined in Chapter 1 the process by which Japan actively gave support and held fast to the fixed-rate system, the focuses of Chapter 1 and Chapter 2 are not the same. Whereas Chapter 1 focused on the ways in which the expansion of potential damage and the accompanying fears led to efforts to strengthen the fixed-rate system, this chapter sheds light on the fact that, even after the Nixon Shock, a realistic **change in the system was delayed** due to the fears over a collapse of the fixed-rate system. Chapter 3, in turn, will focus on how fears over potential damage led to efforts to actively bolster the floating system once it became clear that an adherence to the fixed-rate system was actually creating greater instability and losses in the situation where international trade and capital transaction were growing.

In short, this dissertation intends to study the effects of potential damage and fears over them at each of the stages so that we could understand their roles in the overall picture. And, what this dissertation attempts to demonstrate through studying such cases is that **(1) the expansion of international trade and international capital movement plays an important role in disabling the preexisting currency system, arousing fear in the people, and motivating them to take action. (2) it is not only by our profit-seeking**

motivation but also by the expansion of potential damage and people's fear of it that an economic system is fortified (explained in Chapter 1), a change in the system is resisted and delayed (which will be explained in this chapter), and a change in the system is propelled (which will be explained in Chapter 3).

Then, specifically how did the expansion of international trade and international capital movements make it impossible for the fixed-rate system to persist? Before examining this historical process, which will be discussed in Section 2, we will first examine in the Section 1 below some theoretical reasons why the fixed-rate system became dysfunctional.

Section 1 Framework - Demerits of the Fixed Exchange Rate System

(1) One of the problems of the fixed-rate system is as follows. In an environment where the currency exchange rates are fixed, the exports of countries with an undervalued rate relative to their export competitiveness tend to have an advantage, while countries with an overvalued rate face a disadvantage. As a result, a gap tends to emerge in the export competitiveness among these countries, leading to a **slowdown in the competition** over some products. And such a tendency inhibits the expansion of the free economy.

The previous chapter discussed how the fixed exchange rates of the United States and Japan promoted their competition by putting U.S. exports at a disadvantage and Japanese ones at an advantage. However, this process was relevant only up to a point where Japan's export competitiveness **caught up** with that of the United States. Even once Japan's competitiveness had overtaken that of the U.S., such advantage and disadvantage continued to influence their economies, widening the gap in their export competitiveness. It is a common thing that key industries diverge among countries according to their comparative advantage, but the problem was that the fixed-rate system alone could have so much influence in determining a country's comparative advantage.

Such a problem of the fixed-rate system can be understood better by comparing it to the floating system, which is considered by many economic experts to be capable of alleviating the problem. For example, when Japanese exports are going strong, under the floating system, demand for the yen increases, leading to an increased pressure for the yen's appreciation. This is because Japanese companies exchange the payments in dollars to yen for use in Japan. At the same time, when exports are going strong, Japan's economic credibility rises and thus encourages overseas investors to exchange other currencies into the Japanese yen. This too works to increase the pressure for the yen's appreciation. What happens then is that the higher yen makes the overseas prices of Japanese products more expensive, and thus Japanese products become harder to sell overseas than before. Meanwhile, due to the high yen, import prices become relatively cheaper, making imported goods easier to sell within Japan. Such phenomena work to restrain the expansion of Japanese exports and its trade surplus. Of course, if a country succeeds in improving its productivity and producing high-quality commodities, it would be possible for the country to further heighten its export competitiveness and expand its trade surplus despite an appreciation of the currency. However, until this is achieved, an appreciation of a currency temporarily serves to restrain the country's expansion of exports and trade surplus.

On the other hand, under the floating system, if the dollar depreciates due to a greater U.S. trade and budget deficit, the overseas prices of the U.S. products fall and thus they will sell more than before. Meanwhile, due to the lower dollar, import prices become relatively higher, making the imported goods harder to sell within the U.S. Such phenomena work to improve the competitiveness of U.S. exports and its trade balance. Of course, even with a depreciation of the dollar, a decline in productivity and product quality would invite a further decline in export competitiveness and expand the trade

deficit. However, a depreciation of the dollar would temporarily work to promote U.S. export expansion and improve its trade balance.

Many scholars have pointed out that the floating system has the above function of automatically adjusting the export competitiveness and trade balance among states. And such adjustments are thought to stimulate export competition among states. (However, the adjustments do not occur immediately and experience a time lag. Moreover, the adjustments do not work well in an environment where the currency exchange rate is determined more by the capital balance than by the trade balance.²²⁷ The latter point will be discussed in detail in Chapter 4.)

On the other hand, as discussed above, in an environment where the exchange rates are fixed, countries with undervalued rates relative to their export competitiveness have an export advantage, while those with overvalued rates have a disadvantage. As a result, a gap tends to emerge in the export competitiveness among these countries. Of course, as discussed above, if a country succeeds in improving its productivity and producing high-quality commodities, the pressure exerted by the rates can be overcome. Thus, it is true that the fixed-rate system does not necessarily diminish competition, and moreover, the currency exchange rate alone does not determine a country's export competitiveness. However, until a country achieves an improvement in productivity and an increase in the production of high-quality commodities, an overvalued exchange rate will continue to suppress export competitiveness, and such a continued pressure would make it easier for companies to fail along the way. Thus, the fixed-rate system is an environment that can diminish opportunities for competition over some products among certain states, and inhibit the expansion of the free economy.

And what needs to be stressed here is that the problem of the fixed-rate system did not worsen on its own, but that it is aggravated through the expansion of international trade. For instance, if the scale of the international trade is small, the U.S. products that could be driven out by Japanese and West German products will be limited, allowing the U.S. products to survive by relying on domestic demand. However, as the scale of trade expands and various trade commodities are transacted in large amounts, the U.S. products that could be driven out will also expand in terms of categories and scale. Consequently, there will be a slowdown in the competition over some products. In such a manner, the structural contradiction of the fixed-rate system is aggravated through the expansion of the international trade.

(2) The next problem of the fixed-rate system is that, even while there is apparent aggravation of trade imbalance, it is difficult to alter exchange rates in a timely manner since it requires international political agreements.

As mentioned in the previous chapter, the advantage of the fixed-rate system is that it is promptly enforceable by political leadership and intergovernmental agreements. But, to put it the other way around, it means that the system may no longer work well when political leadership and intergovernmental agreements are weakened. As Yoshiharu

²²⁷ Balance of capital account is the net result of public and private international investments flowing in and out of a country, whereas trade balance reflects the difference between the total value of exports and the total value of imports.

Kitada, a former professor at Tokyo Keizai University, described, “It was only natural that the system that was supported by international financial cooperation would collapse with the breakdown of that cooperation.”²²⁸

For instance, many major countries before the Nixon Shock had been urging the United States to improve its current account balance so as to restore the world’s confidence in the dollar, but rather than defending the value of the dollar for the stabilization of the international currency regime, the U.S. chose domestic economic boost, leading to an increase in the amount of imports and further aggravation of its current account balance. But other countries did not respond to the request from the U.S. either. For example, although West Germany achieved rapid economic development after World War II, it revalued the Deutsche mark by the end of 1960s only twice in 1961 and 1969, and moreover, those revaluations were implemented not primarily because of the pressures from the U.S., but in part because West Germany aimed at suppressing inflation through the revaluation and in part because the country was overpowered by the enormous volume of speculative capital inflow. As for Japan, monetary authorities, economic experts, and business communities were even more resistant to a currency revaluation. Even when foreign pressures for yen revaluation were heightening between 1969 and 1971, Japan, in fear of damage to its export industry, kept rejecting it, and in the end did not implement any revaluation up until the Nixon Shock. And, while necessary agreements among major countries were being delayed, the world’s trade imbalance kept widening.

Also, under the fixed-rate system, countries can easily miss not only the appropriate timing of revaluation but also the appropriate timing of devaluation, for the following political reason: Since the fixed-rate system mandates that exchange rates stay fixed, a country’s decision to undertake currency devaluation will be seen as confessing the failure in their economic policy. Devaluation will damage the credibility of the government and thus it is not easy for a government to commit to it.²²⁹ Along with actual harm that devaluation brings, one of the reasons that the U.S. continued to reject devaluation of the dollar in spite of obvious erosion in the confidence in the dollar was the concern about such damage to the governmental credibility, and therefore, as quoted in the previous chapter, president Nixon was desperate to make the suspension of dollar-gold convertibility look not like a defeat but a victory.

Thus, under the fixed-rate system, which requires international agreements to modify exchange rates, timely adjustment can be much delayed and meanwhile trade imbalance can be seriously aggravated. If international agreements on currency adjustments and actual currency adjustments occur with a certain degree of frequency (even if not as often as daily currency fluctuation under the floating system), the trade imbalance can be eased in a more timely manner, but such agreements are not easy to reach under the fixed-rate system because the success of agreements depends not only on the relations between nations but also on their domestic political situations. And as the adjustment of exchange rates and the correction of world trade imbalance are delayed further, countries have to suffer huge changes in their exchange rates later, in the face of overwhelming international capital movements (speculations) and foreign pressures.

²²⁸ Kitada, Yoshiharu. “Maruku no doyo to en.” *Keizai*, July 1971, 202.

²²⁹ Komiya, Ryutarō. “Adjustable peg no kekkan.” *Keizaigaku Ronshu*, dai 36-kan dai 4-go, January 1971, 14.

This shortcoming of the fixed-rate system is broadly known, but what needs to be emphasized here is that this shortcoming did not grow on its own but was aggravated through the expansion of international trade and international capital movement. For example, if the scale of international trade and capital movement is small, the speed that international economic imbalance aggravates and the pace that the currency market destabilizes will remain relatively slow. Thus we can take relatively longer time to reach political agreements and decisions for the adjustment of exchange rates. However, as the scale of international trade and capital movement increases and thereby the speed of international imbalance aggravation and the pace of currency market destabilization accelerate, the time that can be taken to reach international agreements gets shorter and thus the timely response to the situation become more difficult. In such a manner, the structural contradiction of the fixed-rate system is aggravated through the expansion of the international trade and international capital movement.

(3) The next problem of the fixed-rate system is that, because exchange rates are fixed, the exchange rates under the fixed-rate system often do not correctly reflect the ever changing real economic competitiveness of countries. Rather, they tend to reflect it in a distorted way, and mislead people's judgment and drive them toward wrong policies and economic activities.

If exchange rates are allowed to fluctuate daily as in the floating system, it certainly brings exchange risk (although the risk can be mitigated by futures transactions) but the good side is that such fluctuations are gradual and thus countries and the corporations can adjust their economic strategies gradually and thereby reduce the shock of such fluctuations. However, under the fixed-rate system, even when the pressure for the modification of exchange rates actually exists, such pressure may not be recognized clearly because exchange rates are firmly fixed. As a result, economic activities tend to take place in a manner that does not prepare for a change in the exchange rate, and sometimes in a way that can even increase the economic damage once the change takes place.

But, even if we resist modifying the exchange rates, the pressure for the change does not go away but it only mounts up. As exemplified in the case where the yen was revalued more drastically than other currencies after the Nixon Shock, the exchange rate has to change considerably later on if it has been artificially suppressed.²³⁰ Also, when there is a concentration of currency-buying under the floating system, the currency's exchange rate gradually rises, making it more expensive to continue buying the currency. But, under the fixed-rate system, even when there is a massive currency speculation, the state intervenes in the market to sustain the exchange rate, and thus speculators can continue buying the currency at the same rate. This aspect of the fixed-rate system often prolongs the period of the speculation. And this is not a problem that only emerges in case of revaluation. The problem applies to the case of devaluation as well. As Paul

²³⁰ Because Japan was suppressing a revaluation for a long period, it had to experience steep revaluation compared to West Germany, which had been revaluing its currency from time to time.; Ishida, Sadao. "Sengo nihon Keizai naigai no ugoki to kin'yu seisaku no un'ei." *Seikei ronso*, Dai 63-kan dai 2, 3-go, 1995, 306.

Volcker said, “waiting to devalue until the case was crystal clear and the need was large could unleash strong speculative forces in the market and create economic distortions.”²³¹ And such a sudden change may result in a huge economic damage because of the lack of preparation against such a change.

In short, over the long term, fixing an exchange rate prevents the rate from properly reflecting the actual condition of national economy, conceals the rate adjustment pressure mounting underneath, misleads people’s judgment, and delays an appropriate response. As a result, by depending largely on their fixed exchange rates that do not quite reflect the economic fundamentals, those defenseless and unprepared countries and the corporations suffer severe economic damage later. Of course, there are many factors that cause wrong decision-making and thus the fixed-rate system is not the only one that causes wrong judgment. For example, as to the reason why Japan could not respond promptly to the pressure for yen revaluation, some blame the characteristics of the Liberal Democratic Party regime.²³² However, other factors do not cancel out the fact that the wrong signal of the fixed exchange rates that do not reflect the reality is one of the big factors that mislead people’s perception and response.

In case of a key currency country, such problem emerged more prominently. At least in countries other than the U.S., a lack of foreign currencies ultimately sent big warning signals (although not as frequent as the warning signals in the floating system), since the lack of foreign currencies resulting from external deficits would make the countries unable to intervene in their own foreign exchange market and would invite defaults. For that reason, the countries are guided either to make improvements in their international balance or to consider devaluation if improvements are not expected to be made in a timely manner. However, for the U.S., an external deficit did not serve as a strong warning signal, because the U.S., a key currency country, made foreign payments using its own currency, which could be printed at will. As a result, the U.S. could continue aggravating its trade balance and widening the distortion between the value of the dollar and the country’s actual economic power. A perceivable strong danger signal appeared to the U.S. only when the situation culminated in the Nixon Shock. Although Paul Volcker, looking back, said, “shouldn’t we have heeded the warning signals about inflation and the dollar that the exchange markets were sending us, if only for our own good?”²³³ the position of the U.S. as a key currency country that could make foreign payments using its own currency made it easy to ignore the warning signals that signaled the distortion between its actual economic power and its currency rate. In these ways, the fixed-rate system had the effect of misguiding and delaying both the key and non-key currency countries in tackling the real situations they were in.

And what needs to be once again pointed out here is that this problem of the fixed-rate system did not grow on its own but it was aggravated through the expansion of international trade and international capital movement. If the scale of international trade and international capital movement is small, the international imbalance would also be relatively small, and thus the degree at which a fixed exchange rate would erroneously reflect a nation’s actual economic competitiveness would also remain relatively small.

²³¹ Volcker, Paul. and Gyohten, Toyoo. *Changing Fortunes*. Times Books, 1992, 41.

²³² Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 71

²³³ Volcker, Paul. and Gyohten, Toyoo. *Changing Fortunes*. Times Books, 1992, 62.

However, as the scale of the international trade and international capital transactions expands and the international imbalance grows, a fixed exchange rate will tend to more erroneously reflect a nation's actual economic competitiveness. The bigger the distortion, the more difficult it becomes for people to perceive and handle things realistically, and as a consequence, they would suffer huge damage when the situation begins to force a correction of the distortion. In such a manner, the structural contradiction of the fixed-rate system aggravates through the expansion of the international trade and international capital movement.

(4) The next problem of the fixed-rate system is that the fixed-rate system, which can work to sustain the international trade and international capital movement for some time, gradually becomes unable to handle the scale of the international trade and capital movement as they expand.

As explained in the previous chapter, the Bretton Woods System prevented the world from reverting to bloc economies, stabilized the exchange market by removing foreign exchange risk, and thereby contributed to the expansion of trade and international capital transactions. However, the fixed-rate system possessed structural contradictions that made it inevitable for the system to be crushed by the very expansion of international trade and capital transactions that it supported.

The Bretton Woods System was the fixed-rate system in the form of gold-dollar standard, and it was the latter aspect of the system (gold-dollar standard) that first became dysfunctional. The Bretton Woods System was predicated on the rule that the gold and the dollar were always convertible, but this rule faced troubles due to the excessive supply of the dollar and the expansion of international capital. An increase in the supply of the key currency, the dollar, was necessary because the international economy would face a growth limit without a sufficient supply of the key currency. However, the contradiction was that as the supply continued to increase, the dollar could no longer be able to be exchanged with gold, whose amount was limited. As a result of the continued selling of the dollar in the world currency markets and the continued buying of gold, the U.S. was forced to suspend the gold-dollar convertibility, leading to the collapse of the gold-dollar standard system.

The next thing that became dysfunctional as a result of the expansion of international trade and international capital movement was the fixed-rate system itself. Before and after the Nixon Shock, major countries implemented dollar-buying intervention in response to the dollar-selling in the foreign exchange market, but the enormous sale of the dollar made it impossible for them to continue the intervention, and eventually, they had to shift to the floating system. Afterwards, the major countries that feared economic instability that would result from the lack of a fixed-rate system rebuilt the system in December 1971 through the Smithsonian Agreement, a multilateral agreement that readjusted the fixed exchange rates of major countries. However, this Smithsonian system did not last long due to the large-scale dollar-selling in the market, and consequently, the major countries had to once again shift to the floating system. These instances illustrate the contradiction that international trade and capital, which expanded thanks to the fixed-rate system, made the very system dysfunctional as they expanded.

What needs to be stressed here is the central role that the expansion of international trade and capital played in the collapse of the Bretton Woods system. Even if there are many factors that make the fixed-rate system dysfunctional as discussed above, a country's fixed exchange rate can still be defended through foreign exchange intervention if the scale of the international capital is small, and thus a collapse of the fixed-rate system can be averted despite the various problems inherent in the system. However, once the international capital expands, the enormous scale of currency selling and buying makes it difficult for countries to control their exchange rates and maintain the fixed-rate system through intervention. In such a manner, the structural contradiction of the fixed-rate system aggravates through the expansion of the international trade and international capital movement.

However, to add quickly in order to avoid misunderstanding, it should be noted that the above explanation does not imply that the fixed-rate system is now obsolete and thing of the past in today's world where the scale of international capital movement has become enormous. For example, China, now the second largest economy in the world, is still maintaining a strictly managed floating system which looks very akin to the fixed-rate system. Many other countries have adopted such system as well. However, the structure of the problem still remains the same: as the scale of international capital movement expands, it becomes more difficult to maintain the fixed rates solely by exchange intervention. As a country has more businesses that operate overseas through trade and investment and invites more businesses and investments from overseas, the country's foreign exchange control has to be relaxed in order to allow such economic activities. And as the foreign exchange control is relaxed, a shift to the market-oriented floating system becomes a matter of time. What is pointed out above is that the expansion of global economy and globalization brings such pressure for a shift, and not that the fixed-rate system and strictly managed floating system are already unseen today.

Section 2 Historical Development

In Section 1 above, we have looked at some problems of the fixed exchange rate from a theoretical perspective. In this Section 2, by focusing in particular on the case of Japan, we will study how those problems became historically significant, and how the aggravation of those problems heightened fear among monetary authorities over a possible loss of wealth that Japan had accumulated, prompted them to rebuild the fixed-rate system, and delayed their shift to the floating system.

(1) Resistance to the Collapse of the Fixed Exchange Rate System: From August to December 1971

As explained in the previous chapter, President Nixon announced on August 15th 1971 (August 16th Japan time) eight new economic policies, including the suspension of gold and dollar convertibility and 10% surcharge on imports to the United States. On the surface, the dollar rate stayed the same. But the aim of the suspension was to accelerate the buying of other currencies that had more credit and encourage their revaluation so that the dollar would be indirectly devalued against other currencies.

However, because Japanese authorities became blinded to the real situation as they continued to stubbornly resist the yen revaluation, they naturally assumed that the United States' intention was to maintain the value of the dollar. For this reason, many people could not immediately understand the real objectives behind the suspension of gold-dollar convertibility.

For example, according to Takashi Hosomi, then the Vice Minister of Finance for International Affairs, upon hearing Nixon's speech on the radio, "we frankly could not understand what Nixon was thinking ... but no one thought that the speech was intended to devalue the dollar. It was the next day, on the 17th, that we realized his intention. By then the massive selling of the dollar was already going on in the Tokyo exchange market, while the exchange markets such as the ones in London and Frankfurt were already closed down."²³⁴

Eisuke Sakakibara, who was at the Office of the Vice Minister of Finance for international affairs at the time, also testified as follows: "I remember that, because it was a sudden announcement, I did not understand what was really meant by the suspension of gold-dollar convertibility. Hosomi, the Vice Minister of Finance for International Affairs, and Toyoo Gyohten, then the Head of the Office of Vice Minister of Finance for International Affairs, both had more information than I did, so they probably understood more. But they probably did not understand immediately the enormous impact that the announcement would have. But it became gradually apparent from the calls from Paul Volcker, the Undersecretary of the Treasury Department, as well as conferences and talks that followed, that an era had come to an end."²³⁵

²³⁴ Hosomi, Takashi. *Gekido suru kokusai tsuka - Sumisonian kara ju-nen*. Jijitsushinsha, 1982, 370.

²³⁵ Sakakibara, Eisuke. *Tsuyoi en wa Nihon no kokueiki*. Toyo Keizai Shinposha, 2008, 68.

The problem was not only that there were delays in grasping the situation but also that no measures that tackled the heightened real revaluation pressure were ready because the government and the Bank of Japan had been stubbornly refusing to consider a yen revaluation. The measures taken up to that point were meant to suppress the international pressure to revalue the yen, and not designed for situations where the pressure could no longer be suppressed. The failure resulting from such lack of preparation manifested itself as follows.

First, when the Nixon's speech was delivered at 10 a.m. on the 16th (Japan time), the exchange market was already open in Japan. The issue was whether to close the market. According to Ushio Shiota, a journalist, Takashi Hosomi, then the Vice Minister of Finance for International Affairs, considered the necessity of closing down the market, but Yusuke Kashiwagi, the former Vice Minister of Finance for International Affairs and then an advisor at the Ministry of Finance, and Ichiro Hatoyama, the Administrative Vice Minister of Finance, proposed that the market remain open for the day since it would cause a disruption to close down a market that was already open. Hosomi then reported this opinion to the Finance Minister Mikio Mizuta, who in turn did not order a close-down.²³⁶

But, in the meantime, the participants in the exchange market (exchange banks), prompted by fear of losses, quickly grasped the meaning of Nixon's speech, and sold the dollar at a historic high. During the 16th alone, the volume of spot trading was 612 million dollars, over 8.7 times the amount of the average daily transaction during the week immediately before the Nixon Shock. The dollars purchased by the Bank of Japan amounted to 598 million, posting a historic record as well.²³⁷

In the afternoon of the same day (the 16th), the Ministry of Finance and the Bank of Japan held an emergency meeting and debated whether to open or close down the exchange market the following day. Administrative Vice Minister of Finance Hatoyama proposed that the market should be closed down the following day in coordination with the European countries to monitor the progress of events. However, the International Financial Bureau opposed the closure, and the Bank of Japan also expressed that the market closure was inappropriate.²³⁸ In particular, Advisor Kashiwagi took a stance against Hatoyama and argued that the market should remain open for the following reasons. First, as there were more foreign currency transactions in Japan compared to Europe, the economic damage would be huge if the market is closed down and market participants could not conduct foreign transactions. Second, once the market is closed down, a foreign exchange intervention cannot be implemented, making it difficult for them to maintain the yen exchange rate once the market is reopened. Moreover, it was hard to predict how much the yen would soar in that situation. Third, if the yen is revalued, then it could diminish Japan's export volume to a great extent, further worsening the domestic economy that was already facing a recession. Finally, since the

²³⁶ Shiota, Ushio. *Kasumigaseki ga furueta hi - Tsuka senso no juni-nichi kan* -. Saimaru Shuppankai (Simul Press), 1983, 76.

²³⁷ *Ibid.*, 78 - 79.

²³⁸ Ekonomisuto Henshubu. *Sengo sangyo-shi e no shogen 4 Kin'yu no saihensei*. 1978, 206; Nihon ginko hyakunen-shi hensan iinkai ed. *Nihon Ginko hyakunen-shi 6-kan*. Nihon ginko, 1986, 319-20.

strong Foreign Exchange and Foreign Trade Control is in place, it must be possible to prevent the inflow of speculative capital.²³⁹

These were their reasons but, according to Gyohten, then the Head of the Office of Vice Minister of Finance for International Affairs, there was yet another reason for the decision to keep the market open: “they [those who opposed the closure] advanced a strong argument for protecting the banks. Banks had large amounts of dollar assets on their books, which they had taken on under strong persuasion by the Ministry of Finance and the Bank of Japan. If the markets were closed, they would be unable to sell them and would suffer huge losses.”²⁴⁰ The amount of foreign currencies that each bank had was as follows. Fuji Bank: 150 million dollars, Mitsubishi Bank: 140 million dollars, Sumitomo Bank: 130 million dollars, Sanwa Bank: 125 million dollars, the Bank of Tokyo: 110 million dollars, Mitsui Bank: 95 million dollars, and eight other banks: 470 million dollars, which amounted to the total of 1.22 billion dollars. Thus, in case of 30 yen revaluation, each bank was expected to suffer an average loss of 2.6 billion yen overnight.²⁴¹ But what was the reason that the government and the Bank of Japan requested the exchange banks to hold dollars? According to the journalist Ushio Shiota, the government wanted to hide Japan’s international balance surplus. It feared that the surplus would lead to greater pressure from overseas to revalue the yen. Thus, by having the banks hold part of the surplus in foreign currencies, the government attempted to avert the pressure.²⁴² This meant that once the market is completely closed, the exchange banks that had been most cooperative would suffer the most. This consideration is said to have further bolstered the argument that the market should remain open.²⁴³

For the above reasons, the top officials in the Ministry of Finance and the Bank of Japan leaned toward the policy of keeping the market open. However, since the markets were not yet open in France, Italy, Belgium, and Luxemburg because of time-zone difference, the officials decided to wait and observe the situation for a while. The final decision was to be made the following day.²⁴⁴ At noon on the 17th, the Ministry of Finance and the Bank of Japan held a meeting once again to decide whether to open the market. Ultimately, the market was kept open based on the Finance Minister Mizuta’s decision. The emergency cabinet meeting held on the same day confirmed that Japan would adhere to the ongoing yen rate while maintaining the fixed-rate system, and that it would thoroughly implement “Eight-Point Program to Avoid Yen Revaluation” that had been launched the previous June.²⁴⁵ Moreover, Advisor Yusuke Kashiwagi was appointed

²³⁹ Shiota, Ushio. *Kasumigaseki ga furueta hi - Tsuka senso no juni-nichi kan* -. Saimaru Shuppankai (Simul Press), 1983, 95-96 ; Ekonomisuto Henshubu. *Sengo sangyo-shi e no shogen 4 Kin'yu no saihensei*. Mainichi Shinbunsha, 1978, 206-207; Okurasho Zaiseishitsu ed. *Showa Zaiseishi - Showa 27-48 nen do 12 Kokusai kin'yu, Taigai kankei jiko (2)*. Toyokeizai Shinposha, 1992, 382.

²⁴⁰ Volcker, Paul. and Gyohten, Toyoo. *Changing Fortunes*. Times Books, 1992, 93.

²⁴¹ Shiota, Ushio. *Kasumigaseki ga furueta hi - Tsuka senso no juni-nichi kan* -. Saimaru Shuppankai (Simul Press), 1983, 125.

²⁴² *Ibid.*, 123.

²⁴³ Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 263.

²⁴⁴ *Ibid.*

²⁴⁵ Komiya, Ryutaro and Suda, Miyako. *Gendai kokusai kin'yu ron - Rekishi seisaku hen*. Nihon Keizai Shinbunsha, 1983, 33.

to be dispatched to Europe and the U.S. to gather accurate information on the situations abroad.²⁴⁶

However, while the decision to keep the market open served to avert losses by exchange banks, it was a faulty decision in judging that the rate could be maintained through foreign exchange intervention. At the press conference held on August 17th, Hosomi, Vice Minister of Finance for Foreign Affairs, said, “Even if the exchange market is to remain open and the government makes foreign exchange intervention, it would only amount to around 1.5 billion dollars.”²⁴⁷ However, as proven later, the actual scale of dollar-buying intervention far exceeded the amount Hosomi mentioned, and the intervention could not last long in the face of an enormous scale of dollar-selling. At the press conference held on the 19th, when the dollar continued to be sold in large amounts, the Finance Minister Mizuta remained steadfast to his opinion and commented that “The exchange and stock markets are getting rough, but we are not thinking of closing them down. If we close down the exchange market, it would have a great negative impact on our trade. Since the market is under exchange control [in Japan], we do not think that the yen would be attacked by short-term capital even if the market remains open.”²⁴⁸ But, in the meantime, an enormous amount of dollar-selling was in process. During the morning of the 19th alone, there was a selling of over 600 million dollars.

However, there also was an opinion that Ministry of Finance and the Bank of Japan were well expecting that they would eventually be pressured to implement revaluation. For example, looking back on those days, Tadashi Sasaki, the Governor of the Bank of Japan at the time of the Nixon Shock, said that while the policy makers around August 16th and 17th understood that the yen revaluation could come as a reality, “the government could not announce that yen revaluation was a possibility, when the foreign exchange market was open. Even if we thought in our heart that a certain degree of revaluation was inevitable, we had to say that, at least on the surface, the parity was to be maintained.”²⁴⁹

However, other testimonies give a different impression. For example, looking back, Hosomi said, “It was decided at an early stage that the yen parity should be maintained and that the market should not be closed. There was absolutely no discussion of changing the rate of 360 yen. Because no one was mentally prepared for that, there was no way we could take such a bold measure. This was not just the judgment made by the Ministry of Finance. It was actually the Bank of Japan that pushed most strongly to maintain the rate at 360 yen without closing down the market.”²⁵⁰ Moreover, Takehiro Sagami, then the Director of Research and Planning Division in the Ministry of Finance, who also attended

²⁴⁶ Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 263.

²⁴⁷ Shiota, Ushio. *Kasumigaseki ga furueta hi - Tsuka senso no juni-nichi kan* -. Saimaru Shuppankai (Simul Press), 1983, 135.

²⁴⁸ Komiya, Ryutaro and Suda, Miyako. *Gendai kokusai kin'yu ron - Rekishi seisaku hen*. Nihon Keizai Shinbunsha, 1983, 34.

²⁴⁹ Ekonomisuto Henshubu. *Sengo sangyo-shi e no shogen 4 Kin'yu no saihensei*. Mainichi Shimbunsha, 1978, 210.

²⁵⁰ Shiota, Ushio. *Kasumigaseki ga furueta hi - Tsuka senso no juni-nichi kan* -. Saimaru Shuppankai (Simul Press), 1983, 104.

the meeting, looked back and said, “The unspoken consensus was that the parity (heika) was your majesty (heika) [meaning, the yen rate was too divine to alter]”²⁵¹

As seen above, the testimonies seem contradictory and do not provide a definitive answer as to whether the officials were really mentally prepared for revaluation. However, from their final decision to keep the market open and continue the dollar-buying intervention, we can surmise that the officials intended to defend the yen rate as much as possible.

In contrast to the government and the Bank of Japan, who thought it possible to continue the dollar-buying intervention and maintain the yen rate, the business sector was making more realistic decisions. Kyoji Tagami, a critic, summarizes the moves made by the business sector as follows: “On August 19th, the Japan Federation of Economic Organizations (Keidanren) held an emergency meeting and reached the consensus that ‘It is impossible to maintain the fixed-rate system, and that multilateral parity adjustments are inevitable. The Japan Association of Corporate Executives (Keizai Doyukai) also concluded at their board meeting that ‘It is imperative that the yen be revalued early or that Japan adopt the floating system.’ On the same day, major trading companies also called for ‘an immediate government announcement of a policy to work on an adjustment of the yen.’ ... At the Japan-U.S. Business Leaders’ Summit held in Honolulu on August 21st, the Japanese business leaders, facing the strong demand by the U.S. to revalue the yen, further leaned towards the policy of revaluation ... it became clear that the revaluation will not settle within the range of 10% and under.”²⁵²

According to the journalist Ushio Shiota, the business sector pushed toward parity adjustments “not just because the businessmen were feeling more anxious against the backdrop of an aggravating international financial situation, an inextricable economic relationship between Japan and the U.S., and the worsening anti-Japanese sentiment abroad. But the reason for the shift in their thinking was also that it was no longer possible to fight against damage such as delays in business talks, the collapse of orderly transactions, fears over foreign exchange losses, and pressures resulting from export duties, which were taking place due to the market confusion.”²⁵³ In the midst of the market disruption, fears arose that losses resulting from the long-term instability of the exchange market would be bigger than those resulting from a slight revaluation. Thus the business sector, especially the major corporations, was beginning to change their earlier “defend the yen rate” position (although shipbuilders, plant industries and medium and small businesses, who expected losses from a revaluation, continued to oppose it).

Although there was such demand from parts of the business sector, the government left the market open and continued to intervene in order to maintain the rate, thinking that the revaluation would have a more serious impact on the Japanese economy. However, because the dollar was sold on a massive scale, on August 22nd, a top-level meeting was held in the Ministry of Finance to discuss their next move. In contrast to the meetings held on the 16th and the 17th, at this meeting, the overall consensus was that a shift to the float was inevitable because, first, the response of European countries had gradually become clear, and second, 2.2 billion dollars were sold over the four days between the

²⁵¹ *Ibid.*, 109.

²⁵² Tagami, Kyoji. “Zaikai, Seifu no en taisaku hihan.” *Keizai*, November 1971, 65.

²⁵³ Shiota, Ushio. *Kasumigaseki ga furueta hi - Tsuka senso no juni-nichi kan* -. Saimaru Shuppankai (Simul Press), 1983, 186.

16th and the 19th. However, a final decision was not made. Instead they agreed that, until the European situation became clearer, they should prepare themselves to respond appropriately in case any of the following becomes imperative: (1) maintaining the ongoing policy (2) revaluation or (3) floating up.²⁵⁴

After the Ministry of Finance advisor Kashiwagi returned Japan on August 23rd, a joint meeting of the Ministry of Finance and the Bank of Japan was held in the evening of the same day. Kashiwagi reported the overseas situation based on his conversations with French Director of the Treasury Claude Pierre-Brossolette, the Secretary-General of OECD Emile Van Lennep, Secretary of Treasury Connally, Under Secretary of Treasury Volcker, President's Assistant for International Economic Affairs Peter George Peterson, Managing Director and Chairman of the Board of the IMF Pierre-Paul Schweitzer, Chairman of the President's Council of Economic Advisors Paul W. McCracken: (1) Europe asserted that the devaluation of the dollar is necessary with multilateral adjustments, and that they would not make an agreement unless the yen is revalued to the maximum. (2) The U.S. said that it has done all that was required, and that the rest is up to the collaboration of each country. The method of collaboration is not limited to currency adjustments but would also certainly include trade negotiations and coverage of defense expenses on the behalf of the U.S. The U.S. also stated that it expected Japan to make a major revaluation by shifting to the float.²⁵⁵

Discussions were held in response, and it was decided that a shift to the floating system and revaluation were inevitable.²⁵⁶ However, it took until the 24th to reconcile differences in opinion with the Bank of Japan. The Bank of Japan was reluctant about the shift, identifying the following issues: If the transition is made to the floating system, there is a strong possibility that the yen rises very high. If that happens, the yen will face a major revaluation when multilateral adjustments take place for the reestablishment of the fixed-rate system. The Bank of Japan also worried that, if the market was adjusted minimally through interventions, it might also stimulate and trigger speculations.²⁵⁷ However, the Japanese monetary authorities as a whole concluded that these issues were avertable if interventions were made to the market once the yen was high. And, in the early morning on the 25th, the talk between the Minister of Finance and the Bank of Japan Governor settled on the float rate ranging between 7% and 8% at around 355 yen.²⁵⁸

Subsequently, on August 27th, the Japanese government officially announced that it would provisionally adopt the floating system. At the press conference after the announcement, the Finance Minister Mizuta stressed that the transition to the floating system is strictly a provisional one: "once the market settles down under this measure,

²⁵⁴ Hosomi, Takashi. "Showa 46-49 nen no zaimukan, komon toji no sho mondai." Okurasho shiryō Z108-2-3; Inamura, Koichi. "Showa 45-47 nen no Kokusai kin'yu kyoku gyosei." Okurasho shiryō Z108-10-3 (Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 264)

²⁵⁵ Kashiwagi, Yusuke. *Gekidoki no tsuka gaiko*. Kin'yu Zaisei Jijo Kenkyukai, 1972, 134-40.

²⁵⁶ Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 264.

²⁵⁷ Hosomi, Takashi. "Showa 46-49 nen no zaimukan, komon toji no sho mondai." Okurasho shiryō Z108-2-3 (Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 264)

²⁵⁸ *Ibid.*

trade transactions are expected to stabilize. And then we are going to make efforts to take the next step and remove ourselves from this provisional measure.”²⁵⁹

As discussed earlier, parts of the business community were showing their support for revaluation and the floating system. However, speaking overall, the business community was full of concern about the government’s decision to shift to the floating system. Immediately, voices of concern over damage to industries were raised. Many newspaper and magazine articles pointed to the possibility of a prolonged recession. Some examples include: “A Sharp Drop in Exports is Inevitable: Domestic Recession to Worsen, Bankruptcies Too” (*Nihon Keizai Shimbun*, August 28, 1971), “The Dangers of a Large-Scale Recession” (*Asahi Shimbun*, August 28, 1971), and “Big Damages to Medium and Small Businesses: Revert to the Fixed-rate system as Soon as Possible” (*Mainichi Shimbun*, August 28, 1971), “Special Feature: Will the Nixon Recession Hit? (7) On-Site Reports: Small and Medium-Sized Businesses Facing Bankruptcies” (*Ekonomisuto*, 7 September 1971, 53 - 61).

The following day on August 28th, a shift to the floating system was made according to the previous day’s announcement. This was a slow response given that European countries closed down their exchange markets on August 16th in consideration of a possible confusion, and after taking necessary measures, reopened them by the 23rd, four days earlier than Japan; France and Belgium adopted the double exchange rate system (a system in which a fixed rate with small changes is applied to the commercial rates in trade transactions, while financial rates in financial and other transactions are subjected to the floating system), while West Germany and the Netherlands decided to continue with the floating system.

Japanese authorities purchased approximately 4 billion’s worth of the dollar during the twelve days that the market was open, as the table below shows (the selling of 500 million dollars and buying of 4.5 billion dollars). Considering that Japan’s accumulated foreign currency reserve was 3.5 billion dollars at the end of 1969 and 4.4 billion dollars at the end of 1970, the dollar-buys made during these eleven days were extremely large.

Dollar-selling by Japanese monetary authorities
From August 16 to August 27, 1971.

1971	Direct selling in the market	1971	Direct selling in the market
August 16	\$ 0.6 billion	August 23	\$ 0.01 billion
August 17	\$ 0.69 billion	August 24	△\$ 0.08 billion
August 18	\$ 0.28 billion	August 25	△\$ 0.42 billion
August 19	\$ 0.62 billion	August 26	\$ 0.5 billion
August 20	\$ 0.16 billion	August 27	\$ 1.19 billion
August 21	\$ 0.35 billion	Total	\$ 3.9 billion

△ signifies dollar-buying.

Nihon Ginko hyakunen-shi 6-kan. Nihon Ginko, 1986, 322.

²⁵⁹ Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 265.

As analyzed by the Ministry of Finance later, the dollar was sold through: (1) the inflow of advanced export proceeds of trading and other companies (2) foreign currency position adjustments made by exchange banks (3) current account surplus, and other things such as securities investment. In particular, (1) and (2) played a large role.²⁶⁰

As for the advanced export proceeds, they exceeded initial projections by posting 1.8 billion dollars, if small short-term funds below 50,000 dollars and advanced proceeds for ships received between August 16th and 27th are included.²⁶¹ In response to the European currency turmoil in May 1971, measures had been taken to restrict exchange banks' local loans and loan guarantees. Nonetheless, a large volume of advanced proceeds were received basically because improvements were made more than expected by major trading and other companies to raise funds, and loans could be borrowed easily from foreign banks.²⁶² Even back around this time, it was possible to receive loans from foreign buyers and banks in dollars as long as the borrower was a locally incorporated company, such as a trading company. Immediately after the Nixon Shock, the foreign currencies that the major companies had directed its overseas incorporated companies to send began to enter Japan. As the exchange banks bought them in, the banks sold them to the domestic exchange market to reduce the amount of dollars they held. To limit any more dollars to enter the Japanese market, the Ministry of Finance began to inspect banks and trading companies on August 19th and onwards, surveyed the status of advances they received on exports, and took steps to ensure proper management. On the 21st, the Ministry of International Trade and Industry requested the exchange banks to confirm thoroughly that the transactions in question were indeed advanced export proceeds, and gave an administrative guidance to the trading companies to voluntarily refrain from dollar-selling on the 23rd. However, these measures ultimately did not prevent the entry of large advanced export proceeds. On the 31st, a strong regulation was finally implemented and the inflow of the advance export proceeds began to halt.²⁶³

Regarding the dollars sold by the exchange banks to reduce their possession of the dollar, the following development took place. The net position held by major exchange banks on August 14th, right before the Nixon Shock, was 940 million dollars. It was after the Nixon Shock that these banks made an all-out effort to reduce their dollars. As a result, during the four days between the 16th and 19th alone, the major fifteen exchange banks sold approximately 2 billion dollars. The main resource that these banks sold was mainly that borrowed from foreign banks. In mid-August, the total amount of increase in loans from foreign banks among the fifteen main exchange banks was 1.65 billion dollars.²⁶⁴ To counter this, on August 18th, the Ministry of Finance regulated the loan balances of 24 exchange banks to sever the banks' major sources for foreign currencies.²⁶⁵ In addition, a regulation was put in place to regulate the conversion of foreign currencies into the yen. For this reason, the exchange banks were under the pressure to purchase the dollar again at the risk of suffering exchange rate losses. To

²⁶⁰ "Tsuka chosei ni kansuru hokokusho." March 1973, Okurasho shiryō Z27-379 in Okurasho Zaiseishishitsu ed. *Showa zaiseishi - Showa 27-48 nen do (dai 18-kan) Shiryō (6) Kokusai kin'yū, Taigai kankei jiko*. Toyo Keizai Shinposha, 1998, 270.

²⁶¹ *Ibid.*, 271.

²⁶² *Ibid.*

²⁶³ *Ibid.*

²⁶⁴ *Ibid.*, 272.

²⁶⁵ *Ibid.*

subdue the sale of the dollar, the Bank of Japan strongly urged the exchange banks to adhere to the regulation.

However, at the same time, the Bank of Japan thought it was necessary to tackle the problem that the regulation would strongly invite exchange risks on the part of the exchange banks. Accordingly, while maintaining the regulation, the Bank of Japan approved the repayment of the Bank of Japan foreign currency loans, and shifting that portion to the dollar.²⁶⁶ Moreover, on the 26th, the Bank of Japan allowed the repayment of foreign currency loans before the due date.

However, these ambivalent policies resulted in fueling the dollar-selling. On August 26th and 27th, the dollar-selling once again reignited, and in particular, an astounding 1.2 billion's worth of the dollar was sold in one day on the 27th.²⁶⁷ The total of dollars sold by the fifteen main exchange banks between the 16th and the 27th amounted to approximately 3.5 billion dollars. Out of this, approximately 1 billion dollars was sold by the exchange banks to avert currency risks (adjustment of the foreign currency position by exchange banks) and approximately 2 billion dollars by businesses (the majority of which were advanced export proceeds).²⁶⁸ It was as a result of this large-scale buying of the yen and the selling of the dollar made in fear of potential losses that the government could not continue its interventions and decided to shift to the floating system.

We have now discussed the market response immediately after the Nixon Shock and the reaction of the government and the Bank of Japan. Although the measures they took were consistent with their goal of averting losses on the part of the exchange banks, we can say that the measures were based on misunderstandings and lack of preparation for the following various reasons.

It was mentioned above that the officials in the Ministry of Finance failed to immediately grasp what the Nixon Shock implied. They not only fell short of understanding the situation, but also misunderstood it; according to Gyohten, then the Head of the Office of Vice Minister of Finance for International Affairs, although the intention of the U.S. was an indirect devaluation of the dollar, "we [Japanese monetary authorities] thought that the real U.S. objective was not to devalue the dollar but to free it from gold and try to stabilize its value as quickly as possible. Supporting the dollar at the parity of 360 yen, we believed, would meet the interests of the United States and be taken as an act of cooperation."²⁶⁹ Regarding the government's response at the time, Ryutaro Komiya and Miyako Suda were critical: "As the Deutschmark had been floated in May, among the currencies requiring large exchange rate adjustments in August in order to rectify the international payments imbalances of many countries, the dollar and the yen were in most need of adjustment. Japanese authorities strongly resisted the float, however, and attempted to avoid multilateral currency adjustment and to minimize revaluations of the yen. For the international economic community, the continued opening of the market at the old ¥360 rate was a destabilizing, uncooperative act."²⁷⁰ "Some of Japan's policymakers appeared to think that to maintain the ¥360 rate and keep the market open

²⁶⁶ *Ibid.*, 284.

²⁶⁷ *Ibid.*, 272.

²⁶⁸ *Ibid.*

²⁶⁹ Volcker, Paul. and Gyohten, Toyoo. *Changing Fortunes*. Times Books, 1992, 93.

²⁷⁰ Komiya, Ryutaro and Suda, Miyako. *Japan's Foreign Exchange Policy 1971-1982*. North Sydney: Allen & Unwin, 1991, 37.

was to stay faithful to the old IMF agreement, and the action received positive appraisal internationally (at least, from some supporters of the fixed rate system in Europe).”²⁷¹

In addition, the Japanese government had not prepared any measures to implement in case the yen was really pressured to be revalued, and the government did not even have any simulation of such a scenario either. To borrow the words of Komiya and Suda again, “Considering the situation at the time, the foreign exchange policymakers had to have had prepared for possible scenarios before the Nixon Shock. If they justify themselves that, because of the issue of institutional finance for export there was no way other than to keep open the market and maintain the rate at 360 yen even in such a drastic event as the Nixon Shock, then we have to say that such justification only manifests the inability of the policymakers.”²⁷² In fact, looking at the way the meetings were run after the Nixon Shock, as described above, it is evident that policies regarding the exchange market were decided in a hurry based on the discussions of a few specialists. Fears of revaluation and a stubborn will to maintain the yen rate made it impossible for the monetary authorities to prepare necessary plans and measures in advance.

Moreover, the decision to keep the market open and continue the dollar-buying, which was made without any thorough measures prepared in advance, was a wrong one in that it was based on the expectation that there would be only a small scale of dollar-selling and that the maintenance of the yen rate was possible by dollar-buying intervention. Komiya and Suda severely criticize this too: “The large amounts of dollar purchases led directly and indirectly to the national treasury suffering massive losses. Leaving the market open at the old ¥360 rate, even with very tight exchange management, would have led to a continuation of the inflow of large amounts of dollars (through leads and lags) and would have ultimately forced the market to close. The Japanese government’s policy judgment reflected an over-confident assessment of the effectiveness of exchange management and a lack of understanding of the international monetary situation. And it led to the greatest policy mistake in the history of international policymaking.”²⁷³

The lack of knowledge and preparation as such is also evident in the testimony given by Kashiwagi, then an Advisor in the Ministry of Finance who was dispatched to Europe and the U.S. to gather accurate information on the situations abroad after the Nixon Shock: “It was hard to foresee how things would unfold. So upon Prime Minister Eisaku Sato’s suggestion, I was dispatched to Europe and the U.S. for an investigation ... as I talked with a number of people in Europe, I started to understand the real implication of the Nixon Shock. At first, we had focused on the dollar-yen market. But the scale of the problem was much bigger, one that involves all major national currencies and their multilateral adjustments ... Going to the U.S. from Europe, and meeting with the Managing Director and Chairman of the Board of the IMF and the U.S. Secretary of Treasury ... I came back to Japan with the conclusion that ‘this is an issue that requires

²⁷¹ *Ibid.*, 327.

²⁷² Komiya, Ryutaro and Suda, Miyako. *Gendai kokusai kin’yu ron - Rekishi seisaku hen*. Nihon Keizai Shinbunsha, 1983, 39.

²⁷³ Komiya, Ryutaro and Suda, Miyako. *Japan’s Foreign Exchange Policy 1971-1982*. North Sydney: Allen & Unwin, 1991, 37.

multilateral currency adjustments. The yen will not be free from damage. It will take some time, but the revaluation of the yen is inevitable.”²⁷⁴

In response to this testimony, Eisuke Sakakibara, who was then at the Office of the Vice Minister of Finance, admits that the authorities lacked the ability to understand the situation: “At the time, Yusuke Kashiwagi was one of the very few authorities on international finance in Japan. Even someone like him had to talk to Volcker and van Lennep, and spend a month to realize finally the importance and gravity of the situation. For many Japanese, they couldn’t really understand beyond the fact that the rate of 360 yen, which they thought would never change, had been dismantled.”²⁷⁵

Masaru Hayami, then the Bank of Japan’s Associate Director-General in London, also points out the lack of understanding, whatever the result of keeping the market open: “In Japan at the time, there was probably an undefined sense of fear that the yen would eventually be revalued. But to discuss what it meant to abandon the dollar-gold system that had lasted for over a quarter of the century since the end of the war, and to discuss what kind of impact that would have, was considered a taboo. I believe there were only a handful of people who projected this kind of thing to happen.”²⁷⁶

Shunpei Takemori, a professor at Keio University, is more critical of the government’s lack of awareness: “Specialists in Europe immediately knew the actual meaning of the Nixon Shock and had probably made preparations in advance. However, pathetically enough, Kashiwagi could only figure it out upon hearing from them. It was like this even for Kashiwagi, who was reputed to be the top expert in the field of international finance at the Ministry of Finance. And to say nothing of the entire Ministry of Finance, whose lack of human resources made them call Kashiwagi in from his retirement to go abroad and negotiate. The rest you can very well imagine. In any case, it is a wonder that the decision to open the currency exchange market on the 16th, a serious decision that would impact the Japanese economy, was made without having an adequate understanding of the situation.”²⁷⁷

However, there were not just criticisms. Some claimed that the opening of the market in the end brought about a positive outcome. While pointing out the government’s lack of understanding the situation, Masaru Hayami argued that it was ultimately a good decision, stating that “I can understand that the monetary authorities decided to keep open the market to avoid a panic ... if the market had been closed, it would have triggered unimaginable exchange losses by the exchange banks and the private sector. At the time, such an incident could have occurred at a scale that would have instigated fears for the overall financial system.”²⁷⁸

In response to Hayami’s testimony, Shunpei Takemori, while criticizing the decision to open the market, commented: “As Hayami’s testimony implies, indeed, the Ministry of Finance might have played ‘dumb’ and embraced losses on their part so that the private sector would not suffer from exchange losses. It is possible to look it at that way. It is free to print more yen. They might have thought that, if the private sector can be salvaged by

²⁷⁴ Honda, Keikichi. and Hata, Tadao. *Kashiwagi Yūsuke no shogen - Sengo nihon no kokusai kin'yushi*. Yuhikaku. 1998, 62 - 63.

²⁷⁵ Sakakibara, Eisuke. *Tsuyoi en wa Nihon no kokueiki*. Toyo Keizai Shinposha, 2008, 69.

²⁷⁶ Hayami, Masaru. *En ga sonkei sareru hi*. Toyo Keizai Shinposha, 1995, 31.

²⁷⁷ Takemori, Shunpei. *Sekai defure wa mitabi kitaru (ge)*. Kodansha, 2006 (2009 edition), 192.

²⁷⁸ Hayami, Masaru. *En ga sonkei sareru hi*. Toyo Keizai Shinposha, 1995, 32.

it, then it would be okay”²⁷⁹ Of course this does not mean that there were no companies that suffered exchange losses. Actually, there were many companies who did suffer from exchange losses.²⁸⁰ However, if the market was not kept open, far more would have been badly affected.

Toyoo Gyohten also endorsed the monetary authorities’ judgment and stated as follows: “As for the Ministry of Finance and the Bank of Japan, they certainly suffered a large accounting loss because the \$4 billion we bought at 360 yen was devalued to 308 yen just four months later. Our critics argued that the government had rescued those private banks at the sacrifice of the taxpayers’ money. I find this argument not too well grounded in theory because central banks do not have to settle their foreign exchange accounts on any certain date. The account is ongoing, and makes neither profit nor loss in local currency because it holds its foreign currency reserves to pay them out abroad when needed. You might argue that the additional \$4 billion in reserves was very useful two years later when the first Oil Crisis hit, and Japan had to pay out large amounts of dollars to buy much more expensive imported oil.”²⁸¹

As seen by the discussions above, it is debatable whether the government’s decision to keep the market open and purchase the dollar was ultimately good for the Japanese economy. The evaluation would differ depending on whether one chooses to focus on the domestic economy or international cooperation, and which aspect of the domestic economy is the priority. However, what is important here is not whether the measures taken after the Nixon Shock were positive or negative, but that either way, **(1) the government and the Bank of Japan were swayed by the situation as it unfolded. (2) they were pushed around because their fears over a revaluation and the stubborn desire to maintain the yen rate hampered them from simulating the worst scenario and formulating appropriate policies to meet it (3) the stubborn desire to maintain the yen rate led to the wrong notion that the rate could be maintained even if the market is kept open.**

And after acting in accord with such misperceptions, the monetary authorities ultimately abandoned the continuation of intervention and decided to shift to the floating system, as explained above. But it did not mean that they completely stopped intervention. When the market shifted to the floating system on August 28th, the yen exchange rate, which was 357 yen to the dollar up to the previous day, soared to 341 yen to the dollar. The monetary authorities maneuvered to purchase the dollar and kept the surge as gradual as possible (see the table below), since it worried that Japan would be pressed to make a major revaluation when reverting to the fixed-rate system if the rate continued to increase while the floating system was in place.²⁸² In addition, the exchange management was reinforced to suppress the surge. For example, from August to September 1971, the Bank of Japan regulated the foreign currency loan balances and free yen balances among exchange banks, imposed a ban on advanced export proceeds, and on converting foreign

²⁷⁹ Takemori, Shunpei. *Sekai defure wa mitabi kitaru (ge)*. Kodansha, 2006 (2009 edition), 195.

²⁸⁰ Regarding companies that suffered exchange losses, see Komiya, Ryutaro and Suda, Miyako. *Gendai kokusai kin’yu ron - Rekishi seisaku hen*. Nihon Keizai Shinbunsha, 1983, 37-38.

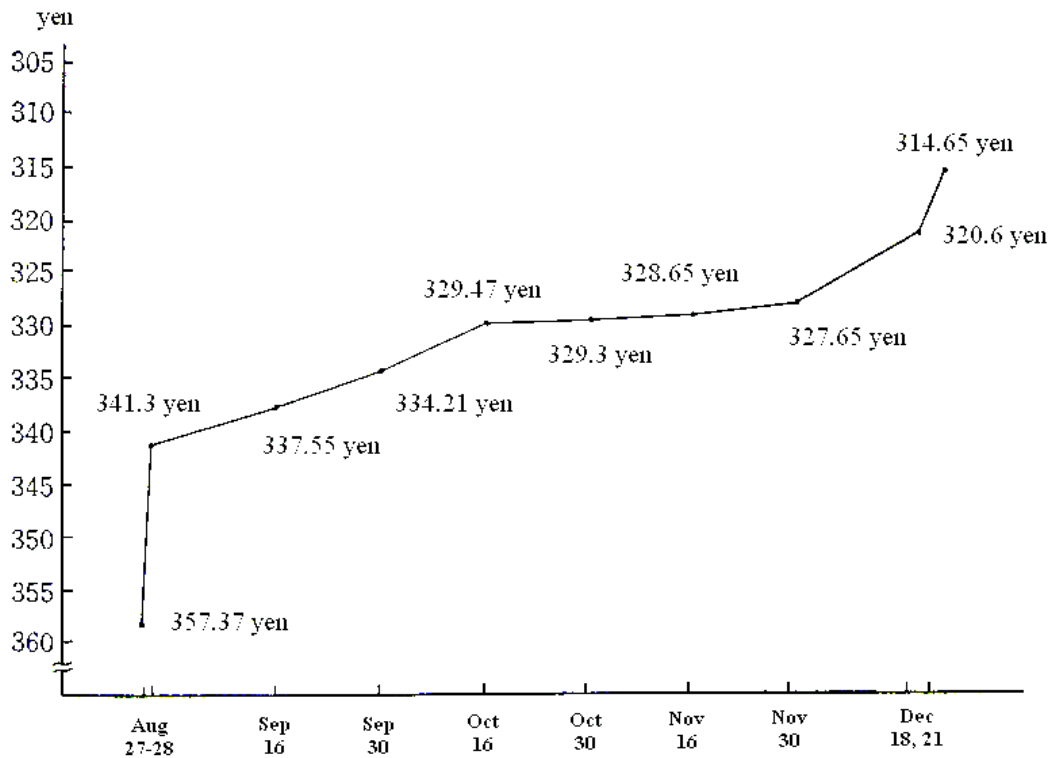
²⁸¹ Volcker, Paul. and Gyohten, Toyoo. *Changing Fortunes*. Times Books, 1992, 94.

²⁸² Yoshino, Toshihiko. *En to doru - Endaka e no kiseki to haikai*. Nihon Hoso Shuppan Kyokai, 1987, 166 - 167.

currencies into the yen. Alongside taking such measures to control the rise of the yen, the Ministry of Finance, out of fear that an appreciation of the yen would worsen the recession, took countermeasures including the 1971 supplementary budget, emergency measures for medium and small companies, and additional fiscal investment and loan program. The supplementary budget provided 500 billion yen for public works.

Intervention date	Buying point	Selling point
After Aug 28	334.8 yen	362.7 yen
After Sep 23	329.4 yen	362.7 yen
After Oct 11	327.6 yen	362.7 yen
After Nov 26	324 yen	362.7 yen
After Dec 7	320 yen	362.7 yen
After Dec 20	301.07yen	314.93 yen

Finance Minister's order of dollar buying/selling intervention under the floating system.
Showa zaiseishi – Showa 27-48 nen do (dai 18-kan) Shiryo (6)
Kokusai kin'yu, Taigai kankei jiko, 273.



Nihon Ginko hyakunen-shi 6-kan. Nihon Ginko, 1986, 333.

In these ways, the concurrent implementation of exchange rate and fiscal policies were made out of the fear that an appreciation of the yen would invite a large recession. Although Japanese exports in fiscal 1971 did well, the domestic economy had already entered a recession period before the Nixon Shock. An appreciation of the yen was another aggravating factor that had the potential of prolonging the recession. In particular, the following industries were the main concerns.

First were shipbuilders and plant industries. Keiichi Matsuyoshi, a reporter for the *Nihon Keizai Shimbun*, reported as follows: “Shipbuilders and plant industries will be the hardest hit. This is because transactions based on dollar-denominated contract have been enormous, with shipbuilding posting approximately 2 trillion yen and plants approximately 1 trillion yen (both as of the end of March this year). Since the shift to the floating system, there already has been currency exchange loss for the deferred payments due to the high yen and the low dollar. The shipbuilding industry alone reports an exchange loss of 1.5 to 1.6 billion yen each month. From the content of the contract above, to roughly calculate, a 10% revaluation would yield 300 billion yen in losses. But, since foreign debt has been on the decline, if the yen is revalued by 10% at the end of September, the exchange loss suffered by the shipbuilding industry would be 175 billion yen, according to the estimate by the Shipbuilders’ Association of Japan. In other words, around two-year’s worth of the net profit of the entire industry would disappear into thin air.”²⁸³

Toshio Yoshida, a deputy managing editor of *Nihon Keizai Shimbun*, also pointed out that foreign exchange losses incurred in the fields of sea transport and machineries would be high as well: “Let’s consider the impact of the yen revaluation based on the dollar-based receivables balance. Shipbuilding has dollar-based receivables of 1.75 trillion yen. With the 10% revaluation, the loss would be 175 billion yen. Heavy electronics has dollar-based receivables of 130 billion yen, so with the 10% revaluation, it would incur a loss of 13 billion yen. The balance of loans and debts in automobiles is 100 billion yen, so it would incur a loss of 10 billion yen. Other major losers are sea transport at 12.3 billion yen ... machineries has dollar-based receivables of 750 billion yen, so with the 10% revaluation, it would incur a loss of 75 billion yen.”²⁸⁴

Moreover, while large corporations had more chance to maintain export competitiveness even in the face of yen revaluation, it was said that damage would be serious for many small and medium-sized businesses because they would not be able to export with any profitability. Another problem was the prospect that large corporations would shift their burdens onto subcontracting small and medium-sized companies in order to suppress the prices of their export goods. The magazine *Keizai* reported on the issue as follows: “Although there are variations by the industry ... the subcontractors’ unit-prices have been cut by 10% or so on average,”²⁸⁵ “The biggest impact of the yen revaluation on the lives of the citizens is that it is rapidly subjecting the Japanese economy to a recession ... the hardest hit were the small and medium-sized businesses that are dependent on exports to the United States. Many of these businesses went bankrupt, and a bitter atmosphere is overtaking them, leaving no option but to switch or

²⁸³ Yoshida, Toshio et al. “Detekuru kigyo sa, sangyo sa.” *Nihon Keizai Kenkyu Senta*, 1 November 1971, 3.

²⁸⁴ *Ibid.*, 7.

²⁸⁵ Suzuki, Akio. “Danketsu koso, doru shokku o hanekaesu michi.” *Keizai*, November 1971, 121.

discontinue the businesses altogether,”²⁸⁶ “Small and medium-sized businesses specializing in export-related industries, in particular electronics, textiles, metal products, and sundry goods, are facing a gloomy future. Their export contacts are terminated. They are forced to lower export prices and subcontracting bids. If things progress the way they are, taking into account the impact of the recession from the previous year, there will be a serious crisis in our everyday lives and businesses, for over 20 million people nationwide who own and work for small and medium-sized businesses. Those workers for large corporations ... are also rapidly becoming subject to the ‘rationalization’ process of the economy. Overtime regulations, cuts in various benefits and lump-sum payments, termination of new hires, and layoffs are taking place across the industries. According to the research by the Ministry of Labor, the termination of new hires as of September 30th has amounted to 51,000 at approximately 510 businesses, centering on the electronics industry. New college graduates are about to face a very gloomy future.”²⁸⁷ “Already, immediately after the dollar shock, Mitsui Toatsu Chemicals announced its personnel cuts. The rush to adopt such ‘rationalization’ schemes that focus on personnel cuts was also been seen by Denki Kagaku, Konoshima Chemical, Nippon Synthetic Chemical Industry, Daicel, Rasa Industries, and Ishihara Sangyo in chemicals, and Unitika and Toray in textiles. Others include Nippon Columbia, Crown, Secaicho Corporation, Nitto Tire, Nisshin Steel, Standard, Shinko Sugar, and Nagoya Seito.”²⁸⁸

The above are excerpts from the magazine *Keizai*. Although we must keep in mind that *Keizai* tends to adopt a left-wing perspective that takes the standpoint of workers in small and medium-sized businesses, the anxiety over small and medium-sized businesses was widespread. For example, in the article “Special Feature: Will the Nixon Recession Hit? (7) On-Site Reports: Small and Medium-Sized Businesses Facing Bankruptcies,” the magazine *Ekonomisuto* focused on small and medium-sized businesses specializing in textiles, foreign-style tableware, ceramic ware, and toys, and the massive bankruptcy crisis they were facing.²⁸⁹ *Nihon Kogyo Shimbun* also estimated that a 10% revaluation will result in a 17% drop in the value of exports among small and medium-sized businesses (the impact borne in particular by textile and sundry goods). The newspaper also cautioned that a demand in lowering prices by 5 to 25% is now evident especially for automobile and electronics parts, and that these fields are experiencing a drop in orders received.²⁹⁰ The Kansai Economic Federation also expressed concerns: “Due to the import surcharges by the U.S. and the transition of the yen to the floating system, Japan’s manufacturing industry is facing a drop in export contracts and profits. As a result, the economic stagnation is now expected to linger over the long term. Against this backdrop, small and medium-sized businesses in particular will suffer a serious damage.”²⁹¹

Above, we have surveyed opinions concerned about the prolongation of economic recession that could result from a yen revaluation, as well as the exchange policies and financial policies that the authorities implemented to suppress a revaluation. However,

²⁸⁶ Kotani, Takashi. “En kiriage to kokumin seikatsu.” *Keizai*, November 1971, 76.

²⁸⁷ Yamaguchi, Yoshiyuki. “En doru mondai o meguru futatsu no michi.” *Keizai*, November 1971, 123.

²⁸⁸ Anonymous. “Sekai to Nihon no keizai.” *Keizai*, December 1971, 7.

²⁸⁹ “<Tokushu> Nikuson fukyo wa kuruka ⑦ <Genchi hokoku> Tosan ni ononoku chushokigyō.” *Ekonomisuto*, 7 September 1971, 53 - 61.

²⁹⁰ *Nihon Kogyo Shimbun*, 28 November 1971.

²⁹¹ *Keizaijin*, October 1971, 19.

during this period, some argued that a yen revaluation, if it fit Japan's actual situation, would not cause too much damage to the economy since there was a large gap between the yen rate and the country's actual competitiveness.

For example, Hisao Kanamori, then vice-director of the Economic Research Institute, Economic Planning Agency, claimed that "there is nothing to be concerned about because a revaluation of the yen would only reflect the real power [of Japanese economy]" and that Japan could escape economic crisis by implementing appropriate measures.²⁹² Moreover, Kichihei Hara, chairperson of JETRO (Japan External Trade Organization), stated on August 26th that a yen revaluation by 15% would be an appropriate level.²⁹³ It was so because, according to the trial calculation at JETRO, even with 15% revaluation, 1.4 billion dollars of trade surplus was expected for the year.²⁹⁴ Also, while recognizing Japan's inclination toward recession, Tadahiro Mitsuhashi of Japan Center for Economic Research commented that a yen revaluation by 15% would be fine. He argued, "the pessimistic opinions underestimate the growing speed of the Japanese economy. Even if a 10-15% of yen revaluation were to be implemented by the end of the year, a timely execution of stimulative measures should make it easy for the country to absorb the shock in a short period of time, and the economy should continue to grow strongly ... In the first place, it was because Japan showed strong economic growth that it became necessary to revalue the yen."²⁹⁵

As seen in the previous chapter, there already were opinions from the late 1960s that recommended a revaluation of the yen through such measures as the establishment of the crawling peg system or a transition to the floating system, but they did not assume 15% revaluation. Before the Nixon Shock, when the support for the 360 yen rate was very strong, it was difficult to publicly state that a yen revaluation by 15% would not harm the economy if appropriate economic measures were to be implemented. Even after the Nixon Shock, it was still rare to argue as such, but it can be said that the mood had changed and such an opinion became less subjected to harsh criticisms.

In other words, the several months following the shift to the floating system was a transition period in which opinions over the rising yen were divided into optimistic and pessimistic ones. According to Susumu Sato, Professor at Musashi University, "The optimists (such as the Kokumin Keizai Research Institute) projected a recovery after the recession hit the bottom in spring 1972, because by that time inventory adjustments are expected to be completed, export contracts after the yen revaluation should be increasing, and government investments are expected to be underway. The pessimists, prominent among the business circles and those closely related to it, predicted that recovery should be impossible for at least two or three years."²⁹⁶ However, it was not so much that the public opinion was evenly divided. Rather, it is more accurate to say that voices that raised concerns over the rising yen were stronger than voices of optimism.

As the public opinion over the rising yen was split among optimists and pessimists, the opinion over foreign currency exchange control to suppress the high yen was also

²⁹² *Asahi Shimbun*, 28 August 1971.

²⁹³ *Nihon Keizai Shimbun*, 27 August 1971.

²⁹⁴ *Nihon Keizai Shimbun*, 27 August 1971.

²⁹⁵ Mitsuhashi, Tadahiro. "En kiriage go no Nihon Keizai." *Keizai Seminar*, November 1971, 26. He lists other reasons but they are omitted here.

²⁹⁶ Sato, Susumu. "Fukyo kokuhuku yosan to oogata kosai hakko mondai." *Keizai Seminar*, February 1972, 64.

beginning to diverge. Although the government and the Bank of Japan were continuing to exercise a strict control over foreign exchange, not all industries in Japan were supporting the exchange control that prevented the dollar-selling and yen-buying, for there were many companies that owned large amount of dollar due to the internationalization of their businesses. For example, Japan Business Federation (Keidanren), through its foreign exchange control study group launched within the Federation, made frequent criticisms of the government's foreign exchange control.²⁹⁷ In response, the Ministry of Finance sought patience among business leaders until the conditions were under control. However, the Federation responded, "Deregulation will never be possible if we keep waiting for the currency situation to completely stabilize. There are voices in favor of an immediate liberalization of the market."²⁹⁸ The exchange banks also harbored great dissatisfaction with foreign exchange control that restricted the dollar-selling. Through the group called Nisuikai and Kawasekai, they voiced their criticism against the stringent foreign currency control measures.²⁹⁹ Such criticisms from the business group and the exchange banks reflected the fact that the foreign currency exchange control system, bolstered by those who continued to believe in the fixed-rate system, ceased to be compatible with the realities of major Japanese corporations and banks that came to possess a large amount of foreign currencies through a large scale of trade and capital transactions. In other words, the existing currency system was no longer compatible with the scale of Japan's trade and capital transactions that had outgrown it.

And, during this period, as there were divided opinions concerning the rise of the yen and foreign exchange control, there also were divided opinions on the fixed-rate system. While some considered the shift to the floating system as a temporary measure and a future reestablishment of the fixed-rate system as an obvious necessity, others were doubtful about the fixed-rate system. The fixed-rate system had become not so much a clear choice as before, as Saburo Okita, the chairperson of Japan Center for Economic Research, wondered "if [the shift to the floating system after the Nixon Shock] ... was necessitating an reestablishment and reinforcement of the IMF-centered regime, or if the shift meant a unrecoverable destruction of the IMF regime, as some claimed."³⁰⁰

For example, in November 1971, Yoshitomi Ishimaru, a general manager of Research Department at Toyo Menka-Kaisha, referred to Milton Friedman's opinion that speculation in a completely free floating system will actually help recover the balance of currencies, and stated that the floating system ought to be continued in place of the fixed-rate system.³⁰¹ Taro Watanabe, a professor at Osaka University, also commented that since the exchange rate system is one type of pricing system, it is all too natural that the market fluctuates according to the changes in the demand. He stated that he is in strong favor of the floating system for that reason.³⁰² Miyohei Shinohara, who had supported the floating system since before the Nixon Shock, also expressed his ongoing support for the floating system, stating that "speculation caused 'instability' under the fixed rate system

²⁹⁷ Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 297.

²⁹⁸ *Ibid.*, 301.

²⁹⁹ *Ibid.*, 297.

³⁰⁰ Okita, Saburo. "Kawari yuku sekai keizai chitsujo." *Boeki to kanzei*, November 1971, 15.

³⁰¹ Ishimaru, Yoshitomi. "Boeki, kawase no oohaba jiyuka o." *Nihon Keizai Kenkyu Senta*, 1 November 1971, 33.

³⁰² Watanabe, Taro. "Kokusai tsuka seido no shorai." *Keizaijin*, October 1971, 29.

but it can bring about ‘stability’ under the floating system.”³⁰³ In the past, publicly supporting the floating system invited criticism and the idea of the floating system was treated as an impossible fantasy. But, after the shift to the floating system, the above voices became nonnegligible and the continuation of the floating system became a realistic choice.

However, as it was for the debates concerning the appreciation of the yen, the opinions for and against the fixed-rate system were not equally polarized. Overall speaking, those who supported for the reestablishment of the fixed-rate system were more dominant than those who were against it, as Ryutaro Komiya and Miyako Suda pointed out: “the Japanese policymakers at the time had a strong attachment to the fixed exchange rate. Many of them were barely aware of the fact that the ending of the fixed-rate system was close.”³⁰⁴ The Japanese government and the Bank of Japan, which had the most power in the decision making on foreign exchange, fixated to the idea of the fixed-rate system. And that played a large role in creating the general atmosphere of pro- fixed-rate system. Even after the shift to the floating system, they were continuing their active foreign exchange intervention and foreign exchange control in order to suppress the appreciation of the yen.

Even among the public, the support for the fixed-rate system was still strong, although the supporters of the floating system were gradually increasing. For instance, Takashi Murano, then a professor at Kokugakuin University, stated “[the suspension of dollar-gold convertibility and the floating system] are creating unstable conditions. The suspension and the floating system would not work to help develop the world economy, let alone stabilize it. The floating system would be such a great barrier to trade that the countries could not bear the situation ... The dollar-gold convertibility must be revived.”³⁰⁵ Similarly, Shoichi Kase, then a professor at Kanto Gakuin University, argued that “if each country implemented self-serving policies, in the worst case scenario, the situation might turn anarchistic just like the 1930s, and the world would face the era of trade war and currency war. Such situation may accompany the risk of dangerous contingencies and even threaten the world peace at the end.”³⁰⁶ In an article titled “A critique of the floating system based on firsthand experiences,” Kunio Miki, a former managing director of the Bank of Tokyo and a professor at Sophia University, called for the need for the fixed-rate system, casting doubt on the claimed automatic balance-adjusting function of the floating system. He doubted it because a currency’s exchange rate might also get affected by such factors as the country’s trade structure and the capital balance.³⁰⁷

To sum up the points, this period (when Japan temporarily shifted to the floating system after the Nixon Shock) can be defined as the period when (1) more monetary authorities and economic experts came to support for the floating system and a relaxation of foreign exchange control (2) the stubborn attitude driven by fear and false recognition to defend the fixed-rate system and the yen rate gradually softened. But it was also a period when (3) the support for a strict foreign exchange control and the fixed-rate

³⁰³ Shinohara, Miyohei. “Riten ooi hendosobasei.” *Ekonomisuto*, 7 September 1971, 84 - 85.

³⁰⁴ Komiya, Ryutaro and Suda, Miyako. *Gendai kokusai kin'yu ron - Rekishi seisaku hen*. Nihon Keizai Shinbunsha, 1983, 39.

³⁰⁵ Murano, Takashi et al. “Kokusai tsuka taisei no saihen nanko ka.” *Boeki to kanzei*, November 1971, 23.

³⁰⁶ Kase, Shoichi. “Tsuini kita kin doru taisei no hokai.” *Ekonomisuto*, 31 August 1971, 18.

³⁰⁷ Miki, Kunio. “Taikenteki hendokawasesoba hihan.” *Ekonomisuto*, 2 November 1971, 62 - 65.

system was still dominant. And, such a strong support worked to delay Japan's complete shift to the floating system, the path that Japan had to take sooner or later.

Amid such debate, from September to mid-November 1971, there was no commotion in the Tokyo exchange market, and the yen rose moderately. Accountable were the strengthened foreign exchange control, the quieting foreign currency purchases as a result of market's reaction against the 'leads' in August, and the flexibility that the exchange banks exhibited in their transactions with customers.³⁰⁸

However, such temporary stabilization did not of course resolve the contradictions inherent in the fixed-rate system. Since late November 1971, projections of currency adjustments among countries began to surface, and thus the revaluation of some currencies against the dollar. As a result, active dollar-selling occurred once again. The dollar-selling by the fourteen major Japanese exchange banks amounted to approximately 1.5 billion dollars between late November and the middle of December, creating turmoil in the foreign exchange market. As was also the case in the market turbulence in August immediately following the Nixon Shock, the cause of the turmoil was the dollar-selling by the trading companies, manufactures, and others that once again took all measures to sell the dollar through leads and lags, as well as the exchange banks' dollar position adjustment that was made in response to the situation.³⁰⁹

Against this, the Japanese government intervened by aggressively purchasing the dollar. As a result, the yen rose moderately, from 327 yen at the end of November to 320 yen by December 18. However, just like the previous interventions, such action did not serve to provide a fundamental solution. One problem was that, by buying the currency that was expected to drop in value, the intervention only expanded the government's foreign currency exchange loss. As seen earlier, the large-scale intervention took place in August 1971, but even after the transition to the floating system, from September to December, the exchange authorities made an intervention that totaled over 3 billion dollars.³¹⁰ As a result, it is said that, from August 15 to December 18, the Bank of Japan and the government incurred a foreign currency exchange loss of 450.8 billion yen and 411.7 billion yen, respectively.³¹¹ The other fundamental issue was the fact that such interventions only served to worsen the contradiction that, "by accumulating more foreign currency reserve through purchasing the dollar to prevent the yen revaluation, it actually works in reverse to strengthen the external pressure to revalue the yen."³¹² It is true that the intervention had a good side to it: by suppressing the speed at which the yen rose, the government and the Bank of Japan allowed time for the industries to figure out how to respond. However, the contradiction was that the more they intervened through interventions, the more foreign currency they accumulated, resulting in the heightening of the international and speculative pressures to revalue the yen.

However, it was not only Japan that could not recognize the change in the situation. It was true that the European countries responded to the Nixon Shock more speedily and

³⁰⁸ "Tsuka chosei ni kansuru hokokusho." March 1973, Okurasho shiryō Z27-379 in Okurasho Zaiseishishitsu ed. *Showa zaiseishi - Showa 27-48 nen do (dai 18-kan) Shiryo (6) Kokusai kin'yu, Taigai kankei jiko*. Toyo Keizai Shinposha, 1998, 273.

³⁰⁹ *Ibid.*, 273 - 274.

³¹⁰ Nihon ginko hyakunen-shi hensan iinkai ed. *Nihon Ginko hyakunen-shi 6-kan*. Nihon ginko, 1986, 332.

³¹¹ Noguchi, Yukio. *Keizai kiki no rutsu - Mono zukuri wa guguru to woru gai ni maketanoka*. Toyo Keizai Shinposha, 2010, 32.

³¹² "Boeki hairaito." *Boeki to kanzei*, October 1971, 14.

flexibly compared to Japan, but it was not because they were simply wiser. Rather, they were more prepared at the time largely because they already had the experience of either revaluation or devaluation earlier and even a shift to the floating system, due to either their bad economic performances or massive dollar-selling at their exchange markets.

But despite their differences in experience and response, both Japan and other countries were no different in that they considered the floating system as an only temporary measure to overcome the situation and that they should return to and keep the fixed-rate system. Because the Bretton Woods system (the fixed-rate system), was formulated to avoid devaluation races and a collapse of the free trade system as happened in the prewar period, it was natural to fear that the absence of the fixed-rate system might lead to a collapse of free economy this time again. But the reality was that the circumstance no more allowed the fixation of exchange rates. The expansion of trade and international capital transactions made such fixation difficult, and this deepening structural contradiction of the fixed-rate system was not something that could be overcome by efforts. But at this point, major countries were not fully understanding such reality.

The lack of understanding among the major countries was evident, for example, in the way the U.S. resisted against the revaluation of the gold (In other words, a devaluation of the dollar) to improve its trade balance. It is true that Nixon's suspension of dollar-gold conversion was meant to devalue the dollar, but it was an attempt to devalue it not by its own direct devaluation. It was an attempt to indirectly devalue the dollar by revaluing the currencies of other countries. Such attempt by the U.S. is understandable considering the fact that the U.S. had a large domestic market and the trade accounted for a relatively small portion of the economy. Also, the U.S. resisted a devaluation fearing that it would compromise the dollar's status as the key currency and that it would result in the capital outflow from the United States. However, if the currency rate does not reflect the country's trade competitiveness, the trade deficit is prone to expand. The more the trade deficit expands, the more the dollar's credibility would fall. When the currency rate is fixated in spite of the actual decline of the currency's credibility, the pressure to correct the distortion between the currency value and its actual credibility deepens and later invites a rapid capital outflow as well as a sudden and steep devaluation. In short, in a circumstance where trade and international capital transactions expanded, it was becoming more difficult to fixate the currency exchange rate, but nonetheless, the U.S. continued to resist.

We can see the reluctance of the United States in the following cases as well. At the Group of Ten Deputies (G10D) held in Paris on September 3-4th to discuss the necessary measures after the Nixon Shock, the participating countries examined the possibilities of multilateral currency adjustment, including an increase in the price of gold (In other words, a devaluation of the dollar). But the U.S. showed opposition.³¹³ Also, at the G10 held on September 15-16th in London, the participating countries pointed out that the U.S. had grave imbalances of payments, and that some multilateral currency adjustments, particularly a devaluation of the dollar, was necessary to correct the imbalances.³¹⁴ To this, the U.S., just as before, refused to alter its policy. In such a manner, at the G10

³¹³ Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 276 - 277.

³¹⁴ *Ibid.*, 277.

conference, “there was a confrontation between the U.S. representatives who kept resisting dollar devaluation and the representatives of other countries who wanted to put the issue of dollar devaluation on the table and request the U.S. to participate in currency adjustments.”³¹⁵ Moreover, when John Connally, the U.S. Secretary of the Treasury, visited Japan on November 9th, he reaffirmed that they would not raise the value of gold because it was against the demonetization of gold that the U.S. was aiming to achieve.³¹⁶

However, the lack of understanding of the situation could be seen not only among the Japanese and the U.S. authorities but also among the authorities of other major countries: After all, the G10 members met at the Smithsonian Museum in the United States in December 1971, a few months after the Nixon Shock, and they rebuilt the fixed-rate system “out of concern that the global float, which the suspension of dollar-gold convertibility brought about, would diminish the size of world trade and delay each country’s economic recovery.”³¹⁷ It was a move that ignored the reality where the sustenance of the fixed-rate system was becoming difficult due to the ever increasing scale of trade and international capital movement. For that reason, as will be explained later, the Smithsonian Agreement, which was made in December 1971, dismantled as early as March 1973.

(2) Abandonment of the Fixed Exchange Rate System: From December 1971 to March 1973

The negotiations at the Smithsonian Museum were multilateral, but here we will focus on the negotiation concerning the yen-dollar exchange rates. The negotiation proceeded as follows, according to Yusuke Kashiwagi: “The United States had been insisting on ‘the revaluation of the yen by 20%’ since the meeting at Rome [held on December 1st and 2nd 1971]. The U.S. was stubborn on this point claiming that a proposal made by the IMF also reached ‘the conclusion that the yen must be adjusted at such a degree.’ On the other hand, we contested this, saying ‘the Japanese economy is already suffering serious recession because the yen rose 15% after the Nixon Shock. Thus any further appreciation of the yen would be unbearable.’ In response, the U.S. lowered their demand by 1%, but we did not reach an agreement on the first day ... On the second day, the U.S. seemed in a hurry to reach an agreement, and our feeling was that the range of revaluation would be somewhere between 15% and 19%. When the U.S. suggested 17%, the Finance Minister Mikio Mizuta responded, ‘17% is bad because Junnosuke Inoue implemented 17% revaluation [in the prewar period] and he was assassinated. I don’t want to die.’ Then what came up was the rate of 308 yen to a dollar, a revaluation by 16.88%. The U.S. finally agreed to it.”³¹⁸

³¹⁵ Kashiwagi, Yusuke. *Gekidoki no tsuka gaiko*. Kin’yu Zaisei Jijo Kenkyukai, 1972, 6, 140-141.

³¹⁶ Okurasho Kokusai Kin’yu Kyoku. “G10 kaigi taisho hoshin.” 23 November 1971 (Ito, Masanao. *Sengo Nihon no taigai kin’yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 288)

³¹⁷ Keizai Kikaku Cho ed. *Sekai keizai hakusho (1973 nen ban)*. Okurasho Insatsukyoku, Chapter 4.

³¹⁸ Honda, Keikichi. and Hata, Tadao. *Kashiwagi Yūsuke no shogen - Sengo nihon no kokusai kin’yushi*, Yuhikaku. 1998, 66 - 67; Hosomi, Takashi. *Gekido suru kokusai tsuka - Sumisonian kara ju-nen*. Jijitsushinsha, 1982, 379.

But this still made Japan feel as if it was a defeat because the revaluation rate was higher than the range of 14-15%, which was what they aimed at first. In fact, the yen exchange rate at the Tokyo exchange market just before the agreement was 320.60 yen per dollar (10.9% higher than the former parity, 360 yen per dollar),³¹⁹ much lower than the agreed 308 yen per dollar. (However, we must consider the fact that the yen rate was being suppressed by the exchange authorities' market intervention and foreign exchange control.) About the mood of defeat and the concern for economic impact that might result from the yen revaluation, Satoshi Sumita, then Administrative Vice Minister of Finance, testified that "Minister Mizuta said on the airplane back to Japan that he was 'reminded of Jutaro Komura who negotiated at the Treaty of Portsmouth after the Russo-Japanese war.' At that time, when Japan was flush with victory, people became furious at the powerlessness of Komura who could only succeed in acquiring southern Sakhalin. This caused a riot at the Hibiya Park. Mr. Sumita said that he felt as if he were in the same situation as Komura. In hindsight, that exchange rate lasted only for a year because the floating system was adopted from the next year [so it was not a big deal]. But at the time, the fact that Japan had to accept such a high revaluation rate was a shocking event that was enough to make Mr. Mizuta fret over the situation so much."³²⁰

Although we have looked only at the negotiations over the yen-dollar exchange rates, the exchange rates of other currencies against the dollar were also discussed at the meeting and, in the process, the U.S. showed their change of attitude concerning dollar devaluation. Because the United States' continued rejection of dollar devaluation would be a great barrier against rebuilding the fixed-rate system, the U.S. had already agreed in its meeting with French representatives (the U.S.-French top-level meeting on December 8th 1971, held just before the Smithsonian meeting) to devalue the dollar through a revaluation of gold. Based on that agreement, the U.S. officially agreed in the Smithsonian meeting to revalue the parity of gold from 35 to 38 dollars per one troy ounce, equivalent to a 7.89% devaluation of the dollar.³²¹ This marked the first devaluation of the dollar in 38 years. In addition, the Smithsonian Agreement widened the range that a currency rate can fluctuate under the new fixed-rate system, from 1% to 2.25%. In such a manner, the new fixed exchange rate regime under the Smithsonian Agreement became more flexible compared to the fixed-rate system before the Nixon Shock. And by making it more flexible, the Agreement sought to make exchange rates more correctly reflect the real changes in the economic situation of countries.

However, although the fixed-rate system was rebuilt, just because the fluctuation margin became a little more flexible did not resolve the issue that the scale of the international capital transactions had become so large that government's interventions could no longer handle it. In particular, in contrast to the previous fixed-rate system, the Smithsonian regime was not supported by dollar-gold convertibility, and thus, as a currency system, it was relatively more fragile and vulnerable to speculations than the earlier one. However, at the time, the focus was given not to the core of the problem that the scale of the international capital transaction could no longer be supported by the

³¹⁹ Sabata, Toyoyuki. *Gorudo ga kataru 20-seiki*. Chuokoron Shinsha, 1999, 306.

³²⁰ Nihon Keizai Shinbunsha ed. *Kensho Baburu Han'i naki ayamachi*. Nihon Keizai Shinbunsha, 2000; Takemori, Shunpei. *Sekai defure wa mitabi kitaru (ge)*. Kodansha, 2006 (2009 edition), 295.

³²¹ See Okurasho Ginkokyokunai ginkokyoku kin'yu nenpo henshu Iinkai ed. *Dai 21-kai Ginkokyoku kin'yu nenpo (1972 nen ban)*. Kin'yu Zaisei Jijo Kenkyukai, 1972, 15.

fixed-rate system. Rather, in the Smithsonian regime, efforts were made to suppress international capital's speculations by adjusting the values of currencies according to each country's trade competitiveness and by putting the U.S. economy on a recovery track. In short, in order to get to the root of the problem, it was necessary to make a transition to the floating system, but, at the time, efforts were made to resolve the problems once again within the framework of the fixed-rate system.

It is true that even at the time, there were many who doubted the validity of the Smithsonian regime. But, in many cases, those doubts were directed at the point that the regime was not based on the dollar-gold convertibility, not at the fixed-rate system itself. For instance, Ichiro Takeuchi, then a research department manager at the Bank of Tokyo, stated that "From the start, there were many who doubted if the new fixed-rate system would be held stably. The general view was that the Smithsonian Agreement was only a temporary measure."³²² But, people had that view not because they no more supported the fixed-rate system but rather because, as Takeuchi continued, "people considered it problematic that we returned to the fixed-rate system with the suspension of the dollar-gold convertibility in place."³²³ It was Takeuchi's perception as well. Thus, he claims, their time was "a transitional period, until the dollar-gold convertibility is recovered, and the fixed-rate system of the IMF was rebuilt in some manner based on that."³²⁴ Takeshi Ota, then a manager at the Administration Division of Foreign Department at the Bank of Japan, also testifies that "in the Bank of Japan, the maintenance of the fixed-rate system under the Smithsonian agreement was viewed as a policy objective without a doubt, and very few took the position of seeing the shift to the floating system as inevitable."³²⁵ In short, the Smithsonian regime was considered temporary not because there was no more support for the fixed-rate system, but because the regime was not based on the dollar-gold convertibility. The support for the fixed-rate system was still strong.

Thus, the Smithsonian regime was the one that emerged backed by monetary authorities' support for the fixed-rate system. However, the regime soon faced a challenge; foreign currency markets once again experienced turmoil. The reasons were as follows. First, to invigorate the domestic economy, the U.S. was implementing the low interest rate policy, which worked to prevent market participants' dollar-buying. Second, estimation was made that the U.S. would post a record-high budget deficit. These facts and estimates allowed an anticipation that the yen, the Deutsche mark, the Dutch guilder, and the Belgian franc would further rise. And such anticipation refueled dollar-selling between January and February 1972.³²⁶

In Japan, the yen, hovering around 314 yen per dollar in the beginning of January, rose to around 308 yen by later that month, followed by a temporary surge to 301 yen by late February. This was largely due to the large inflow of export prepayments and short-term loans immediately after the deregulation that took effect on January 6th (over 1.3 billion dollars during the two months between January and February).³²⁷ In response, the Japanese government intervened by purchasing a large amount of dollars to maintain the

³²² Takeuchi, Ichiro. "Tsuka chousei kara tsuka kaikaku e." *Boeki to kanzei*, May 1972, 14.

³²³ *Ibid.*

³²⁴ Takeuchi, Ichiro. And Ishimaru, Yoshitomi. "En kiriage to kongo no Boeki, kokusai tsuka mondai." *Nihon Keizai Kenkyu Senta*, 1 February 1972, 11.

³²⁵ Ota, Takeshi. *Kokusai kin'yu - Genba kara no shogen*. Chuko Shinsho, 1991, 40.

³²⁶ Nihon ginko hyakunen-shi hensan iinkai ed. *Nihon Ginko hyakunen-shi 6-kan*. Nihon ginko, 1986, 347.

³²⁷ *Ibid.*, 345 - 352.

yen. At the same time, in February, the government revived the regulations on advanced export proceeds that had been abolished after the conclusion of the Smithsonian Agreement. And, on March 1st, the government tightened its controls on converting foreign funds into the yen at foreign banks operating in Japan.³²⁸

However, such attempts to strengthen the foreign exchange control to fix the yen rate were not compatible with the realities of the Japanese economy, which had come to use large volumes of foreign currencies as a result of its economic growth. Japan Federation of Economic Organizations (Keidanren), which had demanded the liberalization of foreign exchange control from before the Smithsonian Agreement, once again criticized the Ministry of Finance's policy by announcing "A Commentary on the Future of Foreign Currency Exchange Control" in mid-February 1972, when the government once again sought to tighten its control. In it, the Federation stated, "It goes without saying that the exchange rate must be stabilized to the best extent possible. However, in order to achieve it, we must achieve internal and external balance by implementing necessary budgetary, financial, trade, and industrial policies. Neglecting these policies and instead depending solely on foreign exchange control is to confuse the order of things. Foreign exchange control should play only a supplementary role in adjusting the international balance of payments."³²⁹

On February 23rd, 1972, the association of trading companies called Boeki Shoshakai (Chairman: Mitsubishi Corporation) also submitted "An Immediate Request Regarding the Liberalization of Foreign Exchange Control" to the Finance Minister, the Minister of International Trade and Industry, and the Governor of the Bank of Japan. The letter criticized the existing foreign exchange control by stating, "Our country's **trade and external investments and loans will continue to increase as the scale of the economy expands**. Unless effective methods to avert foreign currency risks are approved, trading companies will be subject to a great crisis as a result of fluctuations in the foreign currency market or changes in the exchange parity. In the first place, the existing Foreign Exchange Control Law was established in order to effectively manage the small amount of foreign currency reserve that Japan had. Now that the country possesses a fair amount of it, the law is virtually irrelevant, and should be abolished immediately"³³⁰ (Emphasis added by the author).

Criticism of the tightening of the foreign exchange control (in other words, a measure to prevent revaluation) came not only from within Japan, but also from the U.S.³³¹ As Japan continued to enjoy a great trade surplus, the Japanese authorities began to worry that the yen would once again be subject to a revaluation in the near future, even though the Smithsonian Agreement was signed only recently. Learning a lesson from the

³²⁸ Nihon ginko hyakunen-shi hensan iinkai ed. *Nihon Ginko hyakunen-shi 6-kan*. Nihon ginko, 1986, 345 - 352.

³²⁹ Keizaidantairengokai. "Kongo no kawase kanri no arikata ni tsuite no kenkai." 16 February 1972 in Okurasho Shukeikyoku Okura dai 2-gakari. *Kokusai tsuka mondai to gaikoku kawase shikin tokubetsu kaikei*. February 1972 (quoted from Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 317 - 318).

³³⁰ Boeki Shoshakai. "Kawase Kanri jiyuka ni tsuite no kinkyo yobo." 23 February 1972 (Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 318).

³³¹ OECD Fujii Sanjikan. "73-kai Keizai seisaku iinkai dai san sagyobukai giji gaiyo (March 28, 29)." 30 March 1972 (Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 323).

experience of being forced to revalue the yen due to its delayed response, the authorities decided that it was imperative to take early action and avert the pressure to revalue the yen once again. For that purpose, on March 24th, Japan loaned 100 billion yen to the World Bank, and later on the 29th, it decided to terminate its loans and bill purchases in foreign currencies that had been strongly criticized for being part of the government's trade-supporting policies. Moreover, on April 1st, as a measure to encourage imports, Japan decided to increase the transfer ratio of import financing credit for foreign exchange banks (from the existing 30% to 50%).³³²

Moreover, as an additional measure to counter the possible pressure for revaluation, on May 20th, the government concluded what would be known as the "Seven-Point Program" (the second program to avoid yen revaluation, after the Eight-Point Program mentioned in Chapter 1). The contents were as follows. (1) Flexible budgetary and financial policies. Earlier implementation of public works projects. Lowering interest rates, focusing on the interest rate of savings accounts. (2) Measures to promote imports: the expansion of the import quota, promotion of the entry of new importers, reevaluation of the sole agency system, and rationalization of the distribution system. (3) Establishment of the rule of export transactions: Concentration of power in the Ministry of International Trade and Industry to mandate businesses to report on exporting items that are increasing rapidly and to issue recommendations to voluntarily restrain from exporting them. (4) Measures on capital exports: liberalizing the acquisition of unlisted foreign stocks and issuance of yen denominated bonds by international institutions and foreign governments. (5) Measures on exploiting foreign currencies: depositing foreign currencies in foreign exchange banks and allowing exchange banks to make repayments for their external debts, and depositing foreign currencies in the Export-Import Bank of Japan and using them for the development of resources. (6) Promotion of economic cooperation. (7) Establishing laws to implement the above measures in a timely manner.³³³ The goal of this policy was to avert another yen revaluation by rebalancing Japan's international balance of payments, as it continued to post a large surplus even after the currency adjustments at the Smithsonian.

However, while such measures were taken to suppress the rise of the yen, another event took place in the middle of June in 1972, which destabilized the fixed-rate system: From March 1972 onwards, international currency markets regained their stability and the yen recovered to around 304 yen by late March. Then, up to June, the yen quietly fluctuated between 304 and 305 yen.³³⁴ However, when a harbor strike continued for four days from June 16th in Britain, which was struggling with its worsening international balance of payments, a selling of the British pound began. And when Denis Healey of the Labour Party stated on June 19th at the Parliament that the pound could possibly undergo devaluation by July or August, this statement added fuel to the fire, and the pound suffered from massive speculation and plummeted further. During the six days up to June 22nd, the Bank of England alongside the central banks of the European Community intervened in the market and purchased approximately 1 billion pounds (2.6 billion

³³² Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 323.

³³³ "Boeki hairaito." *Boeki to kanzei*, July 1972, 14.

³³⁴ Nihon ginko hyakunen-shi hensan iinkai ed. *Nihon Ginko hyakunen-shi 6-kan*. Nihon ginko, 1986, 345 - 352.

dollars). At the same time, the Bank of England raised the official bank rate by 1% to 6% on June 22nd. But the speculation continued, and finally, on June 23rd, the British government announced that Britain will temporarily adopt the floating system.³³⁵ In the face of large-scale speculations and the ongoing economic stagnation, Britain moved back to the floating system upon quickly realizing that it would be impossible to continue supporting the pound and maintaining the fixed-rate system in that circumstance.

This was the first case of a shift to the floating system since the conclusion of the Smithsonian Agreement. It was an event that showed that the fixed-rate system was no longer capable of handling the growing scale of the international capital movement. And Britain's shift did not remain to be an issue of just one country. The incident was interpreted as a partial failure of the Smithsonian Agreement, and there appeared a market prediction that other currencies would follow and shift to the floating system. Such projection developed into the rumor that the European Community as a whole would shift entirely to the floating system. As a result, there began a massive selling of the dollar and massive buying of the European currencies and the yen.³³⁶

Moreover, the fact that the U.S. current account balance continued to worsen even after the dollar devaluation by the Smithsonian Agreement further increased anxiety and contributed to the dollar-selling. Whereas Japan posted a trade surplus of 3.72 billion dollars during the first half of the fiscal year, the U.S. extended its trade deficit. The reason why the U.S. trade balance worsened further despite the dollar devaluation largely owes to the time lag that exists between currency adjustments and their effects (called the J-curve effect). Another possible reason is that the dollar fell short of recovering its credibility because the U.S., instead of trying to improve its trade balance, continued to implement policies to expand its domestic economy, such as unemployment measures, even after devaluing the dollar.³³⁷

In the midst of the market confusion, Japan and European countries closed their foreign currency markets but the yen already had risen to 302 yen per dollar on June 23rd, the day before the market closed. Once the market reopened on the 29th, the U.S. dollar and European currencies continued to be converted into the yen. In addition, export bills that were placed on hold during the closure and the inflow of securities investment funds to Japan also led to the rapid rise in the yen. As a result, the yen rose to 301 yen per dollar.³³⁸ Besides Japan, the foreign exchange intervention by West Germany during this period amounted to 878 million dollars, and intervention by France amounted to 148 million dollars.³³⁹ Surveying the major countries as a whole, from June 23rd to July 14th, there was a gigantic amount of dollar-selling in the market, which amounted to over 6 billion dollars.³⁴⁰

A sense of crisis began to rise in Japan in such an unstable situation, and monetary authorities and economic experts started discussing seriously the possibility of the collapse of the Smithsonian regime. For example, Takeshi Ota, then a manager at the

³³⁵ Keizai Kikaku Cho ed. *Sekai keizai hakusho (1973 nen ban)*. Okurasho Insatsukyoku, Chapter 4.

³³⁶ Nihon ginko hyakunen-shi hensan iinkai ed. *Nihon Ginko hyakunen-shi 6-kan*. Nihon ginko, 1986, 348.

³³⁷ Keizai Kikakucho ed. *Sekai keizai hakusho (1973 nen ban)*. Okurasho Insatsukyoku, Chapter 4.

³³⁸ Nihon ginko hyakunen-shi hensan iinkai ed. *Nihon Ginko hyakunen-shi 6-kan*. Nihon ginko, 1986, 349.

³³⁹ Fujioka, Masao. *Tenkanki no kokusai kin'yu - Tsuka, kawase o meguru gekido no kiseki* -. Kin'yu Zaisei Jijo Kenkyukai, 1975, 167.

³⁴⁰ "Treasury and Federal Reserve Foreign Exchange Operations", *Federal Reserve Bulletin*, Sep. 1972, 758.

Administration Division of Foreign Department at the Bank of Japan, looked back the period and described the situation as follows: “We, as the Bank of Japan, did not publicly advocate yen revaluation or a shift to the floating system. But, after the summer of 1972, inside the Foreign Department at the Bank of Japan, we secretly continued to work on both directions: On the one hand, to maintain the Smithsonian regime, we were taking measures such as the reinforcement of the foreign exchange control. On the other hand, we were developing the plans to prepare for a shift to the floating system. The contact and the discussion were made very frequently among Advisor Hosomi, Koichi Inamura, the Vice Minister of Finance for International Affairs, Taizo Hayashi, the Chief of International Finance Bureau, Michiya Matsukawa, the Deputy Director, Masao Fujioka, the Deputy Director-General (all from the Ministry of Finance), and Shiro Inoue and Hitoshi Yukawa, both the Board member, Genzo Fujimoto, the chief at the Foreign Department, Eikichi Arai, the Deputy Director (all from the Bank of Japan). Even at the lower level, Tomomitsu Oba, the Chief of the Department of Short-term Capital at the International Finance Bureau and I myself communicated with each other several times a day and it often continued into the night after we left the office.”³⁴¹

At the same time, the U.S. was also beginning to change its own policy. On July 18th, 1972, in the midst of heightening fears in the world markets, the U.S. Department of Treasury agreed to the New York Federal Reserve Bank’s decision to make swap agreements with central banks of other countries and intervene by purchasing the dollar to a limited extent. This was the first time in a year since the Nixon announcement that the U.S. government took steps to maintain the dollar parity. Occasioned by the U.S. action, international currency markets gradually began to get out of the turbulent state, and once again regained their stability. Also in the background of the regained stability was said to be a burgeoning improvement in the U.S. trade balance, an increase in the U.S. interest rate, stabilization of prices, and domestic economic booms in the U.S., Europe, and Japan.³⁴²

However, while the foreign currency market stabilized, Japan remained wary of the possibility of another yen revaluation. For example, Yasuhiro Nakasone, then the Minister of International Trade and Industry, stated on August 9th 1972 at the panel discussion with representatives from the electronics and general machineries industries that “The Japanese economy is cornered and is forced to make a decision: whether to revalue the yen or implement adjustment inflation. As for myself, I believe that yen revaluation must be avoided at all costs. To that end, we must stimulate the economy ...”³⁴³ Moreover, on September 30th, Prime Minister Kakuei Tanaka declared that preventing the yen revaluation was the responsibility of the government, stating, “The current conditions imply that small and medium-sized businesses could not possibly overcome the yen revaluation. Given this, we must take necessary domestic policies ... otherwise, we would face more problems in a passive manner. This is the government’s responsibility.”³⁴⁴

³⁴¹ Ota, Takeshi. *Kokusai kin'yu - Genba kara no shogen*. Chuko Shinsho, 1991, 41.

³⁴² Nihon ginko hyakunen-shi hensan iinkai ed. *Nihon Ginko hyakunen-shi 6-kan*. Nihon ginko, 1986, 349; Volcker, Paul. and Gyohten, Toyoo. *Tomi no kobo - En to doru no rekishi* -. Toyo Keizai Shinposha, 1992, 156.

³⁴³ *Mainichi Shimbun*, 10 August, 1972.

³⁴⁴ *Nihon Keizai Shimbun*, 1 October 1972.

While the Japanese government refused to waver from this stance, the private sector was quick to make realistic judgments. Because there were heightening criticisms from the international society of Japan's enormous trade surplus and increasing pressures for a yen revaluation, by autumn "the general atmosphere in the market was that the government would be forced to revalue the yen once again sometime during the year."³⁴⁵ Even those at the Bank of Japan, which had made efforts to maintain the yen rate through large scale dollar-buying, stated that "since the autumn of 1972, the overall feeling is that it has become difficult to adhere to the rate determined in the Smithsonian Agreement."³⁴⁶ Moreover, according to the journal *Kin'yu zaisei jijo* (Situation of finance and budget), by October 1972, "the financial industry was on the consensus that 'the revaluation will take place next February,'" "the yen revaluation seemed pretty much inevitable," and as a result, "there was an increase in dollar-selling, and the foreign exchange banks and trading companies formulated countermeasures against the possible revaluation."³⁴⁷ The forecast of a revaluation in February 1973 was based on speculation about the scheduling of the meeting of the Diet and the timing of a general election. At that time the view that the Diet would be dissolved in 1972 was particularly strong. Thus, there was speculation that a revaluation would not occur during a general election campaign.³⁴⁸

In contrast to these reactions in some parts of the private sector, the government continued to take an absolute stance against yen revaluation. Because the yen had been revalued just a year before, there were fears that "if another revaluation takes place without enough time from the previous one, the negative impact on the economy is immeasurable."³⁴⁹ For this reason, to prevent the yen revaluation, on October 20th 1972, the government decided to implement the "Five-Point Program" (Third program to avoid yen revaluation). The contents were as follows. (1) Promotion of imports (e.g., planned promotion of the liberalization of restricted import items, a uniform discount of duties, improvements on preferential duties, a widening of import quota, and expansion and improvement of import financing) (2) optimization of exports (3) liberalization of capital (4) expansion and improvement of economic cooperation (e.g., qualitative improvement of economic cooperation, and expansion and improvement of overseas investment financing by the Export and Import Bank) (5) improvements of welfare policy.³⁵⁰

Moreover, regarding foreign exchange control, some regulations were relaxed. The relaxation applied to the regulations on (1) foreign currency carried by travelers, (2) reconversion of the yen to foreign currencies by alien residents at the time of their departure from Japan (3) small amount of currency transmissions by individuals. But at the same time, strengthened regulations were imposed as follows: (1) Securities investments by alien residents of Japan must be limited to the amount of their sale of securities (2) Permission for authorized foreign exchange banks to provide medium- and long-term local loans will no longer be given on a blanket basis, but on an individual

³⁴⁵ Okurasho Kokusai Kin'yukyoku. "Daijin jimu hikitsugi shiryō." December 1972 (Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 335).

³⁴⁶ Nihon ginko hyakunen-shi hensan iinkai ed. *Nihon Ginko hyakunen-shi 6-kan*. Nihon ginko, 1986, 397.

³⁴⁷ *Kin'yu zaisei jijo*, 23 October 1972, 15; *Kin'yu zaisei jijo*, 6 November 1972, 18.

³⁴⁸ Komiya, Ryutaro and Suda, Miyako. *Japan's Foreign Exchange Policy 1971-1982*. North Sydney: Allen & Unwin, 1991, 326.

³⁴⁹ Matsunaga, Yoshio. "Nihon no tsuka seisaku." *Keizai Seminar*, October 1972, 27.

³⁵⁰ Nihon ginko hyakunen-shi hensan iinkai ed. *Nihon Ginko hyakunen-shi 6-kan*. Nihon ginko, 1986, 354.

basis (3) Permission must be attained for charter contracts for used ships and others that are exported from Japan.³⁵¹ In the meantime, foreign exchange interventions were implemented as well. The exchange authority intervened in the market every month, and it is said that there was a selling of over 5.9 billion dollars during the second half of 1972.³⁵²

However, of course, these measures alone would not resolve the issue inherent in the fixed-rate system - the expanding scale of international capital transaction. According to the estimates by the Bank of International Settlements, the size of the Eurocurrency market expanded from 30 billion dollars at the end of 1968 to 91 billion dollars by the end of 1972. Moreover, according to the report by the U.S. Tariff Commission, the fluid assets that the private sector, such as multi-national corporations, could freely transact in the international financial market amounted to 268 billion dollars at the end of 1971. This was double the size of the external assets possessed by central banks and international financial institutions worldwide.³⁵³ And the trend continued in 1972 as well.

Because of this swollen scale of international capital movement, at the beginning of 1973, the world markets once again experienced turmoil. First, the Italian lira was sold in large amounts, due to its worsening inflation, successive occurrences of strikes, turmoil in politics, and expiration of special support of the lira by the European Community. Unable to stop the capital outflow, on January 22nd, Italy decided to adopt a dual exchange rate system. It was a system in which a fixed rate was applied to the commercial rate in trade transactions, while a floating rate was applied to financial rates in financial transactions (and other transactions). And as a result of continuing capital outflow, the financial rate of the lira soon fell by approximately 7.5% from what was stipulated in the Smithsonian Agreement.

However, the problem did not end there. As the capital movement from the lira to Swiss franc became more prominent, the Swiss franc was pressed to rise. To prevent the surge of the Swiss franc, the Swiss National Bank implemented dollar-buying in large amounts, but soon it had to give up the intervention in the face of massive speculations. After all, Switzerland temporarily shifted to the floating system from January 23rd. This marked the second shift to the floating system following Britain.

As the foreign currency market became unstable once again, on January 24th 1973, it was announced that the U.S. trade deficit for the fiscal 1972 was approximately 6.4 billion dollars (it was 2 billion dollars in 1971). Moreover, due to the relaxed pricing and income policies in the U.S., there were fears that inflation rate might increase. These factors stimulated the ongoing dollar-selling even more, leading the dollar to plummet on the New York exchange on January 24th and 25th. To protect the dollar, the Federal Reserve Board took on a massive dollar-buying intervention through the mark-selling.³⁵⁴ However, the situation did not quiet down even into February, and from February 1st onwards, the dollar was sold aggressively once again. In response to the massive dollar-selling in the foreign exchange market in West Germany, the country fortified its foreign

³⁵¹ “Kawase Kanri ni yoru kokusai shushi taisaku.” *Fainansu*, dai 85-go, December 1972, 19-26.

³⁵² Komiya, Ryutaro and Suda, Miyako. *Gendai kokusai kin'yu ron - Rekishi seisaku hen*. Nihon Keizai Shinbunsha, 1983, 12 - 13.

³⁵³ Keizai Kikaku Cho ed. *Sekai keizai hakusho (1973 nen ban)*. Okurasho Insatsukyoku, Chapter 4.

³⁵⁴ Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 344.

exchange controls on February 5th. But despite such effort, West Germany was forced to buy a total of 5.9 billion dollars between February 2nd and 9th.³⁵⁵

And the worldwide dollar-selling also affected Japan. On the Tokyo exchange market, 140 million dollars were sold on February 1st, 182 million dollars on February 2nd and 286 million dollars on February 3rd.³⁵⁶ Meanwhile the Bank of Japan continued to intervene in the market and implemented dollar-buying that amounted to 1.1 to 1.2 billion dollars during the eight transaction days between February 1st and 9th. This amounted to approximately 90% of the spot dealings in the Tokyo exchange market during the same period.³⁵⁷ However, despite such large scale interventions, the market still remained unstable.

While the dollar-selling was accelerating, foreign pressures for yen revaluation started to rise again. On February 6th, congressman Henry S. Reuss suggested a multilateral meeting under President Nixon's initiative and pressed for the float of the mark and the yen.³⁵⁸ On the 8th of the same month, Senator Jacob Javits declared in the Senate that the U.S.-Japan trade imbalance and the increase in Japan's foreign currency reserves were not acceptable, and that West Germany and Japan needed to moderate their anti-revaluation attitudes because their currencies were undervalued.³⁵⁹ On February 9th, *The Financial Times* (London) criticized Japan under the title of "The responsibility rests on Japan" as follows: "the international currency crisis is not essentially a Deutschmark crisis; it is a dollar-yen crisis, with the main burden of responsibility lying firmly on the Japanese government ... If the selling of dollars has taken place principally in Frankfurt, and only to a much smaller extent in Tokyo, it is because the yen is much more heavily protected by exchange controls ... There have been public allusions in Washington to the idea of a new import surcharge ... For too long Japan has remained blandly indifferent to the difficulties it is creating for the rest of the world, and its still expensively protected economy is in stark contrast with the advantages it has gained from the liberal policies of its trading partners. Unless the Japanese Government takes effective action soon to cut its surplus, it may endanger the very principle of liberal trade and payments."³⁶⁰

In this situation where the pressure for yen revaluation continued to rise, Paul Volcker, then the Under Secretary of Treasury, visited Japan secretly on February 8th and negotiated for currency adjustments. Volcker suggested to the Finance Minister Kiichi Aichi that the U.S. was prepared to devalue the dollar by 10% against gold, so they wanted Japan to revalue the yen by 10%.³⁶¹ In other words, he requested the revaluation of the yen against the dollar by 20%. In reply, Minister Aichi presented his view that

³⁵⁵ Okurasho Daijin kanbo chosa kikakuka. *En no hendosobasei iko ni tsuite (shiryō)* (Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 345).

³⁵⁶ Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 344 - 345.

³⁵⁷ Komiya, Ryutarō and Suda, Miyako. *Gendai kokusai kin'yu ron - Rekishi seisaku hen*. Nihon Keizai Shinbunsha, 1983, 17.

³⁵⁸ Fujioka, Masao. *Tenkanki no kokusai kin'yu - Tsuka, kawase o meguru gekido no kiseki* -. Kin'yu Zaisei Jijo Kenkyukai, 1975, 191.

³⁵⁹ Hosomi, Takashi. *Gekido suru kokusai tsuka - Sumisonian kara ju-nen*. Jijitsushinsha, 1982, 22.

³⁶⁰ "The responsibility rests on Japan," *The Financial Times* (London), 9 February 1973.

³⁶¹ Hosomi, Takashi. *Gekido suru kokusai tsuka - Sumisonian kara ju-nen*. Jijitsushinsha, 1982, 29; Volcker, Paul. and Gyohten, Toyoo. *Tomi no kobo - En to doru no rekishi* -. Toyo Keizai Shinposha, 1992, 160 - 161.

floating the yen would cause a sufficient level of rise in the value of the yen, so Japan was more inclined toward shifting to the floating system.³⁶²

The reason why the Finance Minister suddenly referred to the floating system was, according to Ryutaro Komiya and Miyako Suda, as follows. During that time, the 1973 draft budget was being discussed in the Diet on the assumption of a Smithsonian rate of 308 yen to the dollar. If the yen rate was changed, it would have been necessary to revise the draft budget, but the Cabinet and the Ministry of Finance did not regard a revision of a draft budget that had already been submitted to the Diet as desirable. Had it been a temporary float, it would have been unnecessary to revise the budget in order to have it passed by the Diet. From a Diet point of view, the floating of the yen was the more favorable policy.³⁶³ In other words, if the appreciation of the yen was inevitable, it was more convenient for them to let it happen by floating the yen rather than by revaluing the yen's fixed rate.

Moreover, according to the retrospect of Takashi Hosomi, the former Vice Minister of Finance for International Affairs, the attitude inside the Ministry of Finance was changing in the repeating currency crisis: "Inside the Ministry of Finance, after several discussions of the necessity of yen revaluation, we came to largely agree that the floating system was a rational choice under conditions of unpredictable currency, because it would allow us to intervene at our own discretion when the situation necessitated it. Under the floating system, we thought, we would not need to make such enormous desk work of revising the documents related to the budget, and also, we could expect a favorable side effect that we would be able to freely speak about our future currency policy according to the circumstance at the time."³⁶⁴

It was during this period, when the problems of the fixed-rate system started to be recognized and more support for the floating system was mounting within the Ministry of Finance, that the Under Secretary of Treasury Volcker visited Japan. After the negotiation seen above, time ran out and Volcker left Japan for the negotiation with the European countries.

On February 9th, the day following day Volcker's departure, a meeting was held in the Ministry of Finance to discuss what to do with the foreign exchange market on the following day, Saturday the 10th, and they decided to open it as usual. But as there occurred a large amount of dollar-selling and the mark-buying in the European market, the Finance Minister Aichi ordered Hayashi, the Chief of International Finance Bureau, to have a phone discussion with undersecretary Yoshikuni, Advisor Hosomi, and Inamura, the Vice Minister of Finance for International Affairs.³⁶⁵ There were many opinions that the market should be kept open for the reason that if they close down the market it would weaken their position in their next negotiation with other countries. But after all, at the discretion of the Minister, a closure of the Tokyo exchange market was announced at

³⁶² Hosomi, Takashi. *Gekido suru kokusai tsuka - Sumisonian kara ju-nen*. Jijitsushinsha, 1982, 29; Volcker, Paul. and Gyohten, Toyoo. *Tomi no kobo - En to doru no rekishi* -. Toyo Keizai Shinposha, 1992, 160 - 161.

³⁶³ Komiya, Ryutaro and Suda, Miyako. *Japan's Foreign Exchange Policy 1971-1982*. North Sydney: Allen & Unwin, 1991, 39-40.

³⁶⁴ Hosomi, Takashi. *Gekido suru kokusai tsuka - Sumisonian kara ju-nen*. Jijitsushinsha, 1982, 28.

³⁶⁵ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 63.

seven in the morning.³⁶⁶ Masao Fujioka, then Deputy Director-General at the International Finance Bureau, explains that the decision to close down the market was based on the assumption that the dollar-buying intervention in West Germany would not last long, and by the following week the major European countries would close their foreign exchange markets, and at the end, the currency crisis would be brought under control quickly by multilateral conversations.³⁶⁷ This closure of the market was a move ahead of other countries, unlike the delayed move by Japan at the time of the Nixon Shock. The European exchange markets closed on the 12th, 2 days after the closure of Japan's exchange market.

And as the market continued to remain in disorder, on February 13th, to bring stability to the situation, the U.S. government decided to reverse its stance and devalue the dollar once again, and announced that it would devalue the dollar by 10% against the gold parity. As a result, one troy ounce became equal to 42.22 dollars. However, the dollar devaluation failed to recover the credibility of the U.S. economy. In fact, it only occasioned more speculations. This was because this revaluation of gold, equivalent to the devaluation of the dollar, occurred against the backdrop of a deteriorating U.S. international balance; it only incited speculative expectations for further devaluation of the dollar. In particular, oil-producing countries and other developing nations, which had the dollar as the largest portion of their foreign currency reserve, moved to sell the dollar and switch to gold and other strong currencies such as the Deutsche mark and the yen. Even though governments took steps against these moves and sought to maintain the Smithsonian rates by selling their own currencies, there was limit to how much dollar could be purchased, as the dollar was not guaranteed by the value of gold.³⁶⁸

Reflecting such anxiety over the dollar, the Japanese yen, which came under the floating system on February 14th, the day following the announcement of the dollar devaluation, rose to 271 yen against the dollar as soon as the market reopened, up by approximately 12% compared to the Smithsonian rate of 308 yen. By the 15th, the yen rose to 265 yen, up by approximately 15%. However, the turmoil in the Japanese exchange market was relatively small. European countries, who had remained steadfast to the fixed-rate system, continued to become a target of speculators, and as a result, they faced more struggles than Japan. Around the same time that Japan switched to the floating system, Italy's financial and commercial liras came under the floating system as well. The German mark, the French commercial franc, the Dutch guilder, the Belgian franc, and others remained in the fixed-rate system (as a result of the dollar devaluation, the currencies were automatically revalued at 11.11%).

And, as the dollar began to be sold once again due to the deepening distrust of the currency, these European currencies soared immediately against the dollar. On February 23rd, the Deutsche mark, guilder and French and Belgium francs reached the upper limits of their permitted fluctuation range and the West German and Dutch foreign exchange authorities were forced to purchase large amounts of dollars.³⁶⁹ The floating Swiss franc

³⁶⁶ *Ibid.*

³⁶⁷ Fujioka, Masao. *Tenkanki no kokusai kin'yu - Tsuka, kawase o meguru gekido no kiseki* -. Kin'yu Zaisei Jijo Kenkyukai, 1975, 191.

³⁶⁸ Nihon ginko hyakunen-shi hensan iinkai ed. *Nihon Ginko hyakunen-shi 6-kan*. Nihon ginko, 1986, 346.

³⁶⁹ Komiya, Ryutaro and Suda, Miyako. *Japan's Foreign Exchange Policy 1971-1982*. North Sydney: Allen & Unwin, 1991, 31.

rose by 18 to 19% against the dollar.³⁷⁰ The price of gold also increased. Whereas it was 65 dollars per ounce at the beginning of the month, by the end of the month, it rose to 85 dollars per ounce.³⁷¹ Then, on March 1st, there was once again a massive selling of the dollar. On that day, dollar funds rushed towards the Deutsche mark and the Dutch guilder, and the West German Bundesbank's purchases of dollars were said to have reached 2 billion dollars level in morning trading alone, and 2.5-2.7 billion dollars in one day's trading. This broke the international financial record. In the European Community, foreign exchange authorities absorbed a total of 3.6 billion dollars from the market in one day.³⁷² Because of this emergency situation, the following day on March 2nd, Japan, West Germany, Britain, Belgium, Austria, and the Netherlands closed down their foreign exchange markets. France opened the market on the 2nd, but faced a massive dollar-selling as soon as the market opened. Consequently, it was forced to close down during the same day.

Through these events, the major countries finally came to the conclusion that the Smithsonian regime was impossible to sustain. Until the foreign exchange markets reopened on March 19th, many international conferences were held in search of an alternative international currency system that would replace the Smithsonian regime: three conferences by the financial ministries from the European Community, and two by financial ministries from fifteen countries. At the conferences held among the European Community countries on March 4th and 8th, it was acknowledged that the currency crisis was not the result of an imbalance in the currency rates, but one that was triggered by speculation. Based on this perception, it was proposed that governments must continue their market intervention and implement currency swaps for that purpose. It was also proposed that governments must implement exchange management to control the domestic and international transfer of funds and regulate short-term loans.³⁷³

Then, on March 11th, the European Community decided on making small adjustments to the West German mark (3% revaluation against the SDR), as well as to implement a joint floating system that comprised the six European Community Nations (France, West Germany, the Netherlands, Belgium, Luxemburg, and Denmark) except Britain, Italy, and Ireland (Sweden and Norway, both of which were outside of the community, also joined the joint float on March 19th). Japan, Switzerland, Britain, and Italy, which had adopted the floating system by then, confirmed their continuation of the float.³⁷⁴

Through these steps, the currencies of major countries began to be floated against the U.S. dollar. The focus of the currency crisis was then shifted to monitoring what initiatives the U.S. would take to recover the credibility of the dollar, and how the floating system would be operated. At the G10 conference on March 16th, the U.S.

³⁷⁰ Fujioka, Masao. *Tenkanki no kokusai kin'yu - Tsuka, kawase o meguru gekido no kiseki* -. Kin'yu Zaisei Jijo Kenkyukai, 1975, .193.

³⁷¹ Hayami, Masaru. *Hendo sobasei 10-nen - Kaizu naki kokai*. Toyo Keizai Shinposha, 1982, 89.

³⁷² Komiya, Ryutaro and Suda, Miyako. *Japan's Foreign Exchange Policy 1971-1982*. North Sydney: Allen & Unwin, 1991, 31-32.

³⁷³ Fujioka, Masao. *Tenkanki no kokusai kin'yu - Tsuka, kawase o meguru gekido no kiseki* -. Kin'yu Zaisei Jijo Kenkyukai, 1975, .194.

³⁷⁴ Nihon ginko hyakunen-shi hensan iinkai ed. *Nihon Ginko hyakunen-shi 6-kan*. Nihon ginko, 1986, 351 - 352.

agreed to purchase the dollar to stabilize the exchange market.³⁷⁵ And the joint communique of the G10 called for a stabilization of the floating system through continuous government intervention, as well as the expansion and improvement of the swap network, which was necessary to secure funds for such interventions.³⁷⁶

As the U.S. promised future intervention and major countries shifted to the floating system, the market started to stabilize. Seeing such development, on March 19th countries reopened their markets that had been closed for more than two weeks. This marked the complete collapse of the Smithsonian regime (and the postwar Bretton Woods regime), and the start of a new era in which the major countries adopted the floating system. It is true that even at the present there are many countries that are under the fixed-rate system or a system akin to it, but the fact that all the major countries shifted to the floating system during this period symbolized a great transformation of the international currency system. Also, it was a shift that manifested the following phenomenon that this dissertation has repeatedly explained: **as an economy expands, the economic system that had been supporting the expansion gradually becomes unsuitable for the overgrown scale of the economy, and such unsuitability accelerates a shift to a new economic system.**

	Dollar Selling	Dollar Buying	Total
1972 Jan	\$ 0.17 billion	\$ 0.45 billion	\$ 0.28 billion
1972 Feb	\$ 0.00 billion	\$ 0.47 billion	\$ 0.47 billion
1972 Mar	\$ 0.00 billion	\$ 0.07 billion	\$ 0.07 billion
1972 Apr	\$ 0.02 billion	\$ 0.00 billion	- \$ 0.02 billion
1972 May	\$ 0.08 billion	\$ 0.00 billion	- \$ 0.08 billion
1972 Jun	\$ 0.00 billion	\$ 0.27 billion	\$ 0.27 billion
1972 Jul	\$ 0.00 billion	\$ 0.86 billion	\$ 0.86 billion
1972 Aug	\$ 0.00 billion	\$ 0.73 billion	\$ 0.73 billion
1972 Sep	\$ 0.00 billion	\$ 0.76 billion	\$ 0.76 billion
1972 Oct	\$ 0.00 billion	\$ 1.59 billion	\$ 1.59 billion
1972 Nov	\$ 0.00 billion	\$ 1.20 billion	\$ 1.20 billion
1972 Dec	\$ 0.05 billion	\$ 0.80 billion	\$ 0.75 billion
1973 Jan	\$ 0.04 billion	\$ 0.04 billion	\$ 0.00 billion
1973 Feb	\$ 0.00 billion	\$ 1.10 billion	\$ 1.10 billion

Estimated interventions

Intervention in Feb 1973 includes only the period before the shift to the floating system.
From *Gaitame nenkan*; Komiya, Ryutaro and Suda, Miyako. *Gendai kokusai kin'yu ron - Rekishi seisaku hen*, 1983, 15.

This point was well summarized by Economic Planning Agency (in the Ministry of Finance) in its 1973 White Paper on World Economy, although the evaluation was ex

³⁷⁵ Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 353.

³⁷⁶ Fujioka, Masao. *Tenkanki no kokusai kin'yu - Tsuka, kawase o meguru gekido no kiseki* -. Kin'yu Zaisei Jijo Kenkyukai, 1975, .209.

post facto: “It is not easy to maintain the fixed-rate system today, as the dollar credibility has not recovered, large volumes of funds (mostly in inconvertible dollars) exist across the world, and the funds can be mobilized very quickly across the globe. Entering the 1970s, in order to prevent the chaotic transfer of funds, countries have taken stringent steps to control the foreign currencies, but the international currency crisis that took place in February and March 1973 showed that the governments could not effectively tame them. As a result, the countries began to remove themselves from the fixed-rate system one by one.”³⁷⁷ Looking at Japan alone, with the market’s persistent selling of the dollar during the Smithsonian era, the Japanese government purchased large volumes of dollars as shown in the table above, but such a large-scale intervention only heightened the pressure to revalue the yen because it increased potential exchange losses and an increase in foreign currency reserve. It was not a policy that could be undertaken for a long time.

In this chapter, we looked at the process by which **the growing international trade and international capital movement made it impossible for the fixed-rate system to persist as they grew, and propelled the shift to a new currency system. We also looked at how monetary authorities’ fears of potential economic damage from currency fluctuations made them unable to perceive the reality and worked to delay the abandonment of the fixed-rate system and the shift to the floating system until early 1973.**

But the fact that Japan promptly closed the market and made a shift to the floating system in the face of the currency crisis as seen above also reflected the fact that the ability of the Japanese monetary authorities to recognize and handle problems improved, after many mistakes. Evaluating highly Japan’s responses during the last phase of the Smithsonian system, Ryutaro Komiya and Miyako Suda pointed out that (1) the yen was floated earlier than many major currencies. (2) unlike the period between August and December 1971 during which the government implemented currency intervention in order to keep the yen rate low, this time after the shift to the float on February 14th there was no intervention in the market that aimed at artificially maintaining the yen rate, except for the first few days. (On the first day Japan shifted to the floating system, the exchange authorities made 2 billion dollars of dollar-buying intervention. On the second day, they intervened at 265 yen, and on the third day, at 263 yen. When the dollar soared at the end of the month, they even implemented dollar-selling at 270 yen on the 28th.)³⁷⁸ And Komiya and Suda concluded that, because of the swift shift to the float, the currency crisis in Europe that worsened after February 22nd did not spread to Japan.³⁷⁹ Japanese monetary authorities showed a better response this time in part because, as mentioned earlier, they could avoid a revision of their budget plan if they shifted to the floating system instead of revaluing the yen, and in part because resistance to the appreciation of the yen had become weaker during this time than in 1971 because Japan’s domestic economy was starting to recover. But in addition to these, there was another reason, as Komiya and Suda explained: “The reason Japan took such appropriate measures is possibly due to lessons it learnt from the first float. When the fundamental imbalances

³⁷⁷ Keizai Kikaku Cho ed. *Sekai keizai hakusho (1973 nen ban)*. Okurasho Insatsukyoku, Chapter 4.

³⁷⁸ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 64.

³⁷⁹ Komiya, Ryutaro and Suda, Miyako. *Japan’s Foreign Exchange Policy 1971-1982*. North Sydney: Allen & Unwin, 1991, 37-38.

became obvious, it appears that foreign exchange policymakers understood that the problem would not be alleviated by maintaining the existing fixed exchange rate.”³⁸⁰

Such change in attitude and perception is also testified by the Bank of Japan. *Nihon Ginko Hyakunenshi* (The Bank of Japan Centennial History) evaluates Japan’s prompt closing of the market and a shift to the floating system as follows: “It was the first case that we (Japan) took a leading action in the field of international currency. It was what we learned from the Nixon Shock. The background of the decision to close the market was that, after repeated large-scale intervention to maintain the exchange rate at 308 yen per dollar (as agreed in the Smithsonian Agreement), the Bank of Japan officials, since the fall of the year before, began to feel more and more that it was no longer possible to maintain the rate and thus a shift to the floating system was inevitable.”³⁸¹

But the problem was that it took a long time until such improvement was made. For example, Komiya and Suda, while highly evaluating the change, criticized the long delay that preceded it: “from the perspective of the Japanese macroeconomy the yen was floated too late. [In July 1972] Prime Minister Tanaka stated that Japan ‘had to adopt various policy measures to avoid revaluing the yen again’, and since what he was advocating was the maintenance of the Smithsonian rate, the exchange authorities were constrained in their policy options. From an economic perspective, in autumn 1972 the Japanese government should have either revalued the yen again or moved to a floating system.”³⁸²

This chapter explained that **such realistic measures were delayed because fears over both high yen and a collapse of the fixed-rate system gave birth to a strong resistance to an appreciation of the yen and strong support for the fixed-rate system. Because Japan greatly depended on its fixed exchange rate for its export expansion, fear of a yen revaluation and a collapse of the fixed-rate system was enormous, and such fear led to misunderstanding about the fundamentals of the Japanese economy and delayed their decision to revalue or shift to the floating system.**

(3) Financial and Fiscal Measures against the Yen Revaluation: From 1971 to 1973

Thus far we have looked at the process by which monetary authorities continued a currency policy that did not match the reality, because of their fear of a high yen and a collapse of the fixed-rate system as well as their lack of understanding of the actual gap between Japan’s real economic power and its exchange rate. But it was not only the currency policy that moved away from the reality because of fear and the lack of understanding. The Japanese financial and fiscal policies also lost touch with reality for the same reason. Because the focus of this dissertation is currency system, we have

³⁸⁰ *Ibid.*, 38.

³⁸¹ *Nihon ginko hyakunen-shi hensan iinkai ed. Nihon Ginko hyakunen-shi 6-kan.* Nihon ginko, 1986, 350.

³⁸² Komiya, Ryutaro and Suda, Miyako. *Japan’s Foreign Exchange Policy 1971-1982.* North Sydney: Allen & Unwin, 1991, 41; Kanemitsu, Hideo and Komiya, Ryutaro. “Japan’s Foreign Exchange Policy under the Floating System: A Critical Analysis.” a paper presented at the Williamsburg Conference on the Experience of Greater Exchange Rate Flexibility, May 1974.

mainly focused on currency policies, but it is now necessary to explain the consequences of Japan's financial and fiscal policies in the early 1970s because they have connections to the currency policies implemented later.

The financial and fiscal policies were detached from the reality in the following way. In short, the government and the Bank of Japan failed to acknowledge that the yen rate had become incompatible with the actual strength of the maturing Japanese economy, and out of fear that the post-Nixon Shock yen revaluation would cause a major economic damage, took steps to implement large-scale monetary easing and financial supports to stimulate domestic industries. However, although small and medium-sized businesses and other businesses did suffer, as a whole, the appreciation of the yen in fact did not bring a major damage to the Japanese economy. The economy was not so vulnerable that it would take a serious hit from the subsequent appreciations of the yen. For that reason, the major monetary easing and massive financial support, which were implemented under an overblown anxiety, were actually redundant measures and boosted the domestic economy excessively, fueling the fire of inflation. Let us examine this development in more detail.

For those who thought that Japan would suffer much if the yen was revalued, the Nixon Shock was an ominous incident that heralded a prolongation of the recession that had already begun in Japan by then. In 1971, the Japanese economy was entering a cyclical adjustment period, and due to this, "the government, the private sector, and mass media exaggerated in unison the potential impact of deflation that a yen revaluation could incur, by comparing the situation to the situation in 1930, when the suspension of gold-yen convertibility was lifted [and caused deflation]"³⁸³ Many newspaper and magazine articles pointed to the possibility of a prolonged recession, as mentioned earlier. To remind it again, there were articles such as "A Sharp Drop in Exports is Inevitable: Domestic Recession to Worsen, Bankruptcies Too" (*Nihon Keizai Shimbun*, August 28, 1971), "The Dangers of a Large-Scale Recession" (*Asahi Shimbun*, August 28, 1971), and "Big Damages to Medium and Small Businesses: Revert to the Fixed-rate system as Soon as Possible" (*Mainichi Shimbun*, August 28, 1971), "Special Feature: Will the Nixon Recession Hit? (7) On-Site Reports: Small and Medium-Sized Businesses Facing Bankruptcies" (*Ekonomisuto*, 7 September 1971, 53 - 61).

Furthermore, what was feared was not only recession. There also were fears over the possibility that Japan's increase in export and decrease in import due to its domestic recession would heighten foreign pressure for more revaluation. For instance, in his policy speech at the ordinary Diet session in January 1972, Prime Minister Eisaku Sato stated as follows: "We should not allow the prolonged recession to increase our exports, decrease imports, delay the rebalancing of international balance of payments, slow down domestic industrial adjustments, and heighten social conflicts. For this reason, we will strive for the economic recovery with all-out effort such as aggressive use of budget."³⁸⁴ In fact, at the OECD Economic Policy Committee held at the end of April 1972, it was pointed out that Japan should boost its domestic economy and expand its domestic

³⁸³ Ishida, Sadao. "Sengo Nihon keizai naigai no ugoki to kin'yu seisaku no un'ei." *Seikei ronso*, dai 63-kan dai 2-3-go, 1995, 325-326.

³⁸⁴ *Dai 68-kai Shugiin honkaigi gijiroku Dai 3-go(2)*, 29 January 1972.

demand in order to maximize the effect of the currency adjustments.³⁸⁵ Although this was right after the Smithsonian Agreement, it was quite predictable that, if Japan's trade surplus kept increasing, the pressure for yet another revaluation would reemerge.

As described above, because there were concerns over the possibility of serious recession that an appreciation of the yen might cause, as well as anxieties over more international pressure for yen revaluation, it was thought that a strong economic boost was necessary to avoid domestic deflation and the revaluation pressure. Consequently, large-scale monetary easing measures and fiscal policies were implemented.

Specifically, the financial policy was taken as follows. Until 1971, the Bank of Japan had enforced the repayment of loans more than what they loaned out, but by 1972, it suddenly increased the amount of loans it provided; the official bank rate was lowered from 6% in 1970 to 4.75% in 1971, and down further to 4.25% in June 1972 to encourage the borrowing of loans. The impact was that the money supply increased by 22.5% in 1971, followed by 26.8% in 1972.³⁸⁶ Later, Ryutaro Komiya of Tokyo University would seize on this point for criticism: "because of the error in judgment made by the monetary authorities, an excessive amount of money was deliberately supplied."³⁸⁷ And the Bank of Japan itself admits in its *Nihon Ginko Hyakunenshi* (The Bank of Japan Centennial History) that it intentionally increased the money supply to avoid another revaluation of the yen: "In case of our country, the issue of revaluation was a taboo among the people including the government officials, partially because dissatisfaction on the part of the business community continued regarding the Smithsonian Agreement where a larger-than-expected scale of revaluation took place. In such a mood, the Bank of Japan implemented its financial measures on the premise that there should be no more revaluation of the yen. And, in order to avoid another revaluation, there was no other way but to boost the domestic economy and correct the trade imbalance. It was based on this standpoint that, after lowering the official bank rate in last December, we promoted the continuation of expansionary monetary policy for the first quarter of 1972."³⁸⁸

There was a certain merit to this increased amount of loans and money supply: The expansionary monetary policy contributed to the recovery of economy because, for example, it worked to increase the housing investment in Japan during the first half of 1972 and the recovery of capital investment during the second half. However, because the money supply was excessive, it caused a serious inflation (as will be explained in detail later).

The inflation was furthered not just by monetary easing, but also by fiscal policies. After the Nixon Shock, there were fears over the appreciation of the yen, and against this backdrop, the government finalized a large supplementary budget for fiscal 1971 of 500 billion yen in October 1971. Such fiscal expansion continued even after the yen was revalued in the Smithsonian Agreement in December 1971. And, when Kakuei Tanaka became the Prime Minister in July 1972, the expansionary policy accelerated. Before becoming Prime Minister, Tanaka published a book in June 1972 which was titled, *The*

³⁸⁵ Okura Daijin kanbo chosa kikakuka. "'Taigai Keizai kinkyu taisaku no suishin ni tsuite' no setsumei shiryo." 23 May 1972 (Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 323).

³⁸⁶ Takemori, Shunpei. *Sekai defure wa mitabi kitaru (ge)*. Kodansha, 2006 (2009 edition), 221.

³⁸⁷ Komiya, Ryutaro. *Gendai Nihon Keizai - Makuro teki tenkai to kokusai Keizai kankei*. Tokyo Daigaku Shuppankai, 1988.

³⁸⁸ Nihon ginko hyakunen-shi hensan iinkai ed. *Nihon Ginko hyakunen-shi 6-kan*. Nihon ginko, 1986, 378.

Plan for Remodeling the Japanese Archipelago (Nihon retto kaizo ron). In it, he proposed to resolve overpopulation in urban areas and poverty in local regions by building high-speed transportation networks of bullet trains and highways, thereby dispersing the industries concentrated in particular areas and promoting the industrialization of peripheral regions. The Plan was formulated not particularly for alleviating the damage incurred by the yen revaluation, but there was a tendency that the expansive fiscal policies were “highly welcomed by the public that feared deflation resulting from the yen revaluation.”³⁸⁹ In this climate, once Tanaka became the Prime Minister, he put his words into action. The supplementary budget plan for fiscal 1972 and the second addition to the national investment and loan program were large in scale; they amounted to 1.552 trillion yen, a giant supplementary budget that was by then the highest in the history of Japan.³⁹⁰ As a result, the 1972 budget posted a year-on-year increase of 21.8% in general account budget, a 26.4% increase in expenses related to public works, and a 31.6% increase in the investment and loan program.³⁹¹ Following 1972, the fiscal 1973 budget finalized on January 15th 1973 also posted a record high. The budget posted a year-on-year increase of 24.6% in general account budget, and a 28.3% increase in the investment and loan program.³⁹²

But this was not all. When Japan switched to the floating system in February 1973, steps were taken to expand the domestic demand, out of fear that an appreciation of the yen would negatively impact exporters. On March 14th, the government made a cabinet decision called “Emergency Measures for Small and Medium-Sized Businesses as a Response to the Changes in the International Currency Situation.” The content of the measures were as follows. (1) Provision of an emergency loan of 220 billion yen by three government-related financial institutions specializing in small and medium-sized businesses, including Shoko Chukin Bank; relaxation of loan requirements through such measures as the reduction in loan interest, and the establishment of a separate credit line. (2) Emergency loans in response to the U.S. levying of import surcharges; special loans to textile businesses, and moratorium (one to two years) on existing loans for the renewal of infrastructure. (3) New establishment of a special insurance, and expansion and improvement of credit enhancement through fiscal measures. (4) Special taxation measures such as the extension of the deadline for claiming refund by carrying back losses. (5) Improvement measures to facilitate the conversion of businesses. (6) Establishing laws to implement the above measures in a timely manner.³⁹³

However, the government’s measures to expand the domestic demand and the Bank of Japan’s low interest policy invited a large inflation. As mentioned above, the money supply increased by 22.5% in 1971 and 26.8% in 1972, but the trend accelerated even more in 1973, and the money supply for the second quarter of 1973 increased by 37.2%

³⁸⁹ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 90.

³⁹⁰ Kishi, Nobuhito. *Keizaihakusho monogatari*. Bungei Shunju, 1999, 191.

³⁹¹ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 90.

³⁹² Keizai Kikaku Cho. *Showa 48 nen do Nenji keizai hokoku*. Okurasho Insatsukyoku, 1973.

³⁹³ “Kokusai tsuka josei no henka ni tomonau kinkyu chushokigyō taisaku ni tsuite.” 14 March 1973 in Okurasho Kanbo chosa kikakuka. *En no hendosobasei iko ni tsuite (shiryō)* (Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 355 - 356).

year on year.³⁹⁴ The inflation is often attributed mistakenly to the Oil Crisis of October 1973. But, as Ryutaro Komiya and Miyako Suda pointed out, inflation was already largely underway through the financial relaxation and fiscal policies discussed above.³⁹⁵

And the reason why the government and the Bank of Japan implemented such expansionary policies was that, as explained above, they were fearful of yen revaluation and their fears prevented them from understanding the actual gap that existed between Japan's real economic power and its exchange rate. As Sadao Ishida, a former professor at Meiji University, writes: "At the root of the Bank of Japan's stance for the expansionary monetary policy, there was an overestimation of yen revaluation's deflation effect ... In case of the revival of the gold-yen convertibility in 1930, the world was in the middle of global recession that started in 1929 ... [But] in the 1970s, the world was in an inflationary trend in contrast, and Japan was still on the path of growth. There was not enough confidence that the yen revaluation matched the strong growth potential of the Japanese economy."³⁹⁶

However, as the inflation accelerated, the government and the Bank of Japan came to acknowledge the errors in their thinking and had to make changes to their ongoing policies. For example, out of worry that the existing small and medium-sized businesses, as well as microenterprises, would be negatively impacted by a revaluation, Prime Minister Tanaka, before 1973, was thinking that a little price hike was desirable [in order to avoid revaluation pressure] and thus implemented relaxation measures on both fiscal and financial fronts. However, at the Diet session on March 16, 1973, he showed a change in his thinking and took a different stance. He stated that Japan has enough strength to withstand a revaluation, and that he is now resolved to control demand through financial tightening and adjusting the fiscal expenditures. These, he said, are necessary to control the prices, the biggest challenge that Japan faced at the time.³⁹⁷ Moreover, the Bank of Japan also took full-scale steps to implement financial tightening by raising the official bank rate by 0.75% on April 2nd, by 0.5% in May, by 0.5% in July, and by 1% in August. The resulting official bank rate was 7%.

However, these were already late steps. The inflation, now gaining momentum, was hard to tame. In September 1973, just before the onset of the Oil Crisis, the consumer prices soared year-on-year to 14.4%. Against this backdrop, the first Oil Crisis, which erupted in autumn 1973, further accelerated the trend, resulting in the major scale inflation that came to be known as "A Wild Price Spiral" (Kyoran bukka). In response, the Bank of Japan increased the official bank rate in December 1973 by 2% to raise it to 9%. Nonetheless, this was not enough to counter the rapid inflation. Eventually, by 1974, the wholesale prices and the consumer prices rose by 31.4% and 23%, respectively. Partly as a result, in 1974, Japan posted a negative growth of -1.2%, the first negative growth in its postwar history.

³⁹⁴ Takemori, Shunpei. *Sekai defure wa mitabi kitaru (ge)*. Kodansha, 2006 (2009 edition), 221.

³⁹⁵ See Komiya, Ryutaro and Suda, Miyako. *Gendai kokusai kin'yu ron - Rekishi seisaku hen*. Nihon Keizai Shinbunsha, 1983.

³⁹⁶ Ishida, Sadao. "Sengo Nihon keizai naigai no ugoki to kin'yu seisaku no un'ei." *Seikei ronso*, dai 63-kan dai 2-3-go, 1995, 325-326.

³⁹⁷ Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 356.

In this section, as explained above, we have seen the process by which excessive fiscal and financial policies that did not reflect the fundamentals of the Japanese economy worked as the accelerators of inflation before and after the Oil Crisis. It is also explained that fears over possible yen revaluation invited such a mistake. And in this chapter as a whole, we have seen that (1) the expansion of economy and international capital movement, which had been supported by the fixed-rate system, ironically made the system difficult to function and subsist. (2) despite such deepening structural contradictions and the impossibility of the fixed-rate system, the authorities continued implementing misdirected currency, fiscal, and monetary policies, out of fear over potential economic damage. (3) because of such fear as well as misdirected understanding and policies, there was a delay in abandoning the fixed-rate system.

In the next chapter, we will study the process by which the growing world trade and international capital transactions led to monetary authorities' efforts to strengthen the floating system.

CHAPTER 3

Fortification of the Floating Exchange Rate System for Damage Containment and Profit Increase

In Chapter 1, we focused on the ways in which the expansion of the economy, potential economic damage and fears of it led to efforts to strengthen the fixed-rate system. Chapter 2 showed that the expansion of the economy and international capital movement, which had been supported by the fixed-rate system, ironically made it difficult for the system difficult to function and subsist, and that, despite such deepening structural contradictions of the system, there was a delay in abandoning it, due to the fears over the potential economic damage that a collapse of the fixed-rate system would incur.

In this chapter, we take up the process by which the further expansion of economy, potential economic damage and fears of it led to efforts to strengthen the floating system. In other words, we will now look at the ways in which monetary authorities and economic experts began to actively support the floating exchange rate system, whose adoption was inevitable once it became clear that a continued adherence to the fixed-rate system would only bring bigger economic losses, as the floating system buffered the economic shock of the Oil Crisis and contributed to the stabilization of world trade and international capital movement after the crisis. Moreover, we will look at how it became difficult to operate **the floating system in the style of the fixed-rate system** as international capital movements expanded, and even if such operation was maintained, it heightened other countries' protectionism and people's fears over it, leading to a strong support for and a shift to a **market-oriented laissez-faire-style floating system** that let the market determine exchange rates.

As emphasized earlier, what this dissertation attempts to demonstrate through studying such cases is that (1) the expansion of international trade and international capital movement plays an important role in making the preexisting currency system dysfunctional, arousing fear in the people, and motivating them to take action. (2) it is not only by our profit-seeking motivation but also by the expansion of potential damage and people's fear of it that an economic system is fortified (explained in Chapter 1), a change in the system is hampered and delayed (explained in Chapter 2), and a change in the system is propelled (as will be explained in this chapter).

Before examining the actual historical process, which will be discussed in Section 2, we will first examine in Section 1 below some theoretical reasons why the floating system contributed to the expansion of the international trade and capital movement. The advantages of the floating system have already been covered in the previous chapter's discussion of the fixed-rate system, but here, we will revisit them and provide explanations that were not included in the previous chapter.

Section 1 Framework - Merits of the Floating Exchange Rate System

(1) One advantage of the floating system is that it promotes the expansion of free trade through competition. Unlike the fixed-rate system, in which exchange rate adjustments do not occur frequently, the rates fluctuate every day in the floating system, and therefore, price competitiveness fluctuates more frequently among countries, stimulating the international competition to a greater degree.

As mentioned in the previous chapter, in an environment where the exchange rate of countries is fixed, exports from countries with an undervalued exchange rate relative to their actual export competitiveness tend to have an advantage, while that of countries with an overvalued rate faces a disadvantage. As a result, a gap tends to emerge in the export competitiveness among these countries. Of course, as discussed earlier, if a country succeeds in improving its productivity and producing high-quality commodities, the disadvantage can be overcome. Thus, the fixed-rate system does not necessarily diminish competition, and moreover, the currency exchange rate alone does not determine a country's export competitiveness. However, until a country achieves an improvement in productivity and an increase in the production of high-quality commodities, its overvalued exchange rate will continue to suppress its export competitiveness, and such a continued pressure would make it easier for companies to fail along the way. In this sense, the fixed-rate system is an environment that can diminish opportunities for competition over some products among certain states, and inhibit the expansion of the free economy.

On the other hand, in the floating system, even if a great disparity of competitiveness emerges among countries and companies due to various factors, changes in their currency value adjust their price competitiveness, and foster international competition. In other words, companies in countries experiencing currency depreciation can exploit the greater price competitiveness and increase exports, thereby stimulating the international competition. Companies in countries experiencing currency appreciation must work to improve their productivity, efficiency, and technology to overcome the drop in their price competitiveness. Such efforts also stimulate the international competition.

This advantage of the floating system can be seen in actual history. For example, in the early 1970s, Japanese industries were hit hard by the first Oil Crisis. In response, Japan took advantage of the resulting drop in the yen rate to expand its exports. And when the yen soared in the late 1970s, the Japanese companies sought to recover from the drop in their price competitiveness by improving productivity, efficiency, and technology. In such a manner, the floating system worked to stimulate international competition. (However, as mentioned earlier, the adjustments of international balance do not occur immediately and experience a time lag. Moreover, the adjustments do not work well in an environment where the exchange rate is determined more by capital balance than by trade balance. The latter point will be discussed in detail in Chapter 4.)

What must be emphasized here is that the advantage of the floating system - its function to adjust trade competitiveness - did not become crucial on its own, but through the expansion of the international economy. In other words, if the scale of international trade is small, there would be a limit to the range and speed at which the differences in

the competitiveness of countries can be widened. For that reason, it would not be imperative to adjust the rates everyday; rate adjustments on an annual basis would be sufficient. However, as the scale of the international trade expands, the differences in the competitiveness can be widened at a greater speed, making it crucial to constantly adjust the competitiveness through frequent exchange rate fluctuations. Even when considering the fact that we should wait one to two years to see how a change in currency value affects a change in a country's trade competitiveness (J-curve effect), it is better to have daily currency fluctuations to adjust the competition than to have none at all. This is why the adjusting function of the floating system becomes a major advantage as the scale of the international economy expands.

(2) Another advantage of the floating system is that a floating currency can reflect changes in the current economic conditions in a relatively timely manner. Whereas the fixed-rate system requires international and domestic political agreements to change the rates, in the floating system, once the agreement to implement the system is reached, exchange rates can fluctuate automatically without being bound by the requirements of political consensus.

Of course, this is not to say that international political consensus is unnecessary in the floating system. It is necessary, because exchange rate fluctuations can be controlled to a certain degree by a government's arbitrary market interventions, foreign exchange control, and interest rate policies. In other words, even if the floating system is in place, each country can act against exchange rate fluctuations with a political goal in mind. Thus, in order to remove such resistance by individual countries, international political agreements become necessary.

Even so, however, compared to the fixed-rate system, the floating system is subject to fewer political constraints. In the fixed-rate system, there are only two options: to change the exchange rate or to leave it as it is. This is so because changing the exchange rate always requires either "a comprehensive political consensus" among countries or a confrontation with other countries. In contrast, the floating system offers a new option: to allow a small change in currency value through "a partial political compromise." Because the exchange authorities can change the level of their market intervention according to their will, there is less political burden on the floating system than the fixed-rate system. In the floating system, it is not necessary to have "a comprehensive political consensus" to change the exchange rates.

For example, after the transition to the floating system, the Japanese government sometimes worked to prevent the rise of the yen through interventions and currency control during the second half of the 1970s, but once the international criticism mounted against them, the government temporarily halted its interventions, relaxed its currency control and allowed the yen to rise to a certain degree. If, as in the fixed-rate system, there were only two options of maintaining the yen rate or revaluing it altogether, such partial political compromise or concession under the floating system would have been less easy, and therefore, the government could have taken all measures to defend the yen rate. Thus, even when considering the presence of the government's interventions and foreign exchange control, the floating system allows a currency to change and reflect the real economic conditions in a timelier manner than the fixed-rate system.

What needs to be emphasized here is that this advantage of the floating system - timely change of the exchange rate - did not become crucial on its own, but through the expansion of the international trade and capital movement. In other words, if the scale of the international trade and capital movement is small, the speed at which international economic imbalance worsens and the currency market destabilizes will remain relatively slow. Thus we can take relatively longer time to reach political agreements and decisions for the adjustment of exchange rates. For that reason, it would not be imperative to adjust the rates everyday; currency adjustments on an annual basis would be sufficient. However, as the scale of international trade and capital movement increases and thereby the speed of international imbalance and the pace of currency market destabilization both accelerate, the time that can be taken to reach international agreements gets shorter and the timely response to the situation becomes more difficult. Thus, the flexibility of the floating system becomes imperative. In short, the flexibility of the floating system becomes a major advantage, as the scale of the international trade and capital movement expands.

(3) Another advantage of the floating system is that, although allowing the currency to fluctuate everyday would always leave the anxiety of foreign exchange risks, the system makes it easier for monetary authorities and economic agents to perceive the changes in the economic conditions in an accurate manner and allow them to take necessary steps gradually, in accordance with the changes in the currency values.

As discussed in the previous chapter, under the fixed-rate system, even when the pressure for the modification of exchange rates really exists, such pressure may not be recognized clearly because exchange rates are firmly fixed. As a result, economic activities tend to take place in a manner that does not prepare for a change in the exchange rate, and sometimes in a way that can even increase the economic damage in case of a change in the exchange rate. But, even if we resist changing the exchange rates, the pressure for the change does not go away but it only mounts up. As exemplified in the case where the yen was revalued more drastically than other currencies after the Nixon Shock, the exchange rate has to change considerably later on if it has been suppressed. And when that happens, the economy without preparation for the change can suffer great confusion and enormous economic damages.

On the other hand, although allowing the currency to fluctuate everyday would always leave the anxiety of a foreign exchange risk, the merit of the floating system is that such fluctuations are gradual and thus countries and corporations can adjust their strategy gradually and reduce the shock of such fluctuations. That is, the floating system is a currency system that reflects the changes in the economic condition of each country in a more correct manner than the fixed-rate system. (However, as the scale of international capital movement expands, the exchange rate begins to reflect economic conditions in a distorted way. This point will be discussed in detail in Chapter 4).

For example, according to a survey conducted by the Ministry of International Trade and Industry in 1977, almost all categories of business including small and medium-scale companies took necessary steps in response to the rising yen, and successfully averted exchange risks by using the futures market. For this reason, the Ministry, which was considering financial support to such companies, reached a conclusion that such support

was unnecessary.³⁹⁸ In the floating system, then, the currency rates change gradually and thus it is easier for companies and governments to take action that is caught up with the changes, while in the fixed-rate system, such a pressure on currency is harder to discern in advance, because the rate is fixed.

What needs to be emphasized here is that this advantage of the floating system - its function to make exchange rates reflect the changes in the economic condition in a more correct manner - did not become crucial on its own, but through the expansion of the world trade and international capital movement. In other words, if the scale of the international trade and international capital movement is small, there will be a limit to the speed and the scale at which the fixed currencies would distort the actual economic conditions. For this reason, it would not be imperative to adjust the exchange rates every day; currency adjustments on an annual basis would be sufficient. However, as the scale of the international trade and international capital movement expands, changes in countries' economic fundamentals will occur at a greater speed. Thus, in order for currencies to reflect the actual economic conditions of countries, daily currency fluctuations become inevitable. In such a manner, the reality-reflecting function of the floating system becomes a major advantage as the scale of the international economy expands.

(4) The next advantage of the floating system is that it stabilizes the currency market. Because currencies fluctuate daily, speculations that target a change in the exchange rate are dispersed.

In the fixed-rate system, a change in the exchange rate is detained and thus the pressure for the change accumulates. As a result, as the pressure heightens, there tends to be a high concentration of speculation that targets a change in the exchange rate, and thus a major revaluation and devaluation can occur over the short term. As discussed in the previous chapter, the fixed-rate system actually collapsed due to such concentrated speculation. It is true that such speculation works to adjust the currencies to match their actual competitiveness, but since the speculation is concentrated in a very short period of time, it tends to become excessive, distorting the exchange rates in ways that do not accurately reflect the actual economic competitiveness of countries.

On the other hand, the floating system makes daily exchange fluctuations possible and thus speculation is dispersed. Through the dispersion, wide swings in the currency market can be averted more easily. However, as the scale of the international capital movement expands, the currency market becomes unstable despite the dispersion of speculation, because the daily scale of speculation becomes enormous even with the dispersion effect (an issue which will be discussed in detail in Chapter 4). But, as will be discussed in the following section, during the early stage of the floating system, when the scale of the international capital movement was relatively small compared to later period, the floating system performed its speculation-dispersion-function and worked to stabilize the market.

What needs to be stressed here is the central role that the expansion of the international trade and capital played in the establishment of the floating system. In other words, if the scale of the international trade and international capital movement is small, it is possible to defend a fixed rate through market intervention. However, as the scale of the

³⁹⁸ *Boeki to kanzei*, June 1977, 48.

international trade and capital movement expands, in the face of massive speculation, it becomes difficult to control exchange rates and maintain the fixed-rate system simply through interventions of individual countries. For this reason, the shift to the floating system becomes inevitable. In such a manner, the merits of the floating system become major advantages as the scale of the international trade and capital movement expands.

Section 2 Historical Development

In the previous chapter, we looked at the process of the collapse of the fixed-rate system. In this chapter, we will now look at the ways in which monetary authorities and economic experts began to actively support the floating system, as it became clear that the fixed-rate system was no longer sustainable, and as the floating system buffered the economic shock of the Oil Crisis and contributed to the stabilization of internal trade and international capital movement after the crisis. Moreover, we will look at how it became difficult to manage the floating system in the style of the fixed-rate system as international capital movements expanded, and even if such management was maintained, it heightened other countries' protectionism and people's fears over it, leading to a strong support for and a shift to a market-oriented floating system that let the market determine the exchange rate.

(1) Reactive Acceptance of the Floating Exchange Rate System: From 1973 to the Mid-1970s

Around the time the Smithsonian regime collapsed, there were scholars who supported the floating system, as has been described in the previous chapter. However, in the beginning, the majority of them, including the government officials, were not particularly assertive in their support for the system. Most politicians, monetary authorities, and economic experts interpreted the transition to the floating system as simply a temporary move they had to make because of the collapse of the fixed-rate system. In their view, the floating system needed to be replaced promptly by a new fixed-rate system.

For example, on February 13th, 1973, after the shift to the floating system had been decided, Finance Minister Kiichi Aichi stated in a press conference that the government would observe the international currency conditions carefully and hoped to return to the fixed-rate system as soon as possible.³⁹⁹ Similarly, during a plenary session in the Lower House on February 14th, Prime Minister Kakuei Tanaka stated, "regarding the prospect of the currency, we would like to decide the appropriate level of the yen after observing the effect of the devaluation of the dollar and how the international currency situation changes. We will return to the fixed-rate system at the right time."⁴⁰⁰ Also, within the Ministry of Finance, "there were many who thought that [the return to the fixed-rate system] would be decided by the end of March" if certain conditions were met, such as the passing of the fiscal budget by March.⁴⁰¹ The floating system, in short, was seen by many as only a temporary system that would be soon replaced.

Many in the civil sector also saw it as temporary. For example, an economic magazine, *Shukan Toyo Keizai* (Weekly East Asian Economy), predicted that a return to the fixed-rate system could happen as early as in March through the fine adjustment of the currencies by relevant countries. They projected that, even in the worst scenario, the

³⁹⁹ *Yomiuri Shimbun*, 13 February 1973.

⁴⁰⁰ *Yomiuri Shimbun*, 15 February 1973.

⁴⁰¹ *Shukan Toyo Keizai*, 3 March 1973, 15

fixed-rate system would be reestablished at least by fall: “if a failure in multilateral adjustments or other unexpected situations occur, the yen’s return to the fixed-rate system may be delayed until the IMF General Assembly in this fall.”⁴⁰² Another example is the discussion by economic experts hosted by the same magazine. In the discussion, Yoshitomi Ishimaru, a research department manager at Tomen corporation, stated that “it is better to return to the fixed-rate system early” in order to recover the equilibrium of the international balance of payments. On the other hand, in the same discussion, Toshimasa Tsuruta, a senior researcher at the Kokumin Keizai Research Institute (Research Institute on the National Economy), suggested that the floating system should be kept in place longer in order to figure out the appropriate level of the exchange rate. But despite such differences, two discussants both were assuming that a return to the fixed-rate system should take place sooner or later.⁴⁰³ In addition, even Miyohai Shinohara, then the head of the Economic Research Institute of the Economic Planning Agency, who had been supporting the yen revaluation and the floating system from earlier stage, stated his view that the floating system was only needed to determine the yen’s appropriate exchange rate and that it should not be in place for long: “[although it is good to maintain the floating system for about a year] it is unfavorable to let the float continue for a long time, since there is a strong distaste for the idea in the business community ... It seems necessary to keep the float for half a year or more to find the appropriate central rate.”⁴⁰⁴ In the same way, the former vice chairperson of the IMF Committee of 20 Deputies Hideo Suzuki stated, “it is necessary to encourage monetary reform to bring back the peg system [the fixed-rate system] as soon as possible.”⁴⁰⁵

And such attitude toward the floating system was seen outside Japan as well. Looking back, Paul Volcker, then the Under Secretary of the Treasury, described the situation as follows: “The resort to floating in early 1973 was not taken out of any general conviction that it was a preferred system. It was simply a last resort when, by general assent, the effort to maintain par values or central rates seemed too difficult in the face of speculative movements of capital across the world’s exchanges.”⁴⁰⁶ Reflecting such perception, at the IMF Committee of 20 meeting held at the end of March 1973 in Washington D.C., a hope to restore the fixed-rate system was expressed while the floating system was described as something that could be allowed “in particular situations.” In such a manner, the transition to the floating system was seen a particular and peculiar situation, not a normal one. And, at this meeting, it was agreed to further examine such issues as regulating speculative capitals and the recovery of currency convertibility, with a view to the future reconstruction of the international monetary regime (that is, the reestablishment of the fixed-rate system).

In short, as Masanao Ito points out, the basic perception at the time whether in Japan or worldwide was that it was necessary to manage and operate the floating system well and prevent turmoil in the foreign exchange market, until an opportunity to restore the fixed-rate system emerges.⁴⁰⁷ Except for some scholars, the majority opinion was that the

⁴⁰² *Shukan Toyo Keizai*, 24 February 1973, 13-14.

⁴⁰³ *Shukan Toyo Keizai*, 3 March 1973, 19-20.

⁴⁰⁴ *Shukan Toyo Keizai*, 3 March 1973, 77.

⁴⁰⁵ *Shukan Toyo Keizai*, 17 March 1973, 20.

⁴⁰⁶ Volcker, Paul. and Gyohten, Toyoo. *Changing Fortunes*. Times Books, 1992, 124.

⁴⁰⁷ Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 366.

floating system was only a temporary measure that was necessary until the reestablishment of the fixed-rate system.

Such perceptions and attitudes were reflected in the Japanese exchange policy at the time; the monetary authorities were forcibly controlling the yen rate within a very narrow range at around 265 yen per dollar through intervention, in order to preemptively avoid a high revaluation that could be demanded when the fixed-rate system was restored in the future.⁴⁰⁸ The United States harshly criticized such intervention as a “dirty float.” It did not imply though that the U.S. left their exchange market “completely” untouched. As we will see later, afterwards the U.S. tried to maintain the dollar rate against excessive dollar-selling. However, the U.S. exchange policy differed from that of Japan in that the U.S. monetary authorities thought that exchange fluctuations should basically be left in the market’s hands and that interventions were necessary only in case of excessive fluctuations. As we will discuss later, such U.S. exchange policies came to be shared by other countries later as a means to stabilize and reinforce the floating system.

However, the U.S. took such “clean float” policy not particularly because it supported the floating system as a permanent currency system. The reasons why the U.S. implemented such currency policy ahead of other countries were as follows. First, under the floating system, the yen and the Deutsche mark would rise against the dollar if Japan and Germany withhold interventions and adopt the “clean float.” This would then lead to improvements in the U.S. trade deficit. Moreover, to rebuild the fixed-rate system in the future, it was necessary to identify the appropriate rate for each country by floating the currencies without interventions. In short, the U.S. implemented the above currency policy not because it particularly wanted to bolster the floating system or establish the floating system as a permanent currency system. At the time, the support for the floating system was still weak among countries, including the United States.

However, even though interventions were to be made only when extreme fluctuations took place, the problem in an environment where the international capital movement had largely expanded was that such extreme fluctuations did occur frequently, making it difficult to relax foreign exchange interventions and control. And soon, in May 1973, right after the shift to the floating system, the currency market became unstable again. Against the backdrop of the worsening inflation in the U.S. and the aggravation of the Watergate incident, a rapid dollar-selling began.⁴⁰⁹ Instigated by this, the purchase of gold and the mark in Europe soared, while the Italian lira was sold in large amounts. In reaction, on June 13th, the U.S. government announced a new inflation policy that included a 60-day price freeze, in order to recover the credibility of the U.S. economy. Then, on June 15th, West Germany implemented steps to bolster its foreign exchange control. However, the anxiety over the currencies did not quiet down. By late June, the West German exchange authorities purchased a total of 4 billion marks within Europe to stabilize the currency within the region. Nonetheless, facing a wave of speculation, the mark was forced to revalue against SDR by 5.5%.⁴¹⁰ Still, even in July 1973, the currency market remained unstable, and the dollar continued to drop. Then, at the BIS conference of the governors of central banks held on July 8th, an agreement was made once again for

⁴⁰⁸ *Yomiuri Shimbun*, 15, 18 February 1973.

⁴⁰⁹ Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 359.

⁴¹⁰ *Ibid.*, 359-360 ; Zenkoku ginko kyokai rengokai. *Kin'yu*, August 1973, 55-6.

governments to make active market interventions. In response, on the 10th, the U.S. expanded the swap range from the previous 11.73 billion to 17.98 billion dollars. On the 18th, it was announced that the U.S. had been making interventions in the New York market since the 10th onwards.⁴¹¹

As a result, partly due to these steps taken, the dollar rate began to stabilize. An additional factor that quieted the market could be that during the first half of 1973, the U.S. trade balance against Japan showed improvement. The U.S. trade deficit with Japan in 1972 was 6.3 billion dollars, accounting for two thirds of the entire deficit. In contrast, during the first half of 1973, the U.S. trade deficit against Japan was 758.8 million dollars, showing a significant improvement.⁴¹² Meanwhile, Japan's international balance (ordinary and capital balance) worsened; the ordinary surplus that hovered between 1.4 billion and 1.9 billion dollars each quarter in 1972 suddenly shrunk by 800 million dollars year on year by the first quarter of 1973. During the second quarter, an additional drop of 1.2 billion dollars was posted, in effect making the surplus zero.⁴¹³ The reasons why the U.S. trade balance improved and the Japanese international balance worsened in these ways were probably due partly to the currency adjustments made according to the Smithsonian Agreement, and the rise of the yen after the transition to the floating system; the effects of these might have appeared in this time period, after a time lag. In addition to these, Ryutaro Komiya and Miyako Suda point out that the factors such as Japanese exchange banks' lively overseas operations, an increased acquisition of overseas assets and stocks thanks to the appreciation of the yen, an increased repayment of borrowings based on the forecast on future exchange rates, led to the increase in capital account deficit for Japan.⁴¹⁴

Notably, the yen did not rise when the above turmoil hit the European currency market, and the yen did not drop when the Japanese international balance had clearly worsened. It did not either rise or fall. From March 1973 to October, the month the Oil Crisis erupted, the yen remained within the narrow range of 264 and 266 yen. This was because the government sold the yen when there was pressure for its appreciation, and purchased it back when there were signals that the yen would drop. In that way, the Japanese monetary authorities suppressed fluctuations in the yen rate.

We can understand why the Japanese authorities wanted to suppress the rise of the yen. But why did they prevent its fall as well? According to Ryutaro Komiya and Miyako Suda, the reasons why Japanese monetary authorities, who usually prefer low yen, implemented the yen-buying during this period were as follows: (1) To avoid international criticisms, they wanted to put an end to the state of the yen's undervaluation and Japan's enormous international balance of payments surplus, and reduce the accumulated foreign currency reserve through overall balance of payments deficit. (2) Since inflation was beginning to accelerate since the beginning of 1973, they wanted a contraction of the monetary base by lowering import prices and dollar-selling

⁴¹¹ Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 360.

⁴¹² *Boeki to kanzei*, November 1973, 41.

⁴¹³ Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 364.

⁴¹⁴ See Chapter 2 of Komiya, Ryutaro and Suda, Miyako. *Gendai kokusai kin'yu ron - Rekishi seisaku hen*. Nihon Keizai Shinbunsha, 1983; Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 364.

intervention. (3) Monetary authorities forecasted that, even if the yen rate rose, Japan's international balance of payments surplus will be seen again.⁴¹⁵ It is also said that 265 yen per dollar was set as the intervention point because the U.S. and Japan had an agreement behind the scenes to set 257-264 yen as an appropriate range of the yen rate (despite United States' earlier criticism of Japan's "dirty float").⁴¹⁶

The scale of the intervention during the 7 months between March and the end of September 1973 was as high as 5.2 billion dollars.⁴¹⁷ Ryutaro Komiya and Miyako Suda criticized this for causing several hundred billion yen of exchange loss,⁴¹⁸ but the Japanese monetary authorities in 1973, because they had unwillingly adopted the floating system, wanted the range of the yen fluctuation kept as narrow as possible to keep the floating system very similar to the fixed-rate system. The fact that they intervened is not particularly a unique trend of this period, since monetary authorities still implement foreign exchange interventions as of now in the 2000s. But the Japanese intervention policy in the early 1970s was unique in that monetary authorities tried to keep the yen rate fluctuation within a very narrow range, as if the yen was still under the fixed-rate system.

However, it became difficult to hold the exchange fluctuations within a narrow range with the arrival of the Oil Crisis in October 1973. In addition to such factors as Japan's continuing increase in imports, sluggish exports, and worsening capital balance, there emerged a strong fear over the impact of the Oil Crisis on Japan,⁴¹⁹ and as a result, the yen selling accelerated and the yen was pressed to fall. In contrast, the dollar rose, because (1) the U.S. was an oil-producing country (2) the U.S. trade balance announced on October 26th marked 860 million dollars surplus (3) it was expected that the major portion of oil money was to be reinvested by using the dollar and thus the market judged that the U.S. had a sufficient power to withstand the Oil Crisis.⁴²⁰

Specifically, the purchasing and selling of the yen proceeded as follows. An aggressive purchase of the dollar and selling of the yen began on October 29th. The Japanese monetary authorities sold the dollar and purchased the yen for three days to maintain the rate at 266 yen per dollar.⁴²¹ However, it could not overcome the wave of speculation. The authorities then made a switch away from its previous method of making interventions at short intervals. The interval of intervention was widened, and the intervention point was set at 270 yen on November 1st, 275 yen on November 2nd, and

⁴¹⁵ Komiya, Ryutaro and Suda, Miyako. *Gendai kokusai kin'yu ron - Rekishi seisaku hen*. Nihon Keizai Shinbunsha, 1983, 45-53.

⁴¹⁶ Zaimusho zaimu sogo seisaku kenkyujo zaiseishishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do (dai 7-kan) Shiryo Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2004, 39.

⁴¹⁷ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 65.

⁴¹⁸ Komiya, Ryutaro and Suda, Miyako. *Gendai kokusai kin'yu ron - Rekishi seisaku hen*. Nihon Keizai Shinbunsha, 1983, 65.

⁴¹⁹ Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 376.

⁴²⁰ Treasury and Federal Reserve Foreign Exchange Operations, *Federal Reserve Bulletin*, March 1974, 191-2; Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 89.

⁴²¹ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 94.

280 yen on November 13th.⁴²² During this period, the total market intervention amounted to 2.44 billion dollars in November and 1.45 billion dollars in December, for a total of 3.89 billion dollars.⁴²³ This was a record-high intervention since the Nixon Shock.

In addition, to prevent the yen rate from falling, the monetary authorities went beyond making interventions and implemented foreign exchange control in a way that encouraged yen purchases. They took a turn from their previous approach of blocking the inflow and encouraging the outflow of foreign currencies for the reduction of foreign currency reserve in Japan, and instead, they began to encourage the inflow of foreign currencies and yen purchases. Specifically, on November 1st 1973, the currency authority stopped enforcing one to carry out the proceeds from yen-denominated foreign bond issuance. On November 5th, the restrictions on non-residents to acquire Japanese securities was relaxed and repealed.⁴²⁴ Moreover, from this period to February 1974, the currency authority put more restrictions on investments in foreign securities, carrying out foreign currencies for travel and sending small remittances of money abroad, and relaxed its regulations on the conversion of foreign funds into yen for advances on exports.⁴²⁵

Earlier we discussed why the monetary authorities that favored a low yen exchange rate rather bought the yen from March to October 1973. But even after the Oil Crisis, they continued to buy the yen. The reasons why they did so in the post-Oil Crisis period were, according to Tadashi Kano, as follows: (1) To avoid a possible criticism by the international community that Japan started a currency devaluation race. The U.S. was concerned about its international balance of payments, which was in the process of recovery thanks to the currency adjustments since February 1973. The U.S. worried that the balance would deteriorate again, triggered by sharp declines in the currency rates of Japan and European countries. The major countries besides the U.S. were also cautious about the possibility of a new devaluation race and a resulting turmoil in the international monetary system. (2) Necessity in relation to domestic price policy. Japan was in the midst of high inflation, and it was necessary to cool down the inflation anticipation by sustaining the yen rate⁴²⁶ (However, it was not the sole measure they deployed to quench the inflation. Japanese authorities shifted their fiscal and financial policies in order to contain the inflation. The fiscal budget for 1974 was drastically cut under the Finance Minister Takeo Fukuda, who succeeded Minister of Finance Aichi in November 1973. And the Bank of Japan raised the official bank rate for five times between April and December 1973, to make it 9%, the highest since the war).

However, the above change in the foreign exchange control policy was fruitless after all. When the Middle Eastern oil producing nations raised the crude oil prices from 5.11 to 11.65 dollars per barrel on December 22nd 1973, the pressure of dollar-buying and yen-selling became even greater. Then, the Finance Minister Fukuda, Hideyuki Aizawa,

⁴²² Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 376.

⁴²³ *Ibid.*

⁴²⁴ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 94.

⁴²⁵ Okurasho Zaiseishishitsu ed. *Showa Zaiseishi - Showa 27-48 nen do 12 Kokusai kin'yu, Taigai kankei jiko (2)*. Toyo Keizai Shinposha, 1992, 497-499; Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 94.

⁴²⁶ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 95.

the Administrative Vice Minister of Finance, and Michiya Matsukawa, the Chief of International Finance Bureau, held a meeting and decided to give up intervening at 280 yen and set their new defense line at 300 yen per dollar. Based on that decision, their intervention resumed from January 7th 1974.⁴²⁷

But new uncertainties emerged. Once the French franc was sold and became difficult to remain within the floating range set by the European Community's joint floating system,⁴²⁸ the French franc withdrew from the EC's joint float on January 19th 1974. To avert the confusion resulting from this incident, the foreign exchange markets in West Germany and the Benelux countries were closed down on January 21st.

In response to the turmoil in the European market, Japan also closed down the Tokyo foreign exchange market on the 21st and the 22nd. However, once the market reopened on January 23rd, the dollar was purchased and the yen was sold in voluminous amounts through leads and lags, on the grounds that the Japanese exchange authorities would set their intervention point at a lower level.⁴²⁹ The authorities intervened and implemented yen-selling to maintain the rate at 300 yen at all costs. As a result, the total scale of spot transactions posted a record of 742 million dollars on the 23rd.⁴³⁰

Moreover, according to Masanao Ito, the government took the following measure as well: "The day before the market reopened on the 22nd, the government strongly requested through the group Nisuikai to refrain from speculative purchases of the dollar. However, once the market reopened, there was a massive dollar-buying. Then, on the 24th, the monetary authorities conducted a thorough hearing at three exchange banks that posted high dollar purchases (The Bank of Tokyo, Dai-ichi Kangyo Bank, and Sumitomo Bank) and collected from them 60 billion dollars they had borrowed from the Bank of Japan. It was a de facto sanction against companies that purchased large amount of dollars, because this measure forced the exchange banks to collect loans from those companies.⁴³¹ On the 25th, the Bank of Japan suppressed a net increase of loans to major exchange banks, and at the same time, requested the exchange banks to release their dollars in possession. On the 29th, the Ministry of Finance reinforced its restrictions on the balance of foreign currency accounts owned by residents within Japan. Moreover, the Ministry of Finance immediately conducted an on-site inspection of ten major trading companies, in addition to Tonen (oil) and Matsushita Electric, all of whom were found to have bought the dollar in large amounts according to the Bank of Japan's investigation."⁴³² Thus, in an attempted to control the currency, the monetary authorities went so far as to directly exert pressure on the exchange banks and companies.

It is unclear how effective the above measures and interventions were. However, the currency market that was facing turmoil began to quiet down by the end of January. The

⁴²⁷ *Ibid.*

⁴²⁸ *Kin'yu*, dai 324-go, March 1974, 77-8; Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 380.

⁴²⁹ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 95.

⁴³⁰ Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 381.

⁴³¹ *Kin'yu*, dai 324-go, March 1974, 72-73.

⁴³² Okurasho kawase kensakanshitsu. "1-gatsu 23-nichi ni okeru doru gai ni kakaru tokubetsu kensa ni tsuite." 30 June 1974 (Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 381)

excessive rise in the dollar and the drop in the yen came to a halt, and in turn, the dollar began to drop and the yen began to rise. From January 28th 1974, the yen rate began to diverge from 300 yen per dollar, and rose to 287 yen in late February, and to 280 yen in March. And then, the yen stabilized within the range of 275-285 yen per dollar from late March to June 1974. This stabilization of the yen is probably attributable to the following events: On January 29th, the U.S. announced that it would abolish its regulations on external investments and loans, as well as the interest equalization tax; on the 30th, West Germany partially relaxed its regulations on capital inflow.⁴³³; the acquisition of the euro-dollar amounting to 7 billion dollars by the Japanese exchange banks from January to June 1974 loosened the dollar demand, and the Eurodollar was expected to finance the deficit in the Japanese economy.⁴³⁴ This not only eased the demand for the dollar but also helped maintain confidence in the Japanese economy and stabilized the yen rate.

So far, we have examined the currency policy of Japan under the effect of the Oil Crisis. What we can learn from above is that, as stated repeatedly, the Japanese monetary authorities at the time managed the floating system with a mindset of the fixed-rate system. Even under the Oil Crisis, the floating system was still considered as a temporary measure until Japan would return to the fixed-rate system. And such perception was widely shared among both government officials and civilians.

For example, Takashi Hosomi, then the advisor at the Ministry of Finance, stated his support for the fixed-rate system as follows: “In an age like this when the international economy is facing an unprecedented upheaval, I do not think the entire world is flexible enough for the peg system [fixed-rate system] to run well. In this regard ... I feel that there was no choice other than to shift to the floating system ... [However], as a government official, I am receiving requests from businesses and traders for some kind of a rule of thumb in making international transactions, or some set of rules in place to take a balance between the domestic and the international. These are practical requests, and in that regard, I would think that the adjustable peg [fixed-rate system] would be a good choice.”⁴³⁵

Also, witnessing the stormy situation of the exchange market then, Shoichi Kase, a professor at Kanto Gakuin University, also expressed his doubt about the floating system and his support for the fixed-rate system: “I deeply doubt that the market rates are moving truly rationally. The argument supporting the floating system assumes that speculation works stably in the floating system and such optimism about speculation is their basis for supporting the system. But I am not so optimistic about it. I am doubtful about the existence of the so called balanced rate which is often used as one of the rationales for supporting the floating system in Japan ... If the currency is stable, we can also do well with the fixed-rate system.”⁴³⁶

Of course, not all people were doubtful, and during the same period, there were supporters of the floating system. However, even among the supporters, the majority

⁴³³ Okurasho Zaiseishishitsu ed. *Showa Zaiseishi - Showa 27-48 nen do 12 Kokusai kin'yu, Taigai kankei jiko (2)*. Toyo Keizai Shinposha, 1992, 499-500; Nihon ginko hyakunen-shi hensan iinkai ed. *Nihon Ginko hyakunen-shi 6-kan*. Nihon ginko, 1986, 435-436.

⁴³⁴ Furukawa, Tetsuo. “Hendosobasei ka no en no doko.” *Boeki to kanzei*, November 1974, 38.

⁴³⁵ Kase, Shoichi and Hosomi, Takashi and Shinkai, Yoichi and Abe, Keiichi. “Hendo sobasei o do hyoka suruka.” *Nihon Keizai Kenkyu Senta*, 1 February 1974, 28 - 30.

⁴³⁶ *Ibid.*, 30

were of the opinion that the floating system was the second best option, given that there was no way to revert to the fixed-rate system. For example, Yoichi Shinkai, Professor at Osaka University, said: “Adjustments come too late in the adjustable peg [fixed-rate system]. The official stance could be the floating system, and the government can work from within and intervene. Then, the system would work, as it can respond immediately to changes ... In fall 1972, the prices were beginning to soar. If monetary tightening measures had been implemented, perhaps today’s abnormal price hikes could have been prevented. But, at the time, the fixed-rate system was still in place. Because the feelings were strong that the fixed system should be kept, monetary tightening came by too late. If the official stance back then was the floating system as it is today, monetary tightening could have been implemented right away.”⁴³⁷ In this way, Shinkai voiced his support for the floating system, but, as can be seen from the following quote, it was a reserved support: “Under the fixed-rate system, it is perhaps impossible to stabilize the currency values within the country ... so inevitably, the floating system is the better choice, but this does not mean that the system is the best choice ... there are many economists who speak in favor of the floating system, but I doubt if anyone thinks it as an ideal system. If this is a world in which sovereign nations can run their countries free of inflation, then the adjustable peg [fixed-rate system] should be enough. However, the postwar world is certainly prone to inflations. So this is why the floating system is proposed as the second best choice.”⁴³⁸

1973	09	265.47 yen	1974	11	300.09 yen
	10	266.30 yen		12	300.40 yen
	11	277.19 yen	1975	01	299.80 yen
	12	280.00 yen		02	292.76 yen
1974	01	297.52 yen		03	287.67 yen
	02	291.84 yen		04	292.14 yen
	03	282.82 yen		05	291.57 yen
	04	277.60 yen		06	293.33 yen
	05	278.83 yen		07	296.17 yen
	06	282.94 yen		08	297.92 yen
	07	290.32 yen		09	299.44 yen
	08	302.00 yen		10	302.40 yen
	09	299.84 yen		11	302.42 yen
	10	299.42 yen		12	305.60 yen

Dollar-Yen Rate (Interbank rate)
From *Keizai Hakusho 1993*

But the hope among many governmental and civil experts for rebuilding the fixed-rate system was losing its reality in the midst of the Oil Crisis and the turmoil in the exchange market. It was so, because it was not possible to figure out an adequate rate in an

⁴³⁷ *Ibid.*, 29 - 30.

⁴³⁸ *Ibid.*, 31-32.

environment where market rapidly fluctuated. Paul Volcker, then Under Secretary of Treasury, recalls how the international community started to abandon their efforts to reconstruct the fixed-rate system as follows: “The formal decision to wind up the negotiation [that had been continued for the reestablishment of the fixed-rate system] was taken at a C-20 meeting in Rome in January 1974. By that time, both the spreading Oil Crisis and the pervasiveness of inflationary pressures provided a plausible excuse. To most participants, the practical possibility of actually installing a highly structured system had come to seem increasingly remote.”⁴³⁹ However, even though authorities began to feel that a revival of fixed-rate system had become unrealistic, it did not mean that the countries started to actively support the floating system instead. The floating system was still considered and positioned as a temporary system, which they unwillingly had to have.

(2) Increased Support for the Floating Exchange Rate System: From the Mid-1970s to the Late 1970s

However, from this period, things started to move towards a direction, which later allowed people to interpret that the floating system alleviated the economic damage from the Oil Crisis and the disorder in the exchange market: In the above, it was mentioned that one of the reasons why the yen rate stably moved within the range of 275-285 yen per dollar from late March to June 1974 was that Japanese exchange banks acquired the Eurodollar. It loosened the dollar demand, enabled the financing of the Japanese deficit, and stabilized the yen rate. Thus, the Eurodollar helped lessen the damage and confusion of the Oil Crisis. And it is said that such sound supply of the Eurodollar at the time was facilitated by the floating system.⁴⁴⁰ The reason is as follows.

Japan could hold a large amount of Eurodollars during this period because it was expected that the oil money accumulated by the oil producing countries would continuously flow into Europe (OPEC countries' after-tax profit from the sales of oil in the first half of 1974 was 16.6 billion dollars, out of which 10 billion dollars flowed into private markets).⁴⁴¹ Although oil money, seeking profits, must have flowed into Europe even under the fixed-rate system, the floating system is thought to have further facilitated it for the following reason: the confidence in the U.S. economy and the U.S. dollar rose because the U.S. had high oil self-sufficiency, and the rise of the dollar in turn made the Eurodollar market attractive because it was where dollar-denominated investment was possible. If the major countries were under the fixed-rate system and if the dollar did not rise, advantages of making investment in dollars might have been halved and the dollar-denominated oil income might have been invested in other forms, and as a result, there could have been less circulation of oil money to countries.

⁴³⁹ Volcker, Paul. and Gyohten, Toyoo. *Changing Fortunes*. Times Books, 1992, 123.

⁴⁴⁰ Okurasho Zaiseishitsu ed. *Showa Zaiseishi - Showa 27-48 nen do 12 Kokusai kin'yu, Taigai kankei jiko* (2). Toyokeizai Shinposha, 1992, 500-3; Komiya, Ryutaro and Suda, Miyako. *Gendai kokusai kin'yu ron - Rekishi seisaku hen*. Nihon Keizai Shinbunsha, 1983, 142-5; Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 98.

⁴⁴¹ Hayami, Masaru. *Hendo sobasei 10-nen - Kaizu naki kokai*. Toyo Keizai Shinposha, 1982, 128-31; Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 382.

Moreover, the fact that the floating system allowed the natural depreciation of the currencies of low oil self-sufficient or non-oil producing countries seems to have facilitated the back-flow of oil money and Eurodollar to those countries. This was so because, with the same amount of dollars more things could be purchased in those countries, since the dollar rose while the currencies of those countries declined. For example, during this period, Kuwait bought a piece of real estate on the Champs-Elysees in Paris, and a Kuwaiti investing company acquired a 13.7% stake in Lonrho, a British metal mining conglomerate. Similarly, Abu Dhabi purchased the Commercial Union Assurance building in London.⁴⁴² The above investments were expected to yield big profits in case the currencies of those nations rose again after the stabilization of the Oil Crisis. Such anticipation of profit that would result from exchange fluctuations seems to have facilitated the back-flow of oil money during that period.

The advantage of the floating system explained above was not necessarily widely recognized at the time, but it gained wider recognition over time, and based on such recognition, the support for the floating system gradually grew in the latter half of the 1970s.

However, there were also incidents that highlighted the disadvantages of the floating system during this period. When Franklin National Bank in the U.S. and Herstatt Bank in the West Germany recorded large exchange losses between May and June 1974, the market began to be more cautious about the risks inherent in the floating system, and consequently, the back-flow of oil money and the Eurodollar began to stagnate. To avoid foreign currency shortage, the Japanese government took various measures such as raising the limit on advanced export proceeds, additional intake of impact loans, and official borrowing of 1 billion dollars from Saudi Arabia. Through these measures, Japan managed to avoid a possible shortage of foreign currency until September,⁴⁴³ but those incidents certainly were one of the examples that undermined people's support for the floating system. Moreover, another problem the floating system posed was that, when this type of incident occurred, exchange rates drastically fluctuated in a very short period of time. For instance, reflecting the disruption in the supply of the Eurodollar into Japan, the yen rate, which was around 290 yen per dollar in June, fell to 303 yen on August 22nd.⁴⁴⁴ In the same manner, the relative values between the West Germany mark and the dollar fluctuated by 30% between late January and early July in 1974.⁴⁴⁵ Such drastic fluctuations in exchange rates did not reflect the real economic competitiveness of the countries, and this fact seemed to have undermined the supports for the floating system.

Then, at the sixth meeting of the Committee of Twenty held in June 1974, major countries discussed necessary countermeasures to the rapid fluctuations of exchange rates. There, they adopted the guideline that, while the member countries with the floating system “would not be asked to hold any particular rate against strong market pressure” in certain situations, it was necessary for them to “intervene on the foreign exchange market as necessary to prevent or moderate sharp and disruptive fluctuations” and prevent their

⁴⁴² Araki, Nobuyoshi. “Oiru dara no kibo to kanryu.” *Boeki to kanzei*, August 1975, 34.

⁴⁴³ Regarding the government's response at the time, see Ito, Masanao. *Sengo Nihon no taigai kin'yu: 360 en reto no seiritsu to shuen*. Nagoya Daigaku Shuppankai, 2009, 383-384.

⁴⁴⁴ See Komiya, Ryutaro and Suda, Miyako. *Gendai kokusai kin'yu ron - Rekishi seisaku hen*. Nihon Keizai Shinbunsha, 1983, Chapter 4; Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 99.

⁴⁴⁵ Narusawa, Koei. “Kihonteki niwa en wa tsuyoi.” *Nihon Keizai Kenkyu Senta*, 15 July 1974, 17.

exchange rates from deviating from the estimates of the medium-term norm for the exchange rates. That guideline was included in the Committee of Twenty's "Guidelines for the Management of Floating Exchange rates."⁴⁴⁶

On the point that interventions for market stabilization were positively viewed, the guideline contradicted the ideal of the pure floating system (clean float) that objected to any type of intervention, but it was also a necessary strategic change for practically managing the floating system that tended to invite drastic fluctuations in exchange rates. In short, there began to emerge a shift in the way the floating system was managed. It was a management that upheld the floating system by rejecting any intervention that aimed at reversing the market trends and only allowing interventions that aimed at taming extreme market disruptions. As mentioned earlier, the United States had been advocating such way of managing the floating system, but during this period, the support for such management/policy began to be clearly stated in international meetings as well, as the one that needed to be shared by all.

Such change could be seen in Japan as well. For example, Masao Fujioka, then Deputy Director-General at the International Finance Bureau, shared a similar view and criticized active interventions that had been made by the Japanese government, saying, "It was the float in name only. The interventions killed the potential merits of the floating system and blocked market participants from taking part in forming the market. As a result, it was as if Japan did not have any exchange market at all. Of course daily fluctuation by 4 or 5 yen is not a good thing ... [but] the way the government sets a target exchange rate to stabilize the market and defends the rate by interventions will not win the trust of both domestic and foreign market participants in today's situation where the floating system is in place, and thus the interventions will not bring a success."⁴⁴⁷ In this way, he argued that, even though wild fluctuations needed to be tamed, a predetermined/targeted exchange rate should not be enforced against the market trend.

However, the new way of managing the floating system was suggested merely as a guideline at this point. It surely was an important step that heralded the future of the floating system, but there still was no strong consensus among the major countries regarding it. The consensus would gradually grow stronger, but Japan at the time was still making interventions in the market to maintain the yen rate within a narrow range, and France was still insisting on reviving the fixed-rate system. For example, the yen rate remained within a narrow range of 299 - 301 yen between early October of 1974 and late January of 1975, because of the market interventions that were made in accordance with the Finance Minister Masayoshi Ohira's statement that the yen rate should be stabilized at around 300 yen per dollar.⁴⁴⁸ Even after this, active interventions by the Japanese exchange authorities continued until the late 1970s, and in this sense, there continued to be resistance to the aforementioned new management style of the floating system.

However, while there continued the distrust of the floating system and Japan continued its operation of the floating system in the style of the fixed-rate system, a new

⁴⁴⁶ "Executive Directors and Committee of Twenty Guidelines for the Management of Floating Rates"; Zaimusho zaimu sogo seisaku kenkyujo zaiseishishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do 11 Shiryo (4) Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2003, 140-144.

⁴⁴⁷ *Kin'yu zaisei jijo*, 9 September 1974.

⁴⁴⁸ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 100 - 101.

development took place that built on another advantage of the floating system. Above, we have already discussed the contribution of the floating system to the reflux of oil money, but during this period, it contributed to the adjustment of trade competitiveness; the current account balance of Japan started to improve from the latter half of 1974, and the total amount of export in that year was 5.4 billion dollars, an increase of 50% from the previous year (although the current account balance was in a deficit of 4.7 billion dollars because the import exceeded the export), and the floating system is thought to have somewhat contributed to this rapid improvement of export.

This can be explained as follows. Under the floating system, the more a country is hard hit by an increase in oil prices, the more it experiences a drop in its currency value. In that situation, the country's burden of importing oil increases, not only because the oil price is raised by the oil producing nations, but also because the oil price is denominated in dollars. If a country's currency value drops, then it means that they have to pay more with their currency to acquire the dollar-denominated products (this is true only if the U.S. dollar did not drop against the country's currency). However, because the overseas prices of the country's products become cheaper due to its lowered currency rate, it becomes easier for the country to expand exports. This is true when compared to those that were impacted less by the Oil Crisis and experienced a relatively smaller drop in their currencies. In short, under the floating system, the countries that depend strongly on overseas oil bear a burden in their imports due to the drop in its currency rate, but at the same time, these countries can take advantage of their lowered currency values and expand the overseas share of their products. Even when a country is in red ink with its exports and imports combined, once it expands its share and acquires a wider range of customers, the recovery of the currency value does not mean that its market share will shrink back to what it was. It is thought that, in that manner, the floating system helped Japan improve its competitiveness and trade balance over the medium and long terms. Because the yen in 1974 remained around 280-300 yen per dollar, it does not look as though the yen dropped significantly. But it was lower than the pre-Oil Crisis level, which was around 265 yen per dollar.

The above advantages offered by the floating system can be more easily understood by comparing it with the fixed-rate system. In the fixed-rate system, during the period when the exchange rate is maintained, a country can keep buying oil at the same exchange rate. Thus, for oil importing countries, the burden of importing oil is lesser in the fixed-rate system than in the floating system, at least for certain periods of time. However, this advantage applies to all countries that adopt the fixed-rate system, making it impossible for one particular country to have an advantage over others if the countries are equally dependent on overseas oil. Moreover, because the exchange rate is fixed, there is no adjustment of price competitiveness in the short term. Therefore, countries that are largely dependent on overseas oil do not enjoy any price advantage over those that are less dependent. It is simply that, under the fixed-rate system, the more dependent a country is on overseas oil, the more economic damage it incurs, without gaining any price advantage.

It is difficult to judge from when and how much this relatively low yen contributed to Japan's exports. However, for the reasons above, we can say that adjustments of export competitiveness and current balance occur more easily under the floating system than under fixed-rate system. And, what should be emphasized here is that the opinions

defending the floating system with such understanding started to appear at this point. For example, while admitting that the trade imbalance between oil-exporting and oil-importing countries could not be adjusted even under the floating system because of the drastic rise of the oil price, Yoichi Shinkai, a professor at Osaka University expressed his view that the floating system minimized the imbalance among the oil-importing countries: “Since the Oil Crisis, the international trade imbalance has been striking. Thus, there began to emerge doubts about the adjustment function of the floating system for the international trade ... [But] the quadrupling oil price was ... a big destabilizing factor ... it is inappropriate to criticize the floating system itself for the reason that it could not counter the situation well. Rather we can state that, at the time of Oil Crisis, the floating system was effective in limiting the scale of speculative capital transfer and the imbalance among the oil-importing countries. If we were still under the old IMF peg system, there would have been far more confusion in the international currency market.”⁴⁴⁹ Likewise, Takashi Hosomi, then an advisor for Industrial Bank of Japan stated, “What would have happened to Japan’s international balance if Japan was under the fixed-rate system when the oil price quadrupled? For Japan, it seems that there was no other choice [than to adopt the floating system].”⁴⁵⁰ Thus, Hosomi expressed his view that the adjustment function of the floating system played an important role in improving Japan’s international balance of payments.

But the balance adjustment function was not the only reason to support the floating system. Another merit of the floating system started to appear during this period, which was its function to contain inflation. The floating system helped to contain inflation and this aspect of the system helped to establish it as a necessary currency system, as Paul Volcker, then Under Secretary of Treasury, described: “The combination of accelerating inflation and the Oil Crisis late in 1973 went a long way toward establishing floating currencies as the operational international monetary system.”⁴⁵¹ The reasons why the floating system contributes to the containment of inflation are usually explained as follows.

When inflation occurs in Country A, its currency value drops relative to that of Country B, and Country B’s currency value rises relative to that of Country A. This means that when Country A’s products are exported to Country B, the inflated domestic prices of Country A’s products are canceled out by the high currency value of Country B. Therefore, inflation in one country does not trigger inflation in another. Moreover, because countries are not obligated to purchase foreign currencies or sell their own in the floating system, they do not need to flood the market with their own currencies in order to maintain their exchange rates, and trigger excessive liquidity or inflation. As the countries do not “export” inflation to one another, the world is less vulnerable to inflation. This was how the floating system was thought to contribute to the suppression of inflation.

There also was an opinion that the floating system rather invites inflation because, under the floating system, it is less necessary to avoid external deficit and foreign currency shortage than under the fixed-rate system (since a country does not need to

⁴⁴⁹ Shinkai, Yoichi. “Hendokawasesobasei no yogo.” *Keizai Seminar*, November 1975, pp.52 - 53.

⁴⁵⁰ Kase, Shoichi and Kanemitsu, Hideo and Hosomi, Takashi and Miyachi, Soshichi. “Hendosobasei no hen’yo to en.” *Nihon Keizai Kenkyu Senta*, 15 January 1976, 46.

⁴⁵¹ Volcker, Paul. and Gyohten, Toyoo. *Changing Fortunes*. Times Books, 1992, 136.

maintain their currency value by using sufficient foreign currencies), and in that situation, irresponsible government spending can occur more easily. In fact, because inflation became even more serious in many countries after the shift to the floating system, the floating system was often blamed for causing inflation. While there were countries such as Japan and the West Germany whose inflation began to stabilize in 1975, there were countries like Britain and Italy where high level of inflation continued.

To this opinion, the supporters of the floating system counterargued that inflation accelerated not because of the floating system itself, but because of the rise of oil price that occurred right after the shift to the floating system. One of them was the aforementioned Yoichi Shinkai, a professor at Osaka University. He said, “Inflation may occur in the countries that lack moderation in spending, but there is no inevitability in such lack of moderation. It does not have to prevail all over the world. Global inflation can be more easily prevented [under the floating system].”⁴⁵² Thus, he maintained, even if the floating system may facilitate one country’s irresponsible government spending, the floating system would still work to prevent the inflation in that country from spreading over to other countries.

In the above, we have seen the emerging views at the time that saw the floating system as having contributed to promoting the global circulation of capital, adjusting the trade balance, and suppressing inflation. And there was yet another emerging view that saw the floating system as having, through the above contributions, helped stabilize the market and suppress protectionism.

For example, if countries are under the fixed-rate system, once the rise in the oil price causes an international balance deficit and a shortage of foreign currencies in each of those countries, there will be a massive selling of their currencies in the market. In response, countries under the fixed-rate system may choose to close down their exchange markets or implement strong foreign exchange controls and import restrictions, in order to prevent foreign currencies from running out. If the world during the Oil Crisis had experienced such paralysis of the exchange market and fallen prey to protectionism that depended on foreign exchange controls and import restrictions, the world economy would certainly have suffered a more severe damage. However, because the major countries had adopted the floating system, it was possible to implement flexible policies that allowed the currencies to float when interventions fell short of maintaining the currency rate. Thus, market closures almost never occurred during the Oil Crisis. Moreover, the governments did not take steps to implement extreme currency controls or import restrictions. Such advantage of the floating system is well summarized in *Hendo sobasei* (The floating system), edited by Rokuro Tsuchiya, which offered the following after-the-fact evaluation in the early 1980s: “If the world had adopted the fixed-rate system at the onset of the Oil Crisis, vigorous currency speculation and transfer of short-term loans would have occurred. There would have been closures of foreign exchange markets over the long term and international conferences would have been held incessantly. It would not have been easy to reach a solution. However, the adoption of the floating system exempted the governments from making market interventions, thus it was possible to absorb the pressures of speculations without hindrance. For this reason, the floating

⁴⁵² Shinkai, Yoichi. “Kokusai tsuka seido to infureshon.” *Keizai Seminar*, September 1977, 25.

system at the onset of the Oil Crisis worked as a safety valve against widespread speculations in an unstable world economy.”⁴⁵³

However, such appraisal of the floating exchange system was not widely shared in the mid-1970s, and was only beginning to be embraced. In Japan, there was still a strong attachment to the fixed-rate system. The aforementioned method of making interventions only when the market experienced violent fluctuations, and basically leaving market trends untouched was not practiced in Japan yet. However, this was true not only for Japan but also for other countries such as France. France, which had been emphasizing the stability of currency, was still hoping for the reconstruction of the fixed-rate system, while admitting that the floating system was necessary at the time, at least temporarily. On the other hand, the United States was showing a clearly different stance. For instance, on July 20th 1975, William Simon, Secretary of Treasury under the Ford administration, stated in Congress that their priority was the domestic economy and that they would not manipulate the dollar rate by such means as exchange operation or domestic economic policy even if the U.S. external imbalance progressed and the dollar either rose or fell.⁴⁵⁴ Such differences in currency policy among the major countries were an impediment to the progress necessary for reaching an international agreement about the direction of the currency regime.

But, the United States and France started to compromise with each other and the opinions began to converge from around the fall of 1975. Volcker explains such development as follows: “In a burst of negotiating energy over a few weeks in the fall of 1975, the new undersecretary, Ed Yeo, hammered out an agreement with his French counterpart, Jacques de Larosiere, who then held the prestigious position of directeur du tresor and was the senior civil servant in the French Ministry of Finance. They settled on a few paragraphs that provided a legal basis for floating exchange rates ... the philosophical base was unmistakable: Stability in exchange rates, while devoutly to be desired, would have to emerge from ‘orderly underlying economic and financial conditions’ rather than from any specific government decision to determine an appropriate rate. Nations were to avoid ‘manipulating’ exchange rates, and the IMF itself was to exercise from surveillance efforts so that efforts to distort the market through intervention or otherwise would be discouraged.”⁴⁵⁵ Simply put, they began to agree that it was necessary to leave the exchange rates follow the trend of the market.

And the compromise between the two countries paved the way for the first Summit meeting held in Rambouillet in November 1975, where there was progress toward an international agreement about the operation of the floating system. At this meeting, an agreement was made that the floating system should be soon recognized as an official currency system, in addition to the fixed-rate system, which had been the only one currency system officially recognized by the IMF. Countries also discussed how they would run the floating system, and they agreed to leave the exchange rates basically to the market but to intervene only to iron out erratic fluctuations not caused by underlying economic factors. A detailed system of consultation was created for this purpose, with central banks consulting daily and finance ministers meeting quarterly.⁴⁵⁶

⁴⁵³ Tsuchiya, Rokuro ed. *Hendosobasei*. Chuo Daigaku Shuppanbu, 1980, 45.

⁴⁵⁴ *Ibid.*, 39-40.

⁴⁵⁵ Volcker, Paul. and Gyohten, Toyoo. *Changing Fortunes*. Times Books, 1992, 141.

⁴⁵⁶ *Ibid.*, 349

The call to stabilize and bolster the “controlled float” made headway at the IMF interim committee meeting held in January 1976 in Kingston, Jamaica. There, in accordance with the agreement at Rambouillet, the policy to officially approve the floating system through the amendment of the fourth IMF Article of Agreement was decided (the amendment of the IMF agreement was made effective two years later in April 1978). In other words, this move officially approved the floating system, which was originally a violation of the IMF’s agreement. The countries were allowed to freely choose between the fixed and the floating system. At the same time, to prevent the potential turmoil in the foreign exchange market under the floating system, it was suggested that the IMF exercise surveillance and each country collaborate with it. This is called the Kingston Agreement.

In this manner, the major countries started attempting to strengthen the floating system; by approving it as an official currency system, allowing the rates to float freely, and countering violent fluctuations that deviated from the fundamentals, through international conferences such as summits as well as multilateral collaborations. To borrow Gyohten’s words, “it became clear that as floating became established, the international system, such as it was, would not be run by formal rules but increasingly in meetings of powerful ministers that soon became the summits, with their own bureaucratic dependencies.”⁴⁵⁷

And, along with this international trend to reinforce the floating system, there arose voices in Japan that called for more support for the floating system. For example, Hideo Kanemitsu, a professor at Sophia University, said, “the anxiety that trade might be hindered because there would be drastic fluctuations in the exchange market under the floating system did not come true. Rather, the float worked well as an exchange system in the midst of inflation at the early stage, the Oil Crisis that followed, the deflation and the recession that followed the Oil Crisis.”⁴⁵⁸ “In the current economic society where the global structure keeps changing dynamically, a fixed rate, an adequate rate lasts only for a short while. And, in such a situation, there should be an appropriate international currency regime or exchange system that fits the situation ... With the present market-based exchange system, the countries succeeded in ending inflation.”⁴⁵⁹

During this period, Shichiro Banno, Professor of Chuo Gakuin University, also expressed his support for the floating system as follows: “Under today’s flexible and resilient currency system, the foreign exchange markets will not need to face closures even when they come under the pressure that they could not withstand in the past. The market was swayed by neither the concentration of foreign currencies in oil producing countries, nor by the substantial level of fluctuations in the currency rates. It was now possible to lessen or eliminate wide-ranging restrictions on capital movement. It was also possible to take approaches other than controlling the current account balances. Moreover, compared to the past, it was no longer immediately necessary to restrict imports even in the face of a substantial international balance deficit. Inflation rates vary greatly among

⁴⁵⁷ *Ibid.*, 134.

⁴⁵⁸ Kase, Shoichi and Kanemitsu, Hideo and Hosomi, Takashi and Miyachi, Soshichi. “Hendosobasei no hen’yo to en.” *Nihon Keizai Kenkyu Senta*, 15 January 1976, 41.

⁴⁵⁹ *Ibid.*, 48.

countries, but the flexibility of the floating system makes it possible to adjust the differences in the costs and prices.”⁴⁶⁰

Toyoo Gyohten, looking back on those days, also stated, “During the latter half of the 1970s, the world began a serious reappraisal of the floating exchange rate regime, which had been accepted reluctantly and at first with great fear. But we realized that the flexibility of floating rates allowed us to absorb the severe shock created by the Oil Crisis.”⁴⁶¹ In short, he pointed out the fact that, over time, more people came to understand the positive aspects of the floating system.

In the above, we have looked at how authorities and economic experts began to perceive that the floating system partly contributed to promoting the global circulation of capital, adjusting the trade balance, suppressing inflation, stabilizing the market, and containing protectionism. Although it had been quite difficult to accurately evaluate the floating system by then because of the turmoil in the global economy caused by the Oil Crisis, analyses of the floating system were advancing, and with it, more rationales for the support of the floating system were becoming available.

Nevertheless, even though the efforts to strengthen the floating system was progressing at international meetings and the supports for the system was growing more, there still were strong supporters of the fixed-rate system. For example, Ichiro Takeuchi, then an advisor at the Bank of Tokyo, asserted that the floating system could stimulate a devaluation race and lax government spending which in turn could cause inflation and stagflation. And then he continued, “the float is, after all, only a temporary measure, and it is expected that we will first tighten our control of the exchange market and then gradually shift closer to the fixed-rate system in the future.”⁴⁶² Likewise, Takeo Kajiyama, a professor at the University of Kitakyushu, also treated the floating system as a temporary measure, stating, “In the international interaction, there will be no smooth international exchange without fixed and stable exchange rates, which are necessary for the calculation of profitability ... This is why a stable and adjustable fixed-rate system is essential ... The fixed-rate system has not been replaced by the float ‘system.’ The float was adopted merely because the dollar-dependent fixed-rate system disappeared.”⁴⁶³ Likewise, Shoichi Kase, a professor at Kanto Gakuin University, also expressed his support for the fixed-rate system, stating, “If you ask if the fixed-rate system is more desirable, it is certainly so. It is totally wrong to say that the float is more desirable ... [The floating system] was only an inevitable choice, not the desirable choice ... When the countries pull themselves out of the current chaos and get on a stable growth path in the future, it is necessary all in all to return to the fixed-rate system and make the value of their currencies clear.”⁴⁶⁴ Opposition to the floating system, then, was still strong among some scholars.

Moreover, even Japanese monetary authorities, while pretending to go along with the aforementioned market-oriented management of the floating system that was gaining consensus at international meetings, was actually continuing to intervene in the market to

⁴⁶⁰ Banno, Shichiro. “Jamaika goi no imi suru mono - Hendosei, koteisei no tokushitsu o kangaeru -.” *Boeki to kanzei*, April 1976, 33.

⁴⁶¹ Volcker, Paul. and Gyohten, Toyoo. *Changing Fortunes*. Times Books, 1992, 152.

⁴⁶² Takeuchi, Ichiro. “Nezuyoi koteisei no hukugenryoku.” *Boeki to kanzei*, December 1975, 25.

⁴⁶³ Kajiyama, Takeo. “Shin tsuka taisei e no shinten to mosaku.” *Boeki to kanzei*, June 1976, 13-14.

⁴⁶⁴ Kase, Shoichi and Kanemitsu, Hideo and Hosomi, Takashi and Miyachi, Soshichi. “Hendosobasei no hen’yo to en.” *Nihon Keizai Kenkyu Senta*, 15 January 1976, 43.

maintain the yen rate at their targeted level. It took a little more time until the Japanese monetary authorities got out of the paradigm of the fixed-rate system and started to practically strengthen the floating system. As we will see later, such a shift accelerated as the potential damage that could be incurred by artificial controls of market fluctuations and the fears over such potential damage grew bigger.

The interventions by the Japanese monetary authorities during this period were made as follows. In late 1975, the U.S. economy lapsed into stagnation, and other countries were not recovering from the Oil Crisis. In such a bad global situation, Japan's exports were expected to stagnate, and consequently, the yen rate, which was hovering around 290-298 yen per dollar in August 1975, fell to 306 yen in December. In response, the Japanese authorities implemented dollar-selling intervention to prevent further depreciation of the yen, but, as the yen recovered to 305 yen on December 30th, they switched to the dollar-buying intervention to stem the rise of the yen. By keeping the rate within such a narrow range, the monetary authorities attempted to avoid both a higher yen, which might hinder exports, and a lower yen, which might invite inflation and foreign criticism.⁴⁶⁵

As 1976 arrived, the Japanese authorities continued their market intervention in order to stem the rise of the yen. One of the reasons for this continued intervention was the unstable situation of the European exchange market in early 1976. Japanese authorities worried that the instability in Europe would affect Japan.⁴⁶⁶ The instability started as follows. Just after the Kingston Agreement, Italy, whose economy had been unstable, became the target of speculation. There began a massive selling of the Italian lira, and the Italian government sold 528 million dollars to sustain the lira, during 20 days in January. But, after all, it could not hold out against its decreasing foreign currency reserve, and announced the closure of its foreign exchange market.⁴⁶⁷ Against the backdrop of such instability in the European market, the Japanese monetary authorities continued their intervention. Between January and April 1976, their interventions amounted to approximately 1.7 billion dollars.⁴⁶⁸

However, foreign criticisms of Japan's interventions were beginning to grow. Japan was quickly recovering from the Oil Crisis compared to other countries, and inflation was getting stable as indices showed; in 1976, wholesale prices rose by 5% in Japan, consumer prices rose by 9.3%,⁴⁶⁹ and the trade surplus was 880 million dollars between January and March 1976.⁴⁷⁰ The international community started to criticize that Japan for keeping the yen rate low and attempting an export-driven economic recovery.⁴⁷¹ For example, C. Fred Bergstein, then a senior researcher at the Brookings Institution, criticized the low yen at a conference held in June 1976. Also, Assistant Secretary of U.S. Treasury Edwin Yeo, upon visiting Japan on August 10th, stressed Japan's responsibility

⁴⁶⁵ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 101 - 102.

⁴⁶⁶ *Ibid.*, 105.

⁴⁶⁷ Kajiyama, Takeo. "Shin tsuka taisei e no shinten to mosaku." *Boeki to kanzei*, June 1976, 17.

⁴⁶⁸ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 105.

⁴⁶⁹ *Ibid.*, 102.

⁴⁷⁰ Ishimaru, Yoshitomi. *Endaka to Nihon keizai*. Mainichi Shinbunsha, 1978, 80.

⁴⁷¹ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 106.

as a surplus country and pressed for an adjustment of the currency rate.⁴⁷² On August 26th, Henry S. Reuss, the Chairman of the House Banking Committee, complained to the Japanese ambassador to the U.S. that Japan had turned against the currency agreements made in Rambouillet and Jamaica and was making currency interventions to boost its exports.⁴⁷³ Overseas magazines made similar criticisms. For example, on August 7th, *The Economist* argued that the yen rate was undervalued due to the market interventions by the Bank of Japan. On August 9th and August 30th, *Business Week* also reproached Japan for maneuvering the yen to make it low.

And then the yen began to ascend, because of (1) the projections that the Japanese government would refrain from making currency interventions in response to overseas criticisms (there was an erroneous report that the Ministry of International Trade and Industry requested the Ministry of Finance to let the yen rise up to 290 to the dollar.⁴⁷⁴). (2) optimistic estimates for Japan's current account balance. (3) the difference in the interest rate between Japan and the United States.⁴⁷⁵ As a result, the yen rate, which was 299 yen per dollar before the San Juan Summit in June 1976, rose to 286 yen by the middle of September. Then the yen temporarily fell to 292 yen by January 4th 1977, because of (1) the projection that the oil prices would be increased substantially by OPEC by the end of the year. (2) political anxieties before the general election. (3) deceleration of exports caused by the economic stagnation in Europe and the United States.⁴⁷⁶ Nonetheless, the yen began to climb once again, reflecting the fact that economic stagnation in Japan led to a sharp rise in exports while suppressing imports.⁴⁷⁷ The Japanese economy enjoyed more growth than other countries. Its share in the world's exports of industrial products rose from 12.8% in 1973 to around 14% by 1976.⁴⁷⁸ Moreover, the current balances for fiscal 1976 were surpluses of 3.7 billion dollars for Japan and 3.4 billion dollars for West Germany. On the other hand, the U.S. recorded a 1.4 billion dollar deficit, France's was 6 billion, Italy 2.9 billion, and Britain 2.5 billion dollars.⁴⁷⁹ Reflecting these conditions, the yen rose to 288 yen by the end of January 1977.⁴⁸⁰

However, this was just the beginning of the yen's rise. At the joint committee of the U.S. Congress on February 9th 1977, University of Pennsylvania Professor Lawrence R. Klein, known as one of the brains of the Carter administration that took office in January 1977, stated that raising the West German mark and the Japanese yen by 10% would raise the annual economic growth rate of major countries by 0.5%. This statement led to the expectation that pressure would be exerted to raise the yen, and thus stimulated the yen to

⁴⁷² Zaimusho zaimu sogo seisaku kenkyujo zaiseishishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do (dai 7-kan) Shiryō Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2004, 46.

⁴⁷³ Okurasho Kokusai Kin'yukyoku nenpo hensan iinkai. *Okurasho Kokusai Kin'yukyoku Nenpo Showa 52-nen ban Dai 1-kai*. Kin'yu Zaisei Jijo Kenkyukai, 1977, 68.

⁴⁷⁴ *Ibid.*, 63.

⁴⁷⁵ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 105.

⁴⁷⁶ *Ibid.*, 106.

⁴⁷⁷ *Ibid.*, 109.

⁴⁷⁸ Ishimaru, Yoshitomi. *Endaka to Nihon keizai*. Mainichi Shinbunsha, 1978, 89.

⁴⁷⁹ *Ibid.*, 37 - 38.

⁴⁸⁰ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 109.

rise.⁴⁸¹ Against this backdrop, Japan posted a trade surplus of 1.3 billion dollars in January, 1.4 billion dollars in February, 1.489 billion dollars in March, and 1.745 billion dollars in April, further driving the yen's hike.⁴⁸² As a result, the yen rose to 272 yen per dollar by April 5th. Yet many judged that the value of the yen was still not commensurate with the scale of Japan's surplus,⁴⁸³ and thus the pressure that demanded Japan to further expand its imports and accept the yen appreciation continued to be exerted. And, amidst such pressure, at the London Summit held in May 1977, Prime Minister Takeo Fukuda tried to defuse the pressure by promising Japan's economic growth rate of 6.7% backed by a stimulus package centering on the expansion of imports and public works. However, at the OECD meeting held in late June, it was argued that the Japanese currency required adjustment sufficient to affect its industrial competitiveness. Moreover, as it became clear that the U.S. was pushing Japan, in order to induce the dollar to drop and the yen to rise, to release to the market its profits that came from its management of foreign currency reserve,⁴⁸⁴ expectations became high that Japanese authorities would allow the yen to ascend. Reflecting this, the yen rose to the 260 yen level by the end of June. In fact, to avoid overseas criticisms of the low yen, on June 28th, Prime Minister Fukuda called in Finance Minister Hideo Bo, Director General of the Economic Planning Agency Tadashi Kuranari, and Foreign Minister Ichiro Hatoyama to give instructions for reducing the foreign currency reserve. In response, the Ministry of Finance and the Bank of Japan sold their gains on Japan's foreign currency reserve and decided to sell the yen to the U.S. forces in Japan.⁴⁸⁵

But, why was it that Japan had to be so sensitive about foreign criticism and loosen foreign exchange intervention to avoid it? It was not just a matter of face-saving. The April 1977 issue of the economic journal *Boeki to kanzei* (Trade and Custom) explains the reason as follows: "One of the reasons why the Ministry of Finance and the Bank of Japan rather reduced the degree of intervention these days is that, with a summit meeting approaching, they are concerned about Japan's increasing foreign currency reserves. Compared to the United States and West Germany, Japan obviously has tighter regulations on currency, capital transaction, and trade. If other countries criticize that point, Japan will be isolated in international opinion. They might even criticize Japan for taking a beggar-my-neighbor policy by saving up the dollar. We cannot forejudge what kind of specific suggestion the Carter Administration would give to Japan, but if things turned out bad, the conflict can escalate to import restrictions on goods from Japan."⁴⁸⁶ In fact, some countries were beginning to refer to the possibility of protectionism in their countries. For example, at the IMF General Assembly held in Washington D.C., the British Finance Minister (Chancellor of Exchequer) Dennis Healey warned that if surplus countries depended on exports to achieve their own domestic growth, then their trade partners have no other way but to adopt a deflationary policy or protectionism.⁴⁸⁷ In this

⁴⁸¹ *Boeki to kanzei*, April 1977, 16.

⁴⁸² Ishimaru, Yoshitomi. *Endaka to Nihon keizai*. Mainichi Shinbunsha, 1978, 80 - 81.

⁴⁸³ *Ibid.*, 81.

⁴⁸⁴ Zaimusho zaimu sogo seisaku kenkyujo zaiseishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do (dai 7-kan) Shiryo Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2004, 48.

⁴⁸⁵ *Ibid.*, 49.

⁴⁸⁶ *Boeki to kanzei*, April 1977, 17.

⁴⁸⁷ Okurasho Kokusai kin'yukyoku nenpo hennshu Iinkai. *Okurasho Kokusai kin'yukyoku nenpo Showa 53 nen ban dai 2-kai*. Kin'yu Zaisei Jijo Kenkyukai, 1978, 29.

way, the international criticism accompanied the actual risks of heightening the pressure on Japan to further liberalize its market and of causing a rise of protectionism in other countries. For that reason, Michiya Matsukawa, the Vice Minister of Finance for International Affairs, on returning from his visit to Europe, announced at a press conference on September 10th that it was necessary to handle the currency issue and the trade issue separately, because it could complicate the situation if they were associated.⁴⁸⁸ But criticism of Japan continued to mount thereafter, and with it grew Japan's anxiety over protectionism in foreign countries.

There were other reasons why the rise of yen came to be more acceptable to Japan; it was because the Japanese companies did have strength to withstand a slight rise of the yen, and they came to know how to tackle currency fluctuations through the years of experience of the floating system. The June 1977 issue of *Boeki to kanzei* (Trade and Custom) describes such situation as follows: "The Ministry of International Trade and Industry conducted a survey on the effects of the high yen on the industries ... without exception, the export industries under the survey viewed that 'the rate falling under 270 yen to the dollar would have a major negative impact on the business' ... [but] almost all categories of business including small and medium-scale companies took necessary steps in response to the rising yen, and successfully averted exchange risks by using futures market. For this reason, the Ministry, which was considering a financial support, reached the decision that such support was unnecessary."⁴⁸⁹ The fact that Japanese companies developed strategies that took extreme currency fluctuations into consideration and that Japan's exports were robust gave them confidence.

However, when the yen reached 263 yen per dollar on July 11th 1977, the Japanese monetary authorities judged that a further rise of the yen would hurt the Japanese economy and that any more rise was unacceptable; the yen, which was around 290 yen at the beginning of the year, rose to around 260 yen in 6 months. However, the rise of the yen suddenly stopped for the reasons below and therefore full-scale interventions did not take place. From early July to late August, the yen fluctuated softly, and the Japanese exchange authorities even implemented dollar-selling intervention on a small scale.⁴⁹⁰ The yen during this period was relatively weak and stable because of the following reasons (1) FRB Chairman Arthur F. Burns made a statement to Congress that the dollar must be protected to suppress the inflation and sustain the dollar's value as a key currency. (2) The U.S. official bank rate was raised from 5.25% to 5.75% whereas the official bank rate in Japan was lowered from 5% to 4.25% at the beginning of September. (3) On September 3rd, the Japanese government decided to allocate 2 trillion yen to public works and implement policies to promote imports of raw materials. Consequently, at the beginning of September, the yen rate was stable, at 268 yen per dollar.

Meanwhile, criticism of Japan was continuing. Looking back, Gyohten summarizes those criticisms as follows: "in July 1977, we [Japan] announced a record surplus for a single month of 1.5 billion dollars. That led to demands focusing on the yen in particular to appreciate against the dollar. Charles Coombs of the New York Federal Reserve wrote

⁴⁸⁸ Zaimusho zaimu sogo seisaku kenkyujo zaiseishishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do (dai 7-kan) Shiryo Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2004, 47.

⁴⁸⁹ *Boeki to kanzei*, June 1977, 48.

⁴⁹⁰ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 110.

an article to that effect in August. United States pressure intensified for Japan to reduce her surplus by increasing imports from the States; this was the message of a high-level meeting we had in September with a delegation led by Richard Cooper of the State Department and C. Fred Bergsten of the Treasury, who also raised many outstanding trade issues between the two countries. Later in the month, at the annual meeting of the IMF, Dennis Healey, Britain's Chancellor of Exchequer, singled out Japan and accused us of distorting the equilibrium of the entire world economy."⁴⁹¹ Moreover, in Congress, Henry S. Reuss requested the IMF to exercise surveillance on Japan, asserting that Japan's market interventions were not a smoothing operation but a policy to maintain the yen rate at low level, with the potential to invite protectionism.⁴⁹² Morgan Guaranty Trust Company also opined that, in order to improve the U.S. current deficit, the U.S.'s trading partners needed to expand their domestic demand and Japan needed to raise the yen rate, which was, according to the company, undervalued by 10% or more.⁴⁹³ The yen was on the rise, but it was not deemed enough, and the voice of criticism against Japan continued to heighten.

Such criticism stimulated the rise of the yen.⁴⁹⁴ Of course, there were more background factors to the rise of the yen such as Japan's increasing trade and current account surpluses and the United States' increasing trade deficits.⁴⁹⁵ While Japan in 1977 recorded a 14 billion dollar current account surplus and 20.3 billion dollar trade surplus,⁴⁹⁶ the U.S. in the same year recorded a 20.2 billion dollar current account deficit and a 26.5 billion dollar trade deficit.⁴⁹⁷ It was against this backdrop that foreign criticisms of Japan further stimulated the rise of the yen. The yen rose from 268 yen per dollar in early September to 240 yen on November 24th. Looking through 1977, the yen rose substantially from 292 yen per dollar at the beginning of the year to 240 yen at the end of the year.

As the criticism against Japan mounted, the Japanese government refrained from making currency interventions. However, as the yen soared, it judged that a further rise should not be tolerated. Based on this decision, the government made substantial interventions amounting to 1.7 billion and 2.5 billion dollars in October and November, respectively.⁴⁹⁸ However, important to note here is that while these were considerable interventions, they were the kind that only had the effect of alleviating the yen's rise, not ones that would reverse it to the point that the currency would drop, nor halt the rise altogether. During this period, the Ministry of Finance announced that it "would make proper interventions in times of violent market fluctuations,"⁴⁹⁹ and indeed the basic approach of the intervention policy at the time was, as Ryutaro Komiya and Miyako Suda

⁴⁹¹ Volcker, Paul. and Gyohten, Toyoo. *Changing Fortunes*. Times Books, 1992, 154.

⁴⁹² *Nihon Keizai Shimbun*, 22 September 1977 (evening edition); Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 114.

⁴⁹³ *Nihon Keizai Shimbun*, 4 October 1977; Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 145.

⁴⁹⁴ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 145.

⁴⁹⁵ *Keizai Seminar*, December 1977.

⁴⁹⁶ Keizai Kikaku Cho. *Showa 53-nen nenji keizai hokoku*. Okurasho Insatsukyoku, 1978.

⁴⁹⁷ Zaimusho zaimu sogo seisaku kenkyujo zaiseishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do (dai 7-kan) Shiryō Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2004, 6.

⁴⁹⁸ *Ibid.*, 52.

⁴⁹⁹ *Nihon Keizai Shimbun*, 6 October 1977.

analyzed, to intervene only in times of rapid and speculative fluctuations, and to basically rely on the market's supply and demand, not guide the market toward a particular direction.⁵⁰⁰ Although the scale of intervention seemed large, the goal of interventions had become passive, and it became apparent that the government was inclined to accept the high yen.

It is true that, during this period, there still were those in the government who argued that the yen's rise must be suppressed, especially among politicians whose supporters were export businesses. For example, Prime Minister Takeo Fukuda, and Kiichi Miyazawa, who became the Director General of the Economic Planning Agency from late November, took the position that Japan should continue to suppress the rise of the yen⁵⁰¹ Because different opinions existed within the government, it is said that, in October 1977, contradictory instructions were given to the Bank of Japan, the executor of foreign exchange intervention, by the leaders of the International Finance Bureau (of the Ministry of Finance), who felt that interventions were no longer effective, and by others at the Ministry of Finance, who supported an active intervention; pressed to implement contradictory policies, the Bank of Japan protested.⁵⁰² However, after all, no strong intervention that sought to halt the yen's rise or its reversion took place, for the following reasons.

One of the reasons, as mentioned above, was the fear over international criticisms, foreign pressures for market liberalization, and the danger of protectionism abroad. On this point, Ichiro Takeuchi, then an advisor at the Bank of Tokyo explained as follows: "The unemployment rate in the United States remains as high as 7%, and labor unions are raising their voice for protectionism more and more. In Congress, with the midterm election around the corner, congressmen are proposing various kinds of protectionist laws ... the target of the protectionist laws is especially the imports from Japan. There, in order to prevent such protectionism from becoming a serious political issue, it is necessary that Japan make a political concession. This is why, in the negotiation between Japan and Richard Rivers, a special counsel to the U.S. Trade Representative Office, the United States commented that Japan needed to take drastic action. The U.S. representatives wanted Japan to take drastic action and thereby suppress the protectionism in the United States. Therefore, the U.S. is ... strongly demanding that Japan increase its imports, especially the import of industrial goods."⁵⁰³

In fact, in September 1977, U.S. Steel filed a suit against dumping in Japan's steel exports. And, in February 1978, a trigger price (a standard price for the launching of a dumping investigation) was introduced. In addition, during this period, the U.S. took up the issue of the liberalization of agricultural products, and demanded that Japan eliminate import restrictions on such products as oranges and beef. Prime Minister Fukuda, fearing that U.S.-Japan relations would worsen, appointed Nobuhiko Ushiba as the minister in charge of external economic affairs, and from November 1977 to 1978, U.S.-Japan trade

⁵⁰⁰ Komiya, Ryutaro and Suda, Miyako. *Gendai kokusai kin'yu ron - Rekishi seisaku hen*. Nihon Keizai Shinbunsha, 1983, 177-182.

⁵⁰¹ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 111, 148 - 149.

⁵⁰² *Ibid.*, 146.

⁵⁰³ Takeuchi, Ichiro. "Sekai Boeki, tsuka no shoten ni tatsu 'en'" *Boeki to kanzei*, January 1978, 16; For more detailed content of the U.S. demands, see "U.S. Tells Japan 'Surrender On Trade Issues,' in *Executive Intelligence Review*, Volume 4, Number 48, November 29, 1977.

negotiations were conducted. As a result, the agreement concluded on January 13th 1978 (Strauss-Ushiba agreement) promised the expansion of the import of oranges and beef into Japan and Japan's economic growth of 7% for 1978.⁵⁰⁴ However, opening the market in such a manner makes it difficult to reverse the decision once implemented. Thus, rather than liberalizing the market, it was better to let the yen rise and defuse the foreign pressure for the liberalization; it would give more political options later. In other words, the suppression of yen's rise through interventions had the inherent possibility of bringing damages to both the domestic market through market liberalization and the export industries by protectionism abroad.

This point - the necessity of having a "floating system that refrains from intervention" to avoid the emergence of protectionism - was clear to some economic experts at the time. For example, the point was referred to by Masaru Yoshitomi, then the head researcher of the Economic Research Institute of the Economic Planning Agency: "Under the floating system, the currency exchange rate is adjusted over the medium term in accordance with the changes in the purchasing power parity. Thus, unrealistic currency rates [such as those created under the fixed-rate system] that trigger a long-term imbalance in the international balance, are unlikely to develop under the floating system. Therefore, under the floating system, the chances that protectionism would arise due to the issues related to the international balance are small."⁵⁰⁵ However, even under the floating system, adjustments of competitiveness would be hindered if continuous interventions are made. Thus, to avoid protectionism, it was necessary to restrain interventions and let the currencies float according to the market. It is true that, even when no interventions are made, there is a time lag until the currency fluctuations influence the international balance, and in the meantime, protectionism may grow. However, if the floating of the currency is blocked, the pressure for protectionism may grow even bigger. Thus it was necessary to restrain intervention to a certain degree in order to minimize the danger of protectionism.

Another reason for the drop in Japan's market interventions during this period was that monetary authorities were realizing how difficult it was to change the market trend that actually reflected the reality of economy, since the size of international capital transfer had become enormous. For instance, on October 26th 1977, amid a steep rise of the yen, Haruo Maekawa, then the deputy governor of the Bank of Japan, stated that, in order to stabilize the exchange market, the imbalance in the international trade should be corrected, and that there was a limit in keeping the market stable by exchange intervention.⁵⁰⁶ Also, when Prime Minister Fukuda convened a meeting, Bank of Tokyo president Kashiwagi, Long-Term Credit Bank of Japan advisor Inamura, and Bank of Japan Governor Sumida stated their opinion that the high yen was a result of the balance of international payments, and thus the yen could not be pegged by interventions.⁵⁰⁷ Similarly, in the Ministry of Finance, it is said that there was an argument that, since the trade imbalance between Japan and the United States actually existed, there was no way

⁵⁰⁴ Zaimusho zaimu sogo seisaku kenkyujo zaiseishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do (dai 7-kan) Shiryō Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2004, 7.

⁵⁰⁵ Yoshitomi, Masaru. "Hendo sobaseika no hogo boeki-shugi." *Nihon Keizai Kenkyu Senta*, 1 December 1977, 1.

⁵⁰⁶ *Nihon Keizai Shimbun*, 27 October 1977.

⁵⁰⁷ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 146.

to stop the rise of the yen and thus market intervention must be stopped.⁵⁰⁸ Also, according to Tadashi Kano, people within the International Finance Bureau of the Ministry of Finance began to think that high yen could be good for Japanese economy and that Japanese economy could withstand the high yen.⁵⁰⁹

Likewise, there also were people in the private sector who supported passive interventions that did not try to counter market tendencies. For example, Nobuyoshi Namiki, then the head researcher at the Japan Center for Economic Research, pointed out that, had the government relaxed its interventions and let the yen rise in advance during the first half of 1977, the currency's sudden hike during the second half of the year might have been averted: "The yen suddenly 'erupted' after being suppressed to a certain degree for a while ... so it might have been better to let it rise over a long time. However, because the government and the Bank of Japan have been running the floating system in a way that somewhat suppressed the currency from rising, it became impossible to revise the government projections of the international balance, resulting in the 'eruption.'"⁵¹⁰, Namiki, in other words, argued that arbitrary and unnatural interventions had their side effects over the long term.

Ryutaro Komiya, a professor at the University of Tokyo, agreed with Namiki: "Japan was already tending toward the black ink from the beginning of the year. Nonetheless, the government asserted that the current balance for the year would be in some deficit. Based on that reasoning, the government took various steps to suppress the yen from rising. But, considering the fundamentals, the yen should have begun to rise earlier and at a more gradual pace. The yen soared all at once in September and October but that should not have happened if there was no intervention and if the yen gradually began to rise from the first half of this year. In that gradual manner, the yen should have reached ... somewhere close to the current level [without a rapid hike]. However, various factors delayed the adjustments, leading to an abrupt change in the yen rate all at once."⁵¹¹ Such were Komiya's objections to interventions that went against market trends.

Looking at these events overall, it is clear that by this time, both the government and the private sector began to hold less to the thinking that the yen fluctuations should be suppressed to the minimum - the paradigm of the fixed-rate system. Instead, support for the floating system began to mount. In short, there finally occurred a shift in the way the floating system was managed. It was a management that upheld the floating system by rejecting any intervention that aimed at reversing the market trends and only allowing interventions that aimed at taming extreme market moves. However, the shift was not complete. There still were voices that argued that the rise of the yen should be kept to the minimum.

However, while this shift was taking place in Japan, a new trend in the floating system was also taking place overseas. In short, on December 21st 1977, President Carter declared his intention to protect the dollar. This reversed the previous U.S. stance that supported a market-oriented floating system, or a "clean float." The U.S. now began to protect the dollar, and this marked a departure from their previous floating system

⁵⁰⁸ *Ibid.*, 111.

⁵⁰⁹ *Ibid.*, 146.

⁵¹⁰ Komiya, Ryutaro and Namiki, Nobuyoshi and Yoshitomi, Masaru and Matsuda, Osamu. "Nanmon ippai endaka ka no keizai un'ei." *Nihon Keizai Kenkyu Senta*, 15 December 1977, 49.

⁵¹¹ *Ibid.*

management style in which any intervention that aimed at reversing the market trends was rejected. However, the new trend that the U.S. led from this period became more apparent later, so the details about this new trend will be discussed in the next chapter. Let us instead keep our focus on the processes by which the above shift in Japan was bolstered.

The key point here is that the dollar had fallen to the point that the U.S. had to defend it. The U.S. trade deficit, inflation, and the market's distrust of the United States' will to protect the dollar all worked to depreciate the dollar. And reflecting this distrust of the dollar, in February 1978, the German mark, Swiss franc, Dutch guilder all rose rapidly against the dollar, and consequently, upward pressure was placed on the yen too, which was at around 240 yen per dollar at the time.

It was mentioned earlier that, although currency policy in Japan was starting to shift, the shift was not complete. Reflecting such transitory situation, there was a conflict over the currency policy among the monetary authorities. According to Tadashi Kano, amid the increasing upward pressure on the yen, Kiichi Miyazawa, then Director General of Economic Planning Agency, called the Bank of Japan Governor Teiichiro Morinaga on the phone on February 17th 1978 and said that they should keep the 240 yen level through intervention. But Morinaga objected, replying that, while it was true that the higher yen was not favorable, pegging the yen to 240 yen would not be internationally acceptable. Then, Miyazawa asked him if the International Finance Bureau [of the Ministry of Finance] and the Bank of Japan were thinking that the high yen was unavoidable because they thought [the reduction target of] 6 billion dollars of current account surplus in the fiscal year of 1978 would be impossible. In turn, Morinaga asked the opinions of the Prime Minister Fukuda and Finance Minister Murayama. Murayama agreed with Morinaga's opinion.⁵¹² After all, the monetary authorities implemented foreign exchange interventions amounted to 800 million dollars in January and another 1.4 billion dollars in February.⁵¹³

As the yen was pressured to rise due to the uncertainties over the dollar in March 1978, exchange authorities, who had not made a complete transition from the operation of the floating system in the style of the fixed-rate system, took steps to increase the amount of interventions substantially. The intervention made during March was approximately 5.5 billion dollars,⁵¹⁴ well over the 4.6 billion dollar intervention made in August 1971 at the onset of the Nixon Shock. Along with interventions, the monetary authorities tried to relax yen purchases by reinforcing the restrictions on the inflow of short-term loans on March 15th, and by lowering the official bank rate from 4.25% to 3.5% on the 16th.⁵¹⁵ However, the yen hike could not be stopped. The yen, which was 238 yen per dollar in early March, rose to 234 yen on March 15th, 230 yen on the 17th, 228 yen on the 24th, 225 yen on the 27th, and 223 yen by the end of the month, marking the highest rise since the transition to the floating system.

⁵¹² Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 148 - 149.

⁵¹³ Zaimusho zaimu sogo seisaku kenkyujo zaiseishishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do (dai 7-kan) Shiryo Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2004, 59.

⁵¹⁴ *Ibid.*

⁵¹⁵ Nihon ginko hyakunen-shi hensan iinkai ed. *Nihon Ginko hyakunen-shi 6-kan*. Nihon ginko, 1986, 468.

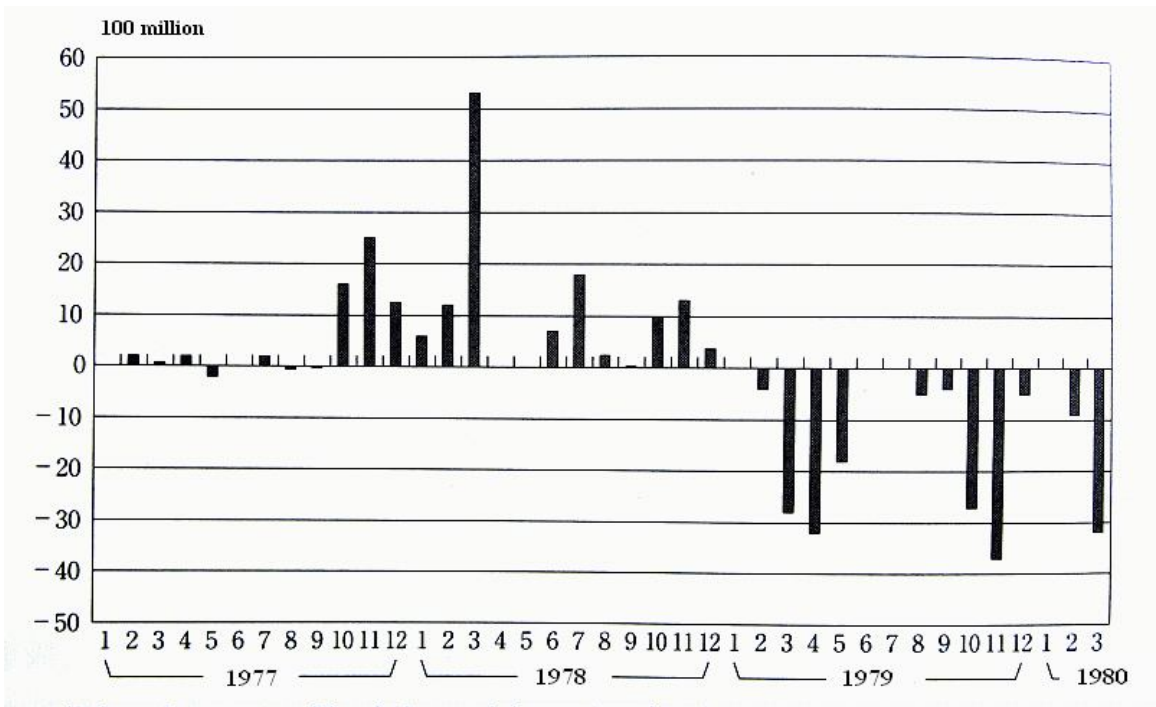
In short, despite the efforts to suppress the rise, the yen continued to soar. Then, among the monetary authorities, suspicion over the effectiveness of interventions and the support for accepting the high yen began to mount further.⁵¹⁶ And as a result, by the end of the month, a decisive transition was made in the operation of the floating system. In short, the monetary authorities decided to stop their foreign exchange intervention. It was decided through the following steps: Although the authorities tried to keep the yen rate at 225 yen per dollar through massive intervention on March 28th, a top official at the International Finance Bureau appealed to Finance Minister Murayama that eventually they would not be able to hold the 220 yen level. Then, Murayama replied that he would not care if the rise of the yen developed into a political problem, and that he also thought that it would be impossible for them to keep the rate if so many people were expecting the rise of the yen, and that if they abandoned intervention and let the market move freely, then speculators might [be puzzled and] hold back. Based on that judgment, with the approval of Prime Minister Fukuda, the intervention was stopped on March 29th.⁵¹⁷

In other words, their understanding was that the divergence of the exchange rate from the fundamentals occurred because forcible interventions allowed speculators to see the government's defense line and thus invited their speculative attack. If the rate fluctuation was left to the market, then speculators' market forecast and the resulting speculation would be dispersed and the exchange rate would settle down to where it should reflect the fundamentals.

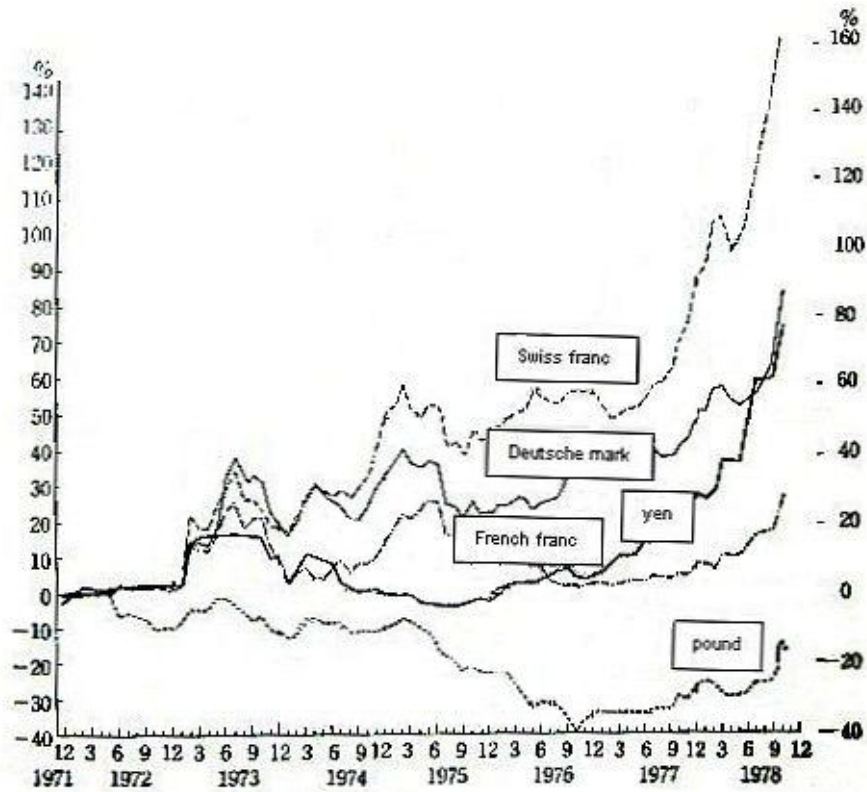
This suspension of interventions, even though its partial intention was to counter speculation, was not a temporary phenomenon but symbolized the transition of Japan's currency policy. Although interventions continued to take place after halting them in April and May (at the graph below shows), their amount was far smaller than what was previously posted and the intention of those interventions was not to block the yen's rise: Specifically, the yen rate that hovered around 260 yen during early October 1977 rose by approximately 40 yen to around 220 yen by late March 1978, when the decision to halt the interventions was made. Then the yen rate, which hovered around 220 yen in late March, rose to 175 by October 1978, posting a similar appreciation of around 40 yen. However, as the graph below shows, the amount of intervention for the latter period was far smaller than that for the former period.

⁵¹⁶ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 120.

⁵¹⁷ *Ibid.*, 149; Volcker, Paul. and Gyohten, Toyoo. *Tomi no kobo - En to doru no rekishi -*. Toyo Keizai Shinposha, 1992, 229 - 230.



Showa Zaiseishi - Showa 49-63 nen do (dai 7-kan) Shiryo
 Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei, 52.



Currency rates against the U.S. dollar.
 From the December 1978 issue of *Tokyo Ginko Geppo*.

From this, it can be observed that the exchange policy took a major turn after the cessation of intervention on March 29th. Even before it, the currency policy had been changing little by little as explained earlier, but, after March 29th, the range of acceptable fluctuation became wider, and the monetary authorities started to leave the exchange rate largely to the market. In short, finally, there occurred a complete shift in the way the floating system was managed. It was a management that upheld the floating system by rejecting any intervention that aimed at reversing market trends and only allowing interventions that aimed at taming extreme market disruptions. This shift implied the deepened understanding and increasing support for the floating system in Japan.

The background that brought about such change has been repeatedly explained above, but it can be summarized and reemphasized as follows.

One of background factor was that the Japanese economy was strong even with the strong yen. For example, mining and manufacturing production kept rising for 6 months from November 1977 to April 1978, and the business earnings of the fiscal year ending in March 1978 also slightly increased compared to the previous term despite there was a concern about the effect of the rapid rise of the yen. Consumer spending in the January-March quarter also rose by 2.1% compared to the previous quarter, and the real gross national expenditure was, by annualized rate, as high as 10%.⁵¹⁸

Another background element was that more people began to think that high yen could be rather favorable for Japan if that reflected the actual condition of the Japanese economy,⁵¹⁹ as Toyoo Gyohten, looking back, illustrated, “We realized that intervention would not be very effective against a strong market, and the view was growing in press and business circles that a strong yen might not be all that bad.”⁵²⁰ Ryutaro Komiya and Miyako Suda also noted that the high yen became more acceptable to people because the rapid rise of the yen to 230 yen per dollar in fall of 1977 did not bring a serious recession, but instead brought favorable effects of lowering the price of raw material imports and stabilizing domestic prices.⁵²¹

Another important backdrop to these developments is that, as made clear from the discussions above, it was no longer possible to control the exchange rate through interventions and strict foreign exchange control. We saw in the previous chapter how the expansion of the international capital movement made it difficult to maintain fixed rates. As the international capital expanded further after the collapse of the Bretton Woods, it became even harder to control the rates. As Masao Fujioka, who then had become an executive director of the Export-Import Bank of Japan, stated “it would be impossible, and therefore we should not try, to aim to stabilize the exchange rate by strengthening the foreign exchange control in the current situation where the Japanese economy has grown so big and financial transactions so complicated.”⁵²² The regulation of the exchange rate through foreign exchange control was something that would cause a side-effect of

⁵¹⁸ *Boeki to kanzei*, August 1978, 13.

⁵¹⁹ Zaimusho zaimu sogo seisaku kenkyujo zaiseishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do (dai 7-kan) Shiryō Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2004, 59.

⁵²⁰ Volcker, Paul. and Gyohten, Toyoo. *Changing Fortunes*. Times Books, 1992, 157.

⁵²¹ See Chapter 8 Section 1 and 2 of Komiya, Ryutaro and Suda, Miyako. *Gendai kokusai kin'yu ron - Rekishi seisaku hen*. Nihon Keizai Shinbunsha, 1983; Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 122.

⁵²² Fujioka, Masao. “En reto tomen wa antei e.” *Nihon Keizai Kenkyu Senta*, 1 March 1978, 8.

interfering in Japan's economic activities, because Japan had become a nation that needed a large-scale international financial transactions to sustain its economy. Also, controlling the exchange rate through foreign exchange intervention had become difficult as well, in the face of increasing amount of international capital movements. Looking back on those days, Gyohten pointed out the change of situation: "One important lesson of the period [the late 1970s], particularly for Japan, was that under the floating-rate regime, monetary authorities could not manipulate the exchange rate by simply intervening against an underlying market trend. That lesson cost us billions to learn ... In the early days of the floating regime, we thought that medium- and long-term elements such as purchasing power parities and balance of payments adjustments would still have a major influence. But then short-term capital flows and interest rate differentials became very important."⁵²³

To see the specific numbers, as mentioned above, the monetary authorities implemented interventions using approximately 5.5 billion dollars in March 1978, which exceeded the 4.6 billion dollars that were used when the Nixon Shock occurred in August 1971. Moreover, the authorities strengthened their regulation of the inflow of short-term loans, and lowered the official bank rate from 4.25% to 3.5% to alleviate the yen-buying speculation. However, the yen rate, which was 238 yen per dollar in early March, rose to 234 yen on March 15th 230 yen on the 17th, 228 yen on the 24th, 225 yen on the 27th and 223 yen at the end of the month. Viewing the events over a longer period, the total amount of the dollars purchased from October 1977 to the end of October 1978 was 18 billion, almost equal the current account surplus of the same period.⁵²⁴ However, during the same period, the currency rate rose from around 260 yen per dollar to approximately 175 yen, demonstrating that even the voluminous interventions that were almost equal to the current account surplus were not able to stop the trend of the market. Such a reality, where the expansion of the international capital transactions made it impossible to control the rates through interventions, forced Japan to shift to the operation style of the floating system in which interventions were to be made only to level the extreme rate fluctuations. In the above we discussed the process by which politicians, monetary authorities, and economic experts changed their perception of the floating system over time. The perception changed not just because those people began to understand the advantages of the floating system, but also because the reality that the expansion of the international trade and international capital movement made it difficult to control the exchange rate forced them to change their perception. This point will be discussed in more detail in the next chapter.

Another important factor to consider is the one that this chapter has emphasized repeatedly. As Japan expanded its scale of trade surplus, fears also mounted over the emergence of protectionism in other countries and the scale of the potential damage that the Japanese economy would incur from it. This caused the government to refrain from making interventions. As seen in the previous chapters, when the fixed-rate system was in effect in Japan, the fixed rate made it difficult to reflect the actual competitiveness of the Japanese economy. As a result, politicians, monetary authorities, economic experts, business communities all thought that a yen revaluation would cause a major negative

⁵²³ Volcker, Paul. and Gyohten, Toyoo. *Changing Fortunes*. Times Books, 1992, 160-161.

⁵²⁴ Gyohten, Toyoo. "Waga kuni no kawase shijo kainyu ni kansuru keso sutadi (jo)." *Fainansu*, Okurasho Kanbo Bunshoka, July 1985, 64-75.

impact on the Japanese economy, and thus the beliefs that the yen rate and the fixed-rate system should be protected at all costs became stronger. However, even when the yen rose substantially under the floating system, as long as the rise reflected Japan's competitiveness, the economy remained strong. Once this was witnessed after the shift to the floating system, the consensus was built around the opinion that economic damages are triggered not by rate hikes that somewhat reflect an economy's strength, but more by arbitrary protectionism and the pressure to open the market, which is hard to retract once it takes effect. In other words, during this period, as was also the case with the fixed-rate system, fears over losing the amassed wealth catalyzed the shift in the system, but this time the object that threatened damage and aroused fear was different. This time they were protectionism and pressures for market liberalization. Then, to reduce the damage, it would be more sensible to let the yen rise, raise expectations of a future drop in Japanese exports and expansion in imports, and avert protectionism and the pressure to liberalize the market. And to do so required refraining from foreign exchange interventions. This real situation promoted Japan's shift to the floating system that left rate fluctuations largely up to the market.

To summarize, this chapter discussed how it became difficult to manage the floating system in the style of the fixed-rate system as international trade and capital movements expanded. We also looked at the process by which strong support for and a shift to the market-oriented floating system occurred, in order for Japan to expand profit and prevent economic damages in ways that were compatible with the expanding scale of international trade and capital movement. In the next chapter, focus will be given to the processes by which further expansion of the international trade and capital movement made it more difficult to maintain the floating system, and consequently led to increased efforts to strengthen it.

CHAPTER 4

The Deepening Contradictions of the Floating Exchange Rate System and the Expansion of Potential Economic Damage

In Chapter 3, we observed the ways in which monetary authorities and economic experts began to actively support the floating exchange rate system as it buffered the economic shock of the oil crisis and contributed to sound internal trade and international capital movement after the crisis. We also looked at how it became difficult to manage the floating system in the style of the fixed exchange rate system as international capital movements expanded, and even if such management was maintained, it heightened other countries' protectionism and people's fears of it, leading to a strong support for and a shift to the *laissez-faire*-style operation of the floating system that let the market determine the exchange rate.

Here in Chapter 4, we will look at the process by which such advantages of the floating system turned out to cause problems as the scale of the international economy expanded further. In other words, we will look at the process by which the growing international trade and international capital transactions paralyzed the floating system's ability to prevent the divergence between fundamentals and exchange rates. We will also look at how the paralysis increased the authorities' fear of the potential damage that the paralysis could cause, propelling their support for the floating system and their development of policies and measures for the fortification of the system.

However, the specific nature of these efforts to strengthen the floating system differed from the nature of the efforts to strengthen the floating system discussed in Chapter 3. Whereas we saw in Chapter 3 the efforts to shift from the fixed-rate system-like operation of the floating system to the market-oriented, *laissez-faire* style floating system, we will look in this chapter at the efforts to shift from the market-oriented *laissez-faire* style floating system to the market-oriented but *non-laissez-faire* style floating system that implemented internationally coordinated intervention.

Before examining the actual historical process involved, which will be discussed in Section 2, we will first examine in Section 1 below some theoretical reasons.

Section 1 Framework - Demerits of the Floating Exchange Rate System

(1) One of the problems is that the floating system, which stimulated the international trade competition, ironically came to cause a slowdown in the competition over some products, as the scale of international capital movement expanded.

It Chapter 3, we saw that the floating system tends to promote the international competition because daily exchange fluctuation leads to more frequent fluctuation of price competitiveness among countries. Even considering the time lag that exists between currency adjustments and the adjustments of competitiveness, we can say that daily fluctuation contributes more to the adjustment of competitiveness than the case where there is no daily fluctuation.

However, as international capital movement expands and as the scale of speculative capital transactions exceeds the scale of capital transactions for trade, it becomes gradually difficult to see the adjustments happen, because, in such a situation, exchange rates tend to reflect countries' capital balance rather than trade balance.⁵²⁵ For example, in a circumstance where exchange rates reflect capital balance, a country's exchange rate can appreciate even when the country records a large trade deficit, and likewise, a country's exchange rate can depreciate even when the country records a large trade surplus.

There were some who perceived this clearly. For example, the economic journalist Paul Einzig explained as early as in 1970 that "The whole case for floating exchanges rests on the false assumption that all transactions in the foreign exchange market are of commercial origin. Its supporters are guilty of overlooking the elementary fact that transactions originating through capital transfers, speculation and arbitrage always divert exchanges from the rate at which supply and demand derived from imports and exports would balance."⁵²⁶ As Einzig pointed out with foresight, the divergence caused by capital movement became gradually prominent over time with the increase of international capital movements, and between the late 1970s and early 1980s, it became evident even to the active supporters of the floating system.

For example, although the U.S. trade deficit expanded dramatically from the early to mid-1980s, the capital inflow attracted by the high interest rate of the U.S. increased the demand for the dollar and kept the dollar rate at a high level. Then, the projection that the dollar would further rise invited more dollar-buying and became a real pressure for a further rise of the dollar. By this means, the floating system functioned in a way that widened the gap in the trade competitiveness, rather than stimulating the competition.

However, this is not the only reason why the floating system can slow down international competition. Unlike the fixed-rate system that suppresses a change in a country's price competitiveness for a prolonged period of time by fixing the exchange rate, the floating system does not determine price competitiveness as such. Under the floating system, in which exchange rates change frequently, a country with a rising exchange rate would continuously lose its price competitiveness in trade while continuously having more capital inflow thanks to its higher exchange rate. This gives birth to a tendency for that country to specialize in the financial industry rather than trade. In such a manner, the floating system can work to promote the separation between countries specialized in trade and countries specialized in financial industry, and thereby

⁵²⁵ Balance of capital account is the net result of public and private international investments flowing in and out of a country, whereas trade balance reflects the difference between the total value of exports and the total value of imports.

⁵²⁶ Einzig, Paul. *The Case against Floating Exchanges*. St. Martin's Press, 1970, ix. However, his opposition to the floating system showed that he did not realize the reality where the fixed-rate system was becoming no more sustainable in the face of the expanding international capital movement.

can slow down the trade competition between these two types of countries. Of course, not all the countries with rising currency value show tendency to specialize in financial industry. For instance, there is still severe competition between a country like Japan which maintains a certain level of trade competitiveness despite the yen's high exchange rate, and developing countries with lower exchange rates. But, from a general perspective, it can be said that a shift to the financial industry is more likely to occur in a country with a high exchange rate than in a country with a low exchange rate. And we can also say that the shift is more likely to occur in the floating system where exchange rates frequently change than in the fixed-rate system where a change in a country's price competitiveness is suppressed for a prolonged period of time.

One example of this is the United States' shift to the financial industry: In accordance with the Plaza Agreement in 1985, the major countries implemented coordinated foreign exchange interventions to correct both the much overvalued dollar and the global trade imbalance. After this action, the dollar started to drop and the U.S. exporters' price competitiveness improved, but another problem arose. As dollar-denominated investments became less attractive because of the weaker dollar, capital started to flow out of the United States. For the U.S., the aggravation of its capital balance was a graver problem than the trade deficit, because the U.S. had already become a country that largely depended on the international capital to finance its trade deficit. The Clinton Administration in the 1990s, hoping that a weak dollar would improve the U.S. trade balance, once resisted the policy that put emphasis on capital balance, but the administration soon turned to a strong-dollar policy to improve the U.S. capital balance, and even took steps to grow its finance industry to attract more international capital. In such a manner, the floating system can work to promote the separation between countries specialized in trade and countries specialized in financial industry and thereby can slow down the trade competition between these two types of countries.

What needs to be emphasized here is that this problem of the floating system did not grow on its own but worsened through the expansion of international capital movements. That is to say, if the scale of international capital movement is small, then the scale of capital inflow or outflow would be relatively small, and thus the pressure for currency appreciation or depreciation would also be relatively small. However, as the scale of the international capital movement expands, then the scale of capital inflow or outflow grows, and thus the pressure for currency appreciation or depreciation would also increase. This can promote the separation between countries specializing in trade and countries specializing in the financial industry and thereby can slow down the trade competition between these two types of countries. In such a manner, the structural contradiction of the floating system deepens as the international capital movement expands.

(2) The next problem of the floating system is that, because the exchange rate is relatively less constrained by international or domestic political agreements in the floating system than in the fixed-rate system, exchange rates under the floating system can fluctuate drastically in a way that does not reflect the trade competitiveness of countries, and thus, exchange rates may not reflect trade competitiveness in a timely manner.

In Chapter 3, it was explained that, compared to fixed currencies, floating currencies reflect changes in economic conditions in a timelier manner, because once the agreement to implement the floating system is reached, currencies can fluctuate automatically without being bound by international or domestic political consensus.

However, as international capital movement increases under the floating system and as countries' exchange rates become more likely to reflect their capital balance rather than their trade competitiveness, the absence of exchange control by political agreement can lead to a prolongation of the situation where exchange rates do not reflect their trade competitiveness. But this does not mean that exchange rates must reflect the trade competitiveness of countries. What is important here is the fact that the floating system did not work in the way its active theorists and supporters expected.

One of the examples is the aforementioned high dollar, which lasted for a long time between the early and mid-1980s without reflecting the expansion of the U.S. trade deficit. By that time, the scale of international capital transactions had grown to the point that it became difficult for one country to adjust its exchange rate through its own exchange policy. For the adjustment, internationally coordinated policies were needed. But, since no strong international agreement on currency adjustment was present, the period during which the dollar rate did not reflect U.S. trade competitiveness was prolonged.

And what needs to be emphasized here is that this problem of the floating system did not grow on its own but it is aggravated through the expansion of the world economy. That is to say, if the scale of international capital transaction is small, then the possibility that one country's market intervention can adjust its exchange rate is relatively high. But, as the scale of international capital transaction grows, even with several countries' simultaneous and large scale interventions, it becomes gradually more difficult to adjust the exchange rate in a timely manner. Naturally, without such agreement for a coordinated intervention, it would be even more difficult to do so. In such a manner, the structural contradiction of the floating system is aggravated as the international capital movement expands.

(3) The next problem of the floating system is that the failure of floating currencies to reflect the trade competitiveness of countries in a timely manner misleads decisions of monetary authorities, politicians, and economic agents and drives them toward wrong policies and economic activities.

In Chapter 3, it was explained that, because the floating system allows the exchange rates to reflect the economic condition of each country in a more correct and timely manner, under the floating system the authorities and economic agents can perceive the economic realities more accurately and take necessary steps gradually in accordance with the change in exchange rates.

However, as international capital movement increases under the floating system and thereby countries' exchange rates become more likely to reflect their capital balance rather than their trade competitiveness, it becomes difficult for economic agents to judge what would be the right economic strategy for them.

For example, if the exchange rates of countries had reflected their trade competitiveness during the 1980s, the dollar should have kept falling, reflecting the increase in the U.S. trade deficit. Then U.S. companies could have responded by making a gradual shift of their business strategy, such as a shift from an import-oriented strategy to an export-oriented one. But, despite the worsening U.S. trade deficit, the dollar stayed strong for too long even considering the J-curve effect (the time lag between currency adjustment and the adjustment of competitiveness), and therefore it became difficult for economic agents to judge what should be done to avoid economic losses and gain profits. For instance, at the time when it would have been better to prepare for a decrease in imports and an increase in exports based on the mid- to long-term prospect of dollar depreciation, companies were rather tempted to move toward focusing on the import or domestic market because those markets were easier to explore when the exchange rate was overvalued. The companies that moved in that direction must have either missed a large potential profit or suffered heavy losses by the drastic dollar depreciation that followed.

Moreover, even if the exchange rate does not reflect a country's trade competitiveness, it is still better if the exchange rate at least reflects the country's capital competitiveness (i.e., diversity in financial products, funding ability of financial institutions, degree of market liberalization for foreigners, etc.). This is so because trade competitiveness is not the sole factor that determines a country's economic strength. Capital competitiveness is another important factor. However, because a large portion of international capital is often attracted by a temporary exchange fluctuation or difference in interest rates, exchange rates tend to **reflect neither trade competitiveness nor capital competitiveness** as the scale of international capital transaction expands.

When this happens, it becomes difficult to decide what to do about changing exchange rates. For instance, if the exchange rate correctly reflects a country's capital competitiveness, then one's investment in that country can be seen as justifiable. But, in a situation where a large portion of international capital is attracted by a temporary trend in exchange rate or rise in interest rate, the exchange rate tends to move in a way that does not reflect a country's capital competitiveness, and because of it, both monetary authorities and economic agents can be swayed by such temporary factors and make wrong economic decisions.

And what needs to be emphasized here is that this problem of the floating system did not grow on its own but it was aggravated through the expansion of international capital movement. That is to say, if the scale of international capital transaction is small, then the fluctuation of an exchange rate and the degree at which the exchange rate distorts the trade and capital competitiveness will be contained within a relatively small range. But, as the scale of international capital movement grows, the fluctuation of an exchange rate and the degree at which the exchange rate distorts trade and capital competitiveness become relatively larger. In such a manner, the structural contradiction of the floating system is aggravated as the international capital movement expands.

(4) The next problem of the floating system is that, although speculation that targets a change in the exchange rate are dispersed by the daily rate fluctuation under the floating system, such dispersion gradually fails to contain the pressure of speculation because its

sheer size comes to nullify the dispersion effect as the scale of international capital movement grows. Consequently, the exchange market becomes unstable even under the floating system.

In Chapter 3, it was explained that, unlike the fixed-rate system which invites a high concentration of speculation that targets a change in exchange rate, the floating system disperses such speculation because it allows daily fluctuation of exchange rates.

However, actual historical development shows us that the floating system's speculation dispersion effect soon became ineffective. Even with the dispersion effect, the daily scale of speculation became too big to contain, as the scale of the international capital movement expanded. And as a result, exchange rates came to fluctuate unstably and drastically. Moreover, when it was observed that an exchange rate could be greatly affected by speculation despite the floating system's speculation dispersion effect, speculators started to concentrate their speculation **along the direction of exchange fluctuation**, making the dispersion effect more ineffective. As a result, we came to see more instances where concentrated speculation invited drastic exchange fluctuations. When a signal of currency appreciation attracted international capital, the inflow of the capital pushed the value of the currency further up, and the appreciation of the currency again attracted more international capital. In such a way, speculations came to cause disruptive rate fluctuations under the floating system.

And what needs to be emphasized here is that this problem of the floating system did not grow on its own but it was aggravated through the expansion of international capital movement. That is to say, if the scale of international capital movement is small, then the exchange rate fluctuation can be minimized by the floating system's speculation dispersion effect. But, as the scale of international capital movement grows, then the fluctuation of exchange rate affected by speculation becomes too big to contain even with the dispersion effect. In such a manner, the structural contradiction of the floating system aggravates as the international capital movement expands.

Section 2 Historical Development

In Section 1 above, we have looked at some problems of the floating system from a theoretical perspective. In this Section 2, by focusing on both Japan and the world, we will study how those problems took on historical significance, and how the aggravation of those problems heightened fear among politicians, monetary authorities, economic experts, and business communities over a possible loss of wealth that Japan had accumulated, and prompted them to stabilize and strengthen the floating system.

(1) Shift to the Floating System Based on Coordinated Intervention: From the Late 1970s to the Mid-1980s

In the previous chapter, we saw the process by which the expansion of the international capital movement gradually disabled the fixed-rate system-like operation of the floating system, and propelled the shift to the market-oriented, laissez-faire style floating system. However, the expansion of international capital movement was forcing Japan and the world to further transform their operation style and reinforce the floating system: As stated in Section 1, although the market-oriented laissez-faire style floating system had the capacity to disperse speculation by allowing daily fluctuation of the exchange rate, the scale of international capital movement had become so large that, even with the dispersion effect, speculation-led drastic rate fluctuation became difficult to suppress. Moreover, as explained in Section 1, when it was observed that an exchange rate could be greatly affected by speculation despite the floating system's speculation dispersion effect, speculators started to concentrate their speculation along the direction of exchange fluctuation, making the dispersion effect more ineffective. As a result, we came to see more instances where concentrated speculations invited drastic exchange fluctuation.

One of the instances that demonstrated such situation was the sharp yen hike that lasted even after Japan shifted its mode of operating the floating system in late March 1978. As described in the previous chapter, the rapid appreciation of the yen prior to late March 1978, which could not be stopped even with major-scale interventions, was something that already showed the overwhelming volume of international capital transactions. Then, the monetary authorities reached the decision to stop intervention in late March 1978, judging that the deviation of the exchange rate from the fundamentals occurred because forcible interventions allowed speculators to see the government's defense line and thus invited their speculative attack. They judged that, if the exchange rate fluctuation was left to the market, then speculators' market forecast and the resulting speculation would be dispersed and the exchange rate would settle down to where it should reflect the fundamentals. But, even after leaving the exchange rate largely to the market, it did not stabilize by the dispersion effect. Rather, the yen-buying continued incessantly, in expectation of its further rise. As a result, the yen steeply rose from around 220 yen in late March 1978 to 175 yen in only a few months, by late October 1978. This happened when it was commonly analyzed in Japan that 230-265 yen was an appropriate exchange

rate in consideration of purchasing power parity and break-even point for exports.⁵²⁷ Even if the increase in international capital transactions was not the only factor that caused the yen's hike, such a steep hike in a short period would not have happened if the absolute volume of the capital transaction was small.

And, in the midst of such steep appreciation, it was natural that the sense of crisis mounted. For example, when the yen hit 190 yen per dollar, Ichiro Yamazaki, a manager at the research department in Daiwa Securities, had the following to say regarding the situation of Japanese exporters: "190 yen is quite an overvaluation ... many fields of export are already overwhelmed by the rate over 200 yen ... A decrease in export will have a large deflation effect because, for Japan, exports have in large part sustained the domestic economy ... The contribution ratio of export for Japan's real economic growth was 27 % [in 1977]. For the first quarter of this year [1978], during which an annualized rate of real economic growth was 10%, export's contribution ratio was 55%. This clearly shows the scale of the negative impact that the yen appreciation would have."⁵²⁸

The Japanese export industry had been in a good condition, but the yen's steep rise in 1978 was expected to have a large impact on it and the Japanese economy as a whole after a certain time lag. For that matter, the monetary authorities were under pressure to reconsider the market-oriented laissez-faire style operation of the floating system.

However, it was not only Japan that was under such pressure in the face of increasing international capital transactions and the drastic exchange rate fluctuations they caused. The U.S. was also in the same situation. The dollar had been falling since 1977, and the U.S. government let it fall. But, because the rapid depreciation of the dollar caused a rise in import prices, it further accelerated the ongoing inflationary trend in the U.S. and invited capital outflow from the country. Thus, the U.S. was under pressure to intervene to defend the dollar.

Consequently, the U.S. changed its stance and started to shift toward defending the dollar. Specifically, on October 19th 1977, Secretary of the Treasury W. Michael Blumenthal stated at the annual general meeting of the American Banking Association that the strong and stable dollar was essential for the whole world. Similarly, Federal Reserve Chairman Arthur F. Burns stated at the Senate Banking Committee on November 9th that the Federal Reserve Bank would endeavor to maintain the strong dollar. And finally, on December 21st 1977, President Carter expressed his willingness to defend the dollar and to implement coordinated market intervention with other countries.⁵²⁹ In January 1978, the U.S. Treasury and the Federal Reserve Board released a joint statement, announcing a new currency swap agreement with the Bundesbank of West Germany and that they obtained promises from foreign monetary authorities to join coordinated intervention. In March, the U.S. and West Germany issued a joint statement that revealed their adoption of such measures as raising the currency swap ceiling and provision of the mark by selling SDR.⁵³⁰

⁵²⁷ Ishimaru, Yoshitomi. *Endaka to Nihon keizai*. Mainichi Shinbunsha, 1978, 87-100; Volcker, Paul. and Gyohten, Toyoo. *Tomi no kobo - En to doru no rekishi -*. Toyo Keizai Shinposha, 1992, 231-232.

⁵²⁸ Yamazaki, Ichiro. "Gyoshubetsu no meian ukibori ni." *Nihon Keizai Kenkyu Senta*, 15 October 1978, 31-32.

⁵²⁹ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 111.

⁵³⁰ Tsuchiya, Rokuro ed. *Hendo sobasei*. Chuo Daigaku Shuppanbu, 1980, 277.

After the announcement of the dollar-defense policy, the Under Secretary of the Treasury Solomon made clear that the new policy went far beyond the pre-Nov. 1 pattern, when intervention was limited merely to counter what were termed “disorderly markets.”⁵³¹ As he said, the new policy was different from the earlier market-oriented laissez-faire policy which rejected any intervention against the basic market trend.

However, despite the fact that the new policy aimed at reversing the market trend, it did not mean, Solomon added, that the U.S. had a specific dollar rate in mind to defend.⁵³² For that reason, there was no large-scale intervention. For example, on February 16th 1978, Solomon commented to the press that the U.S. monetary authorities had not intervened in the market for the past three weeks. Some dealers interpreted this to mean that the U.S. was resuming its policy of “benign neglect” toward the dollar, and they started selling hectically. Later Solomon issued a statement asserting his earlier words had been misinterpreted. He said that because of quiet conditions on the market over the past three weeks there wasn’t a need for the U.S. to support the dollar. And he added that “in the last two or three days, the market has been disorderly and we have intervened.”⁵³³ From this we can see that, despite the emergence of the new operation style of the floating system, the U.S. did not quite actively push it at this stage. (As will be explained later, it became active in late 1978.)

However, in the circumstance where the U.S. current account deficit and its inflation were worsening, the market judged that such an ambiguous dollar defense policy would not reverse the market trend. As a result, the dollar-selling continued well into 1978. By the end of October 1978, the dollar had lost almost a quarter of its value compared to its value in the beginning of the year, and the inflation rate was up to around 9%. Then, from September to October 1978, a sense of crisis that any more depreciation of the dollar and inflation were risky arose in the U.S., and the monetary authorities started to tackle the dollar defense issue more seriously.

Paul Volcker, then the President of the Federal Reserve Bank of New York, recalls the situation as follows: “Anthony Solomon ... calling Toyoo Gyohten among others to an emergency consultation in Washington ... Solomon achieved quick agreement on plans to mass resources to support the dollar, plans that in sheer volume would dwarf any previous package: augmenting swap lines by 7.6 billion dollars with the German, Japanese, and Swiss central banks to a total of 15 billion dollars; borrowing 10 billion dollars in foreign currencies through ‘Carter bonds,’ use of 2 billion dollars in SDRs, and a drawing of 3 billion dollars on the IMF ... Federal Reserve Board in Washington, which had been resistant to strong monetary restraint, would approve a 1 percent increase in the discount rate as part of the package [8.5%→9.5%] ... here we were, back to ‘defending’ an exchange rate, with a more vigorous (if quite tardy) use of monetary policy than had ever been invoked under Bretton Woods.”⁵³⁴

In the package above, to focus on the agreement with Japan, the swap ceiling between the Bank of Japan and the FRB was raised from 2 billion dollars to 5 billion dollars. It was also decided, out of the total amount of the loan from the IMF, to use the yen

⁵³¹ “No Limits on Intervention For Dollar, Official Says,” *Washington Post*, 20 November 1978.

⁵³² *Ibid.*

⁵³³ “Confusion Reigns as Traders Sell Dollars In Reaction to Remarks by Treasury Aide,” *The Wall Street Journal*, 17 February 1978.

⁵³⁴ Volcker, Paul. and Gyohten, Toyoo. *Changing Fortunes*. Times Books, 1992, 150-151.

currency for 1 billion dollars. Moreover, it was decided to sell 640 million dollars worth of the SDR to Japan. In sum, a total amount of about 6.5 billion dollars was prepared as an intervention fund for the stabilization of the dollar-yen exchange rates.⁵³⁵

Based on these agreements, the U.S. announced the comprehensive dollar-defense package on November 1st 1978, and with it, they commenced active market intervention. In November alone, the U.S. dollar-buying intervention amounted to 3.47 billion dollars (2.92 billion dollars against the mark, 350 million against the Swiss franc, and 200 million against the yen.⁵³⁶). And between November and December, the U.S. procured approximately 12 billion dollar-worth of foreign currencies, and sold about 6.6 billion dollars of them in the market.⁵³⁷

This dollar-defense package of November 1978, unlike the dollar-defense policy that was taken a year before, turned out to be successful. The dollar rate, which was 176 yen per dollar before the announcement of the package, became 200 yen per dollar by late November. The reasons for this success were that, first, the market participants had already started to feel the ongoing yen appreciation and dollar depreciation as excessive, and second, Japanese current account surplus was on the decline as a result of the impact of the high yen that appeared after a time lag, and Japan's long-term capital balance deficit was on the increase.⁵³⁸ Another important reason for the success was that the major countries arranged a large amount of funds and expressed their intention to implement coordinated intervention. Toyoo Gyohten, then Deputy Vice Minister for International Affairs, who had an informal meeting with Solomon in late October and participated in the dollar-defense plan, referred to that point as follows: "Other reasons for success were that the package was comprehensive, large, and concerted. The Treasury had taken many measures to defend the dollar during 1978, but they were announced piecemeal and in a halfhearted way, and therefore never succeeded in influencing the market psychology. In fact, a check of the market movements confirms that every time the Treasury announced one of these piecemeal measures, the dollar dropped some more. As for size, a 30 billion dollars war chest was a big amount in those days, and the fact that it was backed by the United States, Japan, Germany, and Switzerland impressed the market and changed the entire climate."⁵³⁹

At first glance, this new currency policy for the defense of the dollar may seem to have symbolized a "return" to the paradigm of the fixed-rate system. To quote again, Volcker also described the dollar defense policy as if it was a return to the previous foreign exchange policy: "we were, **back to** 'defending' an exchange rate, with a more vigorous (if quite tardy) use of monetary policy than had ever been invoked under Bretton Woods."⁵⁴⁰ (Emphasis by author).

However, the currency policy that was suggested and implemented during this period was fundamentally different from the previous one on the following points: (1) During

⁵³⁵ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 150.

⁵³⁶ FRBNY, Quarterly Review, Spring 1979, 73, 77, 79.

⁵³⁷ Tsuchiya, Rokuro ed. *Hendosobasei*. Chuo Daigaku Shuppanbu, 1980, 278.

⁵³⁸ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 125.

⁵³⁹ Volcker, Paul. and Gyohten, Toyoo. *Changing Fortunes*. Times Books, 1992, 159.

⁵⁴⁰ *Ibid.*, 151.

the time when the floating system was operated in the style of the fixed-rate system, countries sought to maintain their exchange rates within a certain range. That is to say, they **determined in advance** what exchange rate would be appropriate to reflect their economic fundamentals, and then attempted to keep the rate. But the above dollar-defense package was different from such an approach. The policy of the package was that it basically left the exchange rate fluctuation to the market; only if the gap between the exchange rate and the fundamentals was conspicuously widened and the correction of the gap was conspicuously delayed **as a result of** the free movement of the market, countries were encouraged to cooperate with each other in creating a chance to reverse the trend and correct the gap. Therefore, the dollar-defense policy was not something that symbolized a “return” to the fixed-rate system-like operation of the floating system. Rather, it signified a shift to a policy that prepared for internationally coordinated intervention in excessive cases, upon basically affirming the logic of the market.

In other words, the implementation of this dollar-defense package symbolized a **transition from a market-oriented and laissez-faire style floating system to a market-oriented but *non-laissez-faire* style floating system based on internationally coordinated intervention. And this transition, as seen earlier, was promoted by the fear that drastic exchange rate fluctuations deviated from the real economic conditions of countries would incur a large economic damage (i.e., losses of the Japanese export industry, inflation in the United States, capital outflow, losses that would be incurred by the emergence of protectionism)**. This operating style of the floating system comes to the fore only when exchange rates largely deviate from the fundamentals, and thus it is not easy to discern it as the era-defining operation style of the floating system. But, in the face of huge capital movement that determines the market trend, large-scale coordinated intervention is the only method that has an immediate effect of reversing the trend, and therefore the new operation style of the floating system gradually came to be established as the era’s standard operation style of the floating system (as will be explained in detail below).

In addition, the dollar-defense policy was, as partially expressed in the words of Gyohten above, different from the previous currency policy on the following points as well: (2) It is true that even before the implementation of the dollar-defense package, there were interventions based on international agreements for coordinated actions. However, the actual implementation of intervention itself tended to be at the individual discretion of each country; each country chose the scale and timing of intervention at its own discretion. But, in the case of this dollar-defense package, the contents of coordinated intervention were prearranged before announcement, and they were announced to the world as one comprehensive measure, giving the market an impression that the intervention was a **gigantic collective will. Each country’s individual measures were becoming increasingly powerless against the force of expanding international capital movements and the force of the market, but as soon as countries revealed their concerted will to implement large-scale intervention, speculators judged that the market trend might reverse.** (3) If the amount of intervention was small, then the market would not have taken it seriously, regardless of whether the intervention was an internationally coordinated one or not. However, the amount of funds prepared for this comprehensive package was 30 billion dollars. What is important here is not only the amount itself but also the fact that the world was informed that such a large amount of

money was ready to be used. The market received an impression that it would be difficult to fight against it.

As such, the dollar-defense package reversed the excessive strong yen and weak dollar trend from November 1978. And, the second Oil Crisis that broke out soon after the implementation of the package made the reversed trend decisive. When the Iranian Revolution took place in December 1978, oil exports from Iran were suspended and the oil price started to increase. As was the case in the 1973 Oil Crisis, Japan, an oil-importing country, was considered vulnerable to such a situation, and therefore the second Oil Crisis accelerated the depreciation of the yen. The yen rate, which was around 195 yen per dollar in late 1978, fell to around 220 yen by late April 1979. In the meantime, the Japanese monetary authorities continued their market-oriented policy (at this point, Japan itself had not yet shifted to the new operation style of the floating system although Japan assisted the U.S. dollar-defense package). They surely intervened in the market, but they did so *not* to reverse the trend but to smooth out disruptive rate fluctuations. Between early 1979 and May 1979, 8.7 billion dollars were used for the interventions.⁵⁴¹ Also, they raised the official bank rate from 3.5% to 4.25% in April 1979, then again to 5.25% in July, in order to contain inflation. This is considered to have eased the pressure of yen depreciation as well. Then, perhaps thanks to these measures, the yen rate moved stably at around 220 yen per dollar from May to August 1979. However, concerns over aggravating Japanese current account deficit and the possibility of higher inflation grew in the market, and this caused the yen rate to fall from late August. The exchange rate fell down to around 250 yen per dollar by late November 1979 and maintained that level until March 1980.

The lower yen was favorable for the Japanese manufacturing industry, but the Japanese monetary authorities began their endeavor to raise the yen value at this point. This may seem contrary to the market-oriented operation style of the floating system that does not interfere with the market trend unless there is disruptive fluctuation. In fact there were people like the Bank of Japan Governor Haruo Maekawa, who regarded the fluctuation of the yen at the time as clearly a disruptive one.⁵⁴² But this time their intention in exchange rate control was not an improvement of their trade balance but suppression of inflation. As one senior official testified, the absorption of the yen through the intervention was necessary to suppress inflation even though they knew it would not reverse the direction of the market.⁵⁴³ Japan already had an experience of missing the timing for a restrictive monetary policy at the time of the first Oil Crisis and letting the wild price spiral happen. Thus, the monetary authorities were more sensitive to the issue of inflation and took an aggressive attitude toward it.⁵⁴⁴ For that reason, following the aforementioned rate increase, they raised the official bank rate from 5.25% to 6.25% in November 1979, and again to 7.25% in February 1980. Their decision to use foreign exchange intervention to prevent inflation was the one that was made on top of these anti-inflation efforts.

⁵⁴¹ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 130.

⁵⁴² *Nihon Keizai Shimbun*, 3 March 1980.

⁵⁴³ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 151.

⁵⁴⁴ Ota, Takeshi. *Kokusai kin'yu - Genba kara no shogen*. Chuko Shinsho, 1991, 58.

Moreover, the Japanese monetary authorities announced a yen defense package on March 2nd 1980. The contents were as follows: (1) An agreement with the U.S. authorities to intervene in consultation with Germany and Switzerland to support the Japanese yen. (2) The U.S. authorities intervene in the New York foreign exchange market and make a swap agreement with the Bank of Japan when necessary (3) Allowing Japanese banks abroad to send funds to the head office in Japan through their interoffice accounts. Removing the ceiling on the interest rate for the free-yen accounts held by nonresident official and international entities. Allowing commercial banks to secure “impact loans” on their own account.⁵⁴⁵

Then, in accordance with the yen-defense policy, yen-buying intervention was made in Tokyo, New York, and Switzerland, and swap agreements were made among the Bank of Japan, the Swiss National Bank, and the Bundesbank. In addition to such measures, the Bank of Japan raised the official bank rate from 7.25% to 9% on March 19th to suppress inflation. This narrowed the difference in interest rates between Japan and the U.S. and thereby somewhat relieved the yen-selling pressure in the market. (Even before the Oil Crisis, the U.S. official bank rate was set at high level because inflation in the U.S. was already serious. The official bank rate was 9.5% since November 1978, but they raised it further up to 10% in July 1979, 10.5% in August, 11% in September, 12% in October, and finally to 13% in February 1980). Moreover, although Japan’s international balance of payments deficit was continuing, it began to show some recovery. The above developments caused the yen to rise gradually from April, raising it to 220 yen per dollar by late May 1980. Inflation began to stabilize since May as well.

After May 1980, prices in Japan began to stabilize, the yen settled at around 220 yen for several months, and the Japanese economy started to recover its credibility. Inflation had been stabilized to the point that, although the Bank of Japan lowered the official bank rate to 8.25% in August in order to stimulate economy, the market judged that 8.25% was still not low enough, considering the deceleration rate of inflation.⁵⁴⁶ The spot price for oil soared when the Iran-Iraq War broke out in September 1980, but the prices in Japan were not very much affected. The Bank of Japan even cut the official bank rate to 7.25% in November 1980, then again to 6.25% in March 1981. One can point out that the inflation rate in Japan was still as high as 7.81% in 1980, but it was much lower than United States’ 13.5%, Britain’s 16.85%, and France’s 13.06%. The Japanese economy was healthier, relatively speaking.

On the other hand, even in 1981, many other countries continued to struggle with inflation. In 1981, the average inflation rate was as low as 4.91% in Japan, while it was 10.38% in the U.S., 13.33% in France, and 12.19% in Britain. In such a situation, the U.S. could not lower its official bank rate. Although the U.S. gradually lowered it from 13% (in the beginning of 1980) to 10% by July 1980, they had to raise it back to 13% by December 1980 and eventually to 14% in May 1981, as the Iran-Iraq War broke out in September and concerns over oil price hike and inflation grew. Afterwards, the official bank rate underwent gradual reduction but still remained relatively high. Specifically, it

⁵⁴⁵ Bigman, David and Yaya, Teizo eds. *Floating Exchange Rates and the State of World Trade and Payments*. Beard Books, 2002, 234-235; Nihon ginko hyakunen-shi hensan iinkai ed. *Nihon Ginko hyakunen-shi 6-kan*. Nihon ginko, 1986, 514.

⁵⁴⁶ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 131.

remained as high as 13% in October 1981, 12% in December 1981, 11% in July 1982, 10% in August, 9% in November, and 8.5% in December 1982. And, by maintaining the official bank rate at such a high level, the inflation rate in the U.S. came to stabilize at last. The inflation rate became 6.16% in 1982, and went further down to 3.16% in 1983.

However, the high interest rate that was maintained for a long period generated some problems. It accelerated capital inflow into the U.S., increased the demand for the dollar, and caused the dollar to rise. Although the U.S. dollar in theory should have been declining because of the continued increase in the U.S. current account deficit, it was staying at high level because of the capital inflow attracted by the high interest rate. And the high dollar put the U.S. exporters at a disadvantage. Japanese capital partially contributed to this; life insurance companies and others were making a heavy investment in long-term U.S. treasury securities that had a better rate of return compared to the Japanese government bonds.

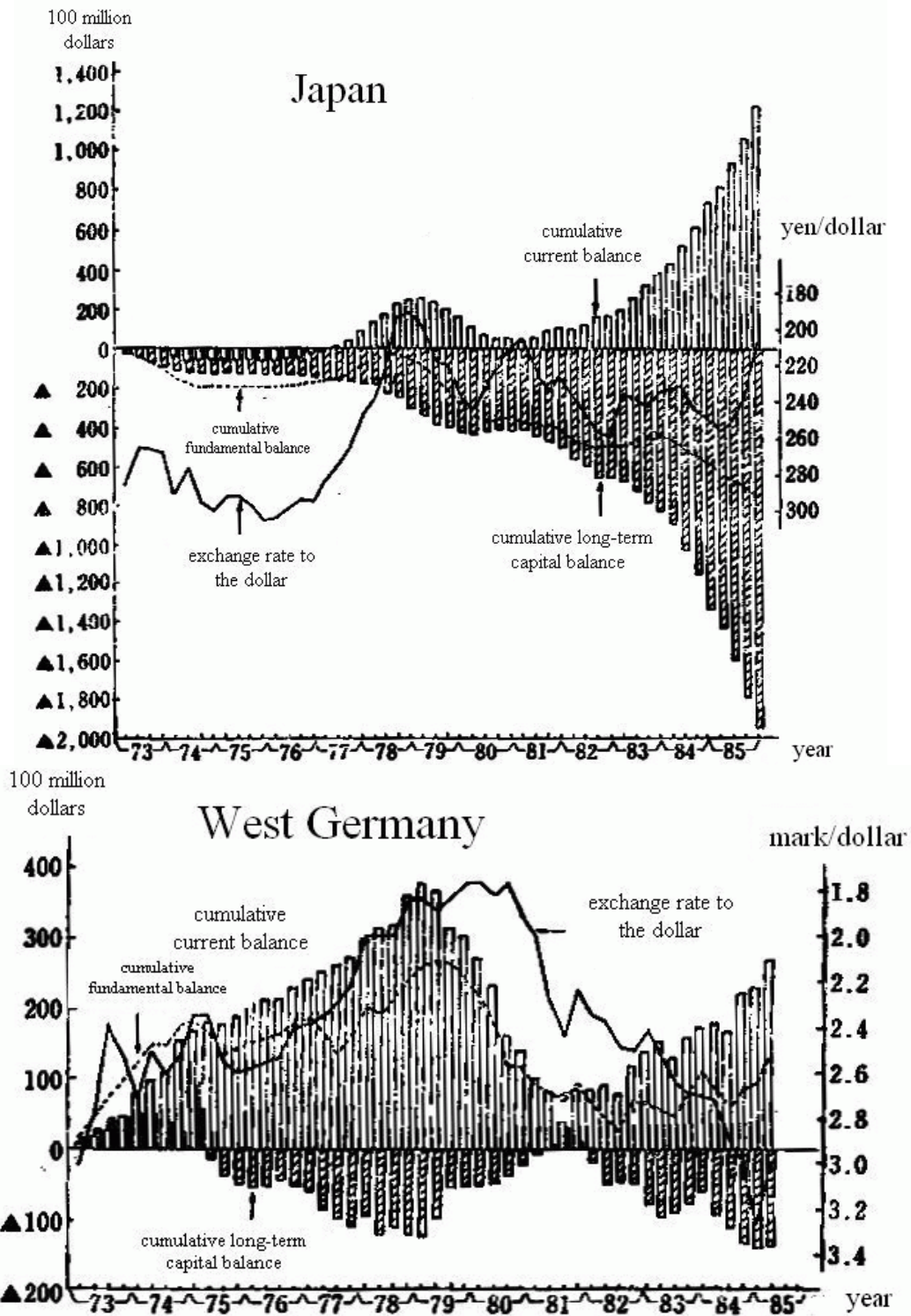
In contrast, Japan was successfully getting out of the chaos of the second Oil Crisis, and increasing its trade surplus based on stable domestic prices and the stable yen rate. However, the yen rate, which ought to have gone up in reflection of Japan's improving economic performance, even fell in this period because of the capital outflow to the United States. To see the specific numbers, primarily due to an improvement in trade balance, Japan's current account surplus dramatically increased from 9.13 billion dollars in 1982 to 24.23 billion dollars in 1983 and to 37.01 billion dollars in 1984. But in the meantime, the yen rate fell, from around 200 yen per dollar in January 1981 to around 250 yen by June 1982, and then to 275 yen by October 1982. Although the yen rate slightly went up to around 240 yen in 1983 and to 225 yen in April 1984, it again fell to 250 yen by October 1984. Judging from the purchasing power parity, the adequate level of the yen rate in 1982 was 223 yen, 217 yen in 1983, and 210 yen in 1984.⁵⁴⁷ From this, we can say that the yen rate at the time was at a very much undervalued level. In short, the yen exchange rate no longer reflected the actual trade competitiveness of the Japanese economy.

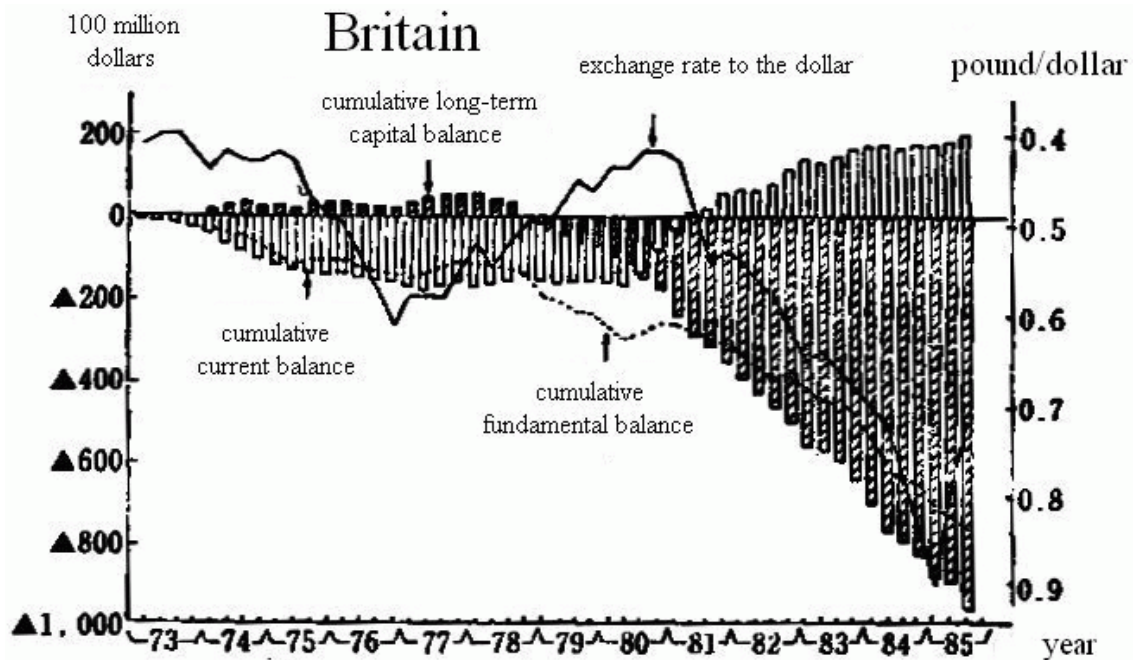
However, this gap between the exchange rate and trade performance was not only the story of Japan and the United States. The fact that the international capital movements made exchange rates unable to reflect countries' trade competitiveness was largely applicable to many other countries that had been promoting liberalization of capital movement in tune with their economic growth. For example, *Tsusho Hakusho 1986* (White Paper on International Economy and Trade 1986) explicitly points this out. The figures below from the White Paper show the relationship between the exchange rate and current account balance. We can see that, in all three countries until 1980 and 1981, their aggravated current account balance was accompanied by a fall in their currency, and their improved current account balance was accompanied by a rise in their currency. From this we can assume that the balance adjustment function of the floating system was at work. However, from around 1981, the currencies of Japan, West Germany, and Britain depreciated against the dollar, despite their improved current account balances.⁵⁴⁸ The figures also indicate that, even considering the possible time lag predicted by the J-curve effect, the period of time during which the exchange rates did not reflect the current account balance was notably long, and the exchange rates even moved in the opposite

⁵⁴⁷ Araki, Nobuyoshi. *En - Ichioku nin no kokusai kin'yu*. Nihon Kanzei Kyokai, 1989, 13-14.

⁵⁴⁸ Tsusho Sangyo Sho ed. *Tsusho hakusho 1986*. Okurasho Insatukyoku, 1986, 92.

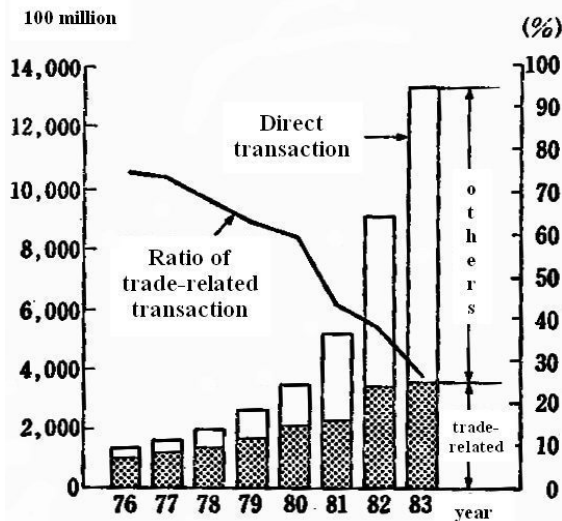
The Relationship between the exchange rate and international balance of payments



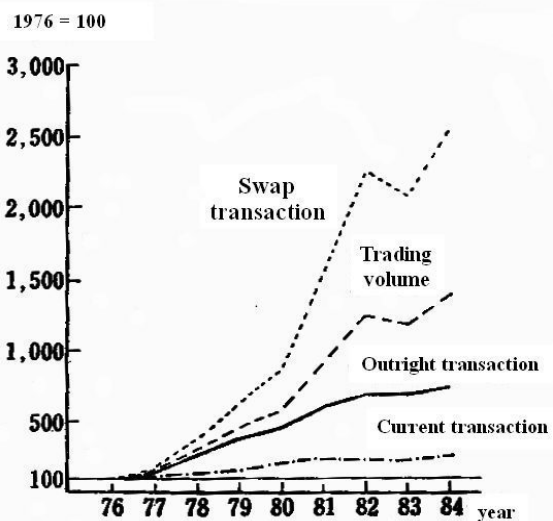


From *Tsusho hakusho* (White Paper on International Economy and Trade) 1986, 93.

Customer transaction (spot trading) in Japan



Dollar trading volume and current transaction in interbank market



- * Outright transaction = spot trading + futures trading
- * Trading volume = outright transaction + swap transaction
- * Current transaction = export + import + invisible receipts + invisible payments + transfer receipts + transfer payments

From *Tsusho hakusho* (White Paper on International Economy and Trade) 1986, 93.

direction from what they were expected to take. With the figures above, the White Paper 1986 explains that the exchange rates stopped reflecting countries' trade competitiveness because the expansion of international capital movement caused their capital balance, rather than trade competitiveness, to determine the level of their currencies' exchange rates. The figures indicate that, although the whole volume of customer spot trading rapidly increased from around 1980, the increase in trade-related transaction was slow, and the percentage of the trade-related transaction sharply dropped from 75% in 1975 to 26% by 1983. This reflected the fact that non-trade-related capital transaction conspicuously expanded,⁵⁴⁹ and the reality where the exchange rate came to be determined more by a country' capital balance than its trade balance.

But what was the reason that the volume of capital transaction expanded so much? It was, of course, because of this cycle: the increase in capital transaction helped the world economy grow and such growth in turn brought about further increase in capital transactions. But especially, the major countries' shift to the floating system was a trigger. In short, to allow exchange rate fluctuations is to loosen the regulations on capital transactions, and to loosen the regulations on capital transactions is to create new chances for financial income and thus to stimulate more capital transfers. In such a manner, the floating system accelerated the expansion of international capital movement.⁵⁵⁰ And Japan was part of this trend. In Japan, there was a thorough revision of the Foreign Exchange and Foreign Trade Control Law in 1980, which substantially relaxed the regulations on domestic and foreign capital transfer. As a result, capital movement grew more rapidly than the movement of goods and services.⁵⁵¹

Thus, the scale of international capital transactions further expanded. And, as the expanded capital transaction started to affect exchange rates, the exchange rates gradually stopped reflecting countries' trade competitiveness, as explained earlier. Active advocates of the floating system had been claiming that the floating system had an automatic balance adjustment function; the trade balance alters the exchange rate and then the altered exchange rate adjusts the trade balance. But, as the scale of international capital movements grew, the alleged automatic adjustment function came to have little effect on correcting the balance of payments. Obviously, the argument for the floating system's balance adjustment function had not taken the impact of growing capital movement into account.

It was a new phenomenon that the increased scale of capital movement should cause exchange rates to stop reflecting countries' trade competitiveness. Thus there were many who did not understand that the increased capital movement was responsible for the phenomenon. For instance, some in U.S. industry thought that the reason the yen stayed weak despite Japan's growing trade surplus was that Japan was still making aggressive foreign exchange interventions. One example is Lee Morgan, Chairman of Caterpillar

⁵⁴⁹ Tsusho Sangyo Sho ed. *Tsusho hakusho 1986*. Okurasho Insatukyoku, 1986, 92-97.

⁵⁵⁰ Iwami, Tooru. *Kokusai tsuka kin'yu shisutemu no rekishi*. Yuhikaku, 1995, 140.

⁵⁵¹ Koizumi, Ryuji. "Shin hoshiki no nikokukan kosho - NichiBei en doru iinkai." in Kuroda, Haruhiko ed. *Kokusai kosho - Ibunka no shogeki to taio*. Kenkyusha Shuppan, 1996, 125.

Tractor and Chairman of the Business Roundtable Task Force, who assumed that the yen was being manipulated by the Japanese Ministry of Finance.⁵⁵²

But the Reagan administration was dismissive of such claim at first. For example, denying such claims, Under Secretary of Treasury Beryl W. Sprinkel maintained that the causes of the weak yen were capital outflow from Japan and the increase in the dollar demand.⁵⁵³ The reason the Reagan administration did not embark on the correction of the high dollar was, for one, because of the unpleasant experience of the weak dollar during the period of the Carter administration that stimulated inflation. In the first place, recessionary inflation during the period of the Carter administration was one of the important causes that brought Reagan in, and thus the Reagan administration did not want to embark on something that could stimulate inflation. Another reason was the general trend toward neo-liberalism or market fundamentalism at the time. Around the time of the Premiership of Margaret Thatcher in Britain which started in 1979, big government, extensive public expenditures, government regulations on the market and industries, and the protection of uncompetitive domestic industries began to be blamed as the sources of recession in Britain. Thatcher implemented neo-liberal policies as the cure. Reagan shared the same economic view, and thus the correction of the high dollar by government intervention was against his stance. Also in the background was the fact that, in the U.S. economy, the weight of the manufacturing and agricultural industries that wanted a weak dollar had been reduced while the weight of the service sector (e.g., financial industry, information and communication industry) that wanted a strong dollar had been increased. Moreover, the Republican Party to which Reagan belonged had the service sector as their strong supporter.⁵⁵⁴ In addition, as the U.S. fiscal condition deteriorated, the attraction of international capital became increasingly vital to supplement the insufficient private saving in the United States.⁵⁵⁵

But the U.S. government's tolerance toward the strong dollar seemed contrary to the market-oriented but *non-laissez-faire* operation style of the floating system. In the eyes of many, the dollar seemed to be largely diverging from the economic fundamentals of the U.S., and thus internationally coordinated intervention was expected, but the U.S. government was leaving the deviation untouched. This was a period when the non-laissez-faire operation style of the floating system that emerged at the time of the dollar-defense policy of 1978 set back temporarily, primarily due to the Reagan administration's ideology of market fundamentalism.

Against this backdrop, a working group was established to conduct research on the effect of foreign exchange intervention. The resulting report (called Jurgensen Report) was released at the G5 summit in April 1983. One of its conclusions was that coordinated intervention can be much more powerful relative to official intervention by a single country's authorities. This positive evaluation of coordinated intervention was also expressed at the Williamsburg summit held in May 1983. There, the Finance Ministers

⁵⁵² Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 72.

⁵⁵³ For details, see Koizumi, Ryuji. "Shin hoshiki no nikokukan kosho - NichiBei en doru iinkai." in Kuroda, Haruhiko ed. *Kokusai kosho - Ibunka no shogeki to taio*. Kenkyusha Shuppan, 1996, 119.

⁵⁵⁴ Funabashi, Yoichi. *Tsuka retsuretsu* (Japanese version of *Managing the Dollar*). Asahi Shimbun, 1992, 99.

⁵⁵⁵ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 165.

and central bank governors announced in a communique that, “While retaining our freedom to operate independently, we are willing to undertake coordinated intervention in exchange markets in instances where it is agreed that such intervention would be helpful.” Thus, on the international level, it was confirmed that coordinated intervention would be implemented when necessary. However, after the communique was issued, Secretary of the Treasury Donald Regan said at a press conference that he could hardly imagine a situation where intervention would in fact be helpful. He revealed that the Reagan administration had no intention to change its hands-off policy.⁵⁵⁶

However, in accordance with the agreement made at the summit, a coordinated intervention was implemented by the U.S., Japan, and West Germany in August 1983, after experiencing a continuous rise of the dollar in July.⁵⁵⁷ However, the intervention was meant to cause only a slight moderation of the rise. The Reagan administration, which believed in market fundamentalism, did not have any intention to implement strong intervention.

However, against the noninterference policy of the Reagan administration, demands to correct the dollar rate reemerged from within the United States. The aforementioned Lee Morgan, after being refuted in his claim that Japan was manipulating the yen rate, did not give up and moved on to ask David C. Murchison, a Washington attorney, and Ezra Solomon, a Stanford University economist, to examine the misalignment of the dollar and the yen. Their report was submitted in September 1983 and distributed.⁵⁵⁸ It claimed that the yen was at a low level because of Japan’s closed financial system and their measures to curb capital inflows, and that yen appreciation should be induced by promoting financial deregulation in Japan, expanding the euro-yen market, and thereby increasing the attractiveness of the yen-based assets.⁵⁵⁹

One could expect that this allegation too could be denied by the market fundamentalist Reagan administration. But the political campaign for correcting the yen rate based on this allegation was, unlike the earlier argument that Japanese monetary authorities were suppressing the yen rate through intervention, accepted by Washington.⁵⁶⁰ The reason, according to the journalist Yoichi Funabashi, was that the trade deficit problem had surfaced as a presidential campaign issue by this time. Reagan’s campaign strategists found it expedient to attribute the trade deficit to the yen. It was not the dollar that was too strong, but the yen that was too weak, they asserted.⁵⁶¹ In addition, we can also assume that, for the Reagan administration, it might have been easier to accept the viewpoint that what was causing the trouble was the regulation of capital movements. Furthermore, to induce yen appreciation by promoting financial deregulation in Japan was to kill two birds with one stone. It served the dual purpose of gaining political support both from the U.S. financial sector and the industrial sector.

⁵⁵⁶ Volcker, Paul. and Gyohten, Toyoo. *Changing Fortunes*. Times Books, 1992, 237.

⁵⁵⁷ Zaimusho zaimu sogo seisaku kenkyujo zaiseishishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do (dai 7-kan) Shiryo Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2004, 212.

⁵⁵⁸ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 72.

⁵⁵⁹ Koizumi, Ryuji. “Shin hoshiki no nikokukan kosho - NichiBei en doru iinkai.” in Kuroda, Haruhiko ed. *Kokusai kosho - Ibunka no shogeki to taio*. Kenkyusha Shuppan, 1996, 120.

⁵⁶⁰ *Ibid.*

⁵⁶¹ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 72.

Consequently, the issue of financial regulation became a topic of debate between the United States and Japan. On November 10th 1983, Prime Minister Takeshita and the U.S. Secretary of the Treasury Regan announced at a joint press conference the establishment of the "U.S.-Japan Yen Dollar Committee" as a venue for discussing the financial issues between Japan's Ministry of Finance and the U.S. Department of Treasury.

At the Yen Dollar Committee meeting, the reasons for the weak yen and the strong dollar were discussed. The Japanese side claimed that the high interest rate in the U.S. was the reason for the strong dollar. To this, the U.S. side replied that there were many cases where exchange rates moved in a direction that did not reflect the differences in interest rate among countries,⁵⁶² and that the dollar had become relatively high because the closed nature of the Japanese financial market blocked the capital inflow into Japan and the appreciation of the yen.

It was true that the Japanese financial system was closed to a certain degree. Although financial deregulation was already in progress in Japan as seen in such examples as the revision of the Foreign Exchange and Foreign Trade Control Law in December 1980 that liberalized the movements of capital, there still were restrictions as exemplified in Japan's *tamegin-shugi* (exchange bank-ism; foreign exchange transactions could be processed only through exchange banks) and the prior notification system. However, Japan argued that those restrictions were not the reason for the low yen. For example, Tomomitsu Oba, then the Vice Minister of Finance for International Affairs who was involved in the Yen Dollar Committee, recalls, "thinking of the determinants of the yen rate ... the liberalization of the financial system had to be regarded as having only a supporting role. But they [the U.S.] demanded that it play a leading role."⁵⁶³

However, what the Japan side disagreed with was the claim that the closed nature of the Japanese financial system was the cause for the depreciation of the yen against the dollar, not that they needed to promote liberalization of the financial market. In other words, not all Japanese monetary authorities were against further financial deregulation.⁵⁶⁴ According to Haruhiko Kuroda, who served as the director general of the International Financial Bureau and the Vice Minister of Finance for International Affairs in late 1990s, the Banking Bureau and the Securities Bureau of the Ministry of Finance at the time were wishing to protect the preexisting domestic financial order, and thus they were hesitant about the liberalization, whereas internationalists in the Ministry of Finance saw the occasion as a chance to accelerate the liberalization of the financial system and internationalization of the yen.⁵⁶⁵ Besides this, some focus on the influence of Nakasone Yasuhiro, who placed importance on the U.S.-Japan relationship and elimination of politics dominated by bureaucrats; allegedly, he lent a hand to the U.S. and used the external pressure to push the Ministry of Finance to speed up the liberalization.⁵⁶⁶

Due to such intentions that existed in Japan, the arguments in the Yen Dollar Committee progressed steadily, and Japan released a report in May 1984 that

⁵⁶² Zaimusho zaimu sogo seisaku kenkyujo zaiseishishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do 11 Shiryō (4) Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2003, 273-89.

⁵⁶³ *Fainansu* (Finance), July 1984.

⁵⁶⁴ Koizumi, Ryuji. "Shin hoshiki no nikokukan kosho - NichiBei en doru iinkai." in Kuroda, Haruhiko ed. *Kokusai kosho - Ibunka no shogeki to taio*. Kenkyusha Shuppan, 1996, 128-129.

⁵⁶⁵ Kuroda, Haruhiko. *Tsuka no kobo - En, doru, yuro, jinmin gen no yukue*. Chuo Koron Shinsha, 2005, 162-163.

⁵⁶⁶ Shiota, Ushio. *Okurasho VS Amerika ka - shikumareta en doru senso*. Kodansha Bunko, 1994, 180.

recommended further liberalization of the domestic financial and capital markets, more facilitated access to the Japanese market by foreign financial institutions, and the liberalization of the euro-yen market for the internationalization of the yen.⁵⁶⁷ And, based on this report, some reforms were implemented later, such as the relaxation of regulations on yen-denominated loans.⁵⁶⁸

But, because the closed nature of the financial market was not the leading cause of the yen appreciation against the dollar, the dollar kept rising and the yen kept falling, regardless of the above progress. And, partly helped by the weak yen, Japan's trade surplus continued to expand. In particular, the volume of exports to the U.S. was sizable; trade surplus with the U.S. amounted to 33.8 billion dollars out of 35.1 billion dollars of Japan's total trade surplus in 1984. In contrast, the fiscal condition and trade balance of the U.S. kept deteriorating. Although the U.S. had succeeded in suppressing inflation through the high interest rate policy, the Reagan administration's economic policy did not achieve what it claimed; it claimed that a reduction of corporate tax and income taxes would stimulate investment, accelerate economic growth, and increase the tax revenue at the end. But in reality, the tax cut merely resulted in an increase in consumption. In the meantime, military expenditure increased as well, further aggravating the U.S. government's fiscal condition.⁵⁶⁹ The U.S. trade deficit swelled from 36.4 billion dollars in 1982 to 112.5 billion dollars in 1984. In this situation, protectionism was gaining power in the U.S. and starting to attack the Reagan administration's noninterference policy.

Facing the challenge, the Reagan administration finally started to feel the need to bring down the dollar's value and decided to reverse its economic policies. At the G5 summit held in Washington in January 1985, Secretary of the Treasury Regan signed a statement reaffirming the commitment made at the Williamsburg summit in May 1983 to implement "coordinated intervention in the markets as necessary."⁵⁷⁰ However, this move is thought to have been influenced not only by the economic situation of the U.S. but also by a request for intervention to President Reagan from British Prime Minister Thatcher, who was concerned about the declining value of the British pound.⁵⁷¹ Reflecting the change of policy, from January 21st to March 1st 1985, the U.S. authorities implemented a dollar-selling intervention; 590 million dollars against the mark, 48.8 million dollars against the yen, and 16.4 million dollars against the British pound, amounting to 660 million dollars in total.⁵⁷² It was a small amount compared to the dollar-selling intervention by other G5 countries that amounted to about 10 billion

⁵⁶⁷ Zaimusho zaimu sogo seisaku kenkyujo zaiseishishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do (dai 7-kan) Shiryo Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2004, 337.

⁵⁶⁸ Regarding the negotiation process at the Yen Dollar Committee, see Takita, Yoichi. and Kajima Heiwa Kenkyujo. *NichiBei tsuka kosho - 20-nen me no shinjitsu*. Nihon Keizai Shinbunsha, 2006. See also Zaimusho zaimu sogo seisaku kenkyujo zaiseishishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do (dai 7-kan) Shiryo Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2004, 327- 345.

⁵⁶⁹ Sakakibara, Eisuke. *Tsuyoi en wa Nihon no kokueki*. Toyo Keizai Shinposha, 2008, 81.

⁵⁷⁰ Zaimusho zaimu sogo seisaku kenkyujo zaiseishishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do 11 Shiryo (4) Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2003, 116.

⁵⁷¹ Volcker, Paul. and Gyohten, Toyoo. *Tomi no kobo - En to doru no rekishi* -. Toyo Keizai Shinposha, 1992,350.

⁵⁷² FRBNY Quarterly Autumn 1985, 52.

dollars, but, the fact that the U.S. did implement intervention signified the reemergence of a market-oriented but non-laissez-faire style operation of the floating system.

And, probably influenced by this move, the dollar that peaked in February 1985 began to fall. However, it was still at a high level, and it was not certain whether the dollar would continue to go down. Moreover, since a time lag exists between currency adjustment and adjustment of the trade balance, the U.S. trade deficit was still increasing. In this situation, protectionism in the U.S. was gaining power even more. For example, in reaction to the mass imports from Japan, the Senate unanimously passed on March 28th 1985 a joint resolution that sought retaliatory measures against Japan, and four days later, the Senate Finance Committee passed the retaliatory bill.⁵⁷³ In July 1985, Senator Lloyd Bentsen, Representatives Dan Rostenkowski and Richard A. Gephardt introduced a bill that tried to impose 25% import surcharges on countries with large trade surpluses with the United States.⁵⁷⁴

There also were those who called for a protectionist intervention policy. In other words, some congressmen tried to incorporate congressional oversight of the exchange rate into trade legislation. One of those bills, the Competitive Exchange Rate Act of 1985, would have reduced the discretionary power of the Federal Reserve Board and the Treasury in international monetary policy, requiring the U.S. administration to intervene in the foreign exchange markets when the current account balance was in substantial deficit.⁵⁷⁵ A similar protectionist bill was also introduced by Senator Bill Bradley as well. He suggested providing funds for the stabilization of the exchange rate so that if the current account deficit increased more than 1.5% of the GNP and if the dollar rate needed to be corrected more than 15% to recover the current account balance, the Treasury would purchase more than 3 billion dollars worth of foreign currencies by using the funds.⁵⁷⁶ In other words, this too was a bill that obligated market intervention. This kind of obligatory intervention that was advocated only to protect the country's own export industry had the possibility of nullifying the development in the operation style of the floating system and of even triggering a devaluation race.

And such a protectionist move gave the U.S. monetary authorities a sense of crisis. Especially, James Baker, who became the Secretary of the Treasury in February 1985, thought that the growing protectionism could bring both the U.S. and the world economies to a crisis, and thus that a policy that corrects strong dollar was necessary in order to prevent protectionist bills from passing the congress. Correcting high dollar may look like a protectionist policy itself, but Baker's primary purpose was not to protect the domestic export industry. Rather his purpose was to suppress protectionism by inducing and speeding up the reversal of the foreign exchange market trends, which was expected to occur sooner or later because the exchange rate seemed quite deviated from the real economic situation. In that sense, as the journalist Yoichi Funabashi says, Baker's move was not a direct reaction to congressional pressure for dollar depreciation. It was more a preemptive action to stave off the protectionist forces in the Congress by attacking the

⁵⁷³ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 163.

⁵⁷⁴ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 15.

⁵⁷⁵ *Ibid.*, 74-75.

⁵⁷⁶ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 225.

trade problem through an alternate route [currency policy and macroeconomic adjustments].⁵⁷⁷

To put it in another way, the policy that Baker had in mind was, as will be explained in detail below, along the lines of market-oriented but non-laissez-faire operation of the floating system, which first appeared with the dollar-defense package in 1978. Like the dollar-defense package, the policy that Baker had in mind was not something that monetary authorities **determine in advance** what exchange rate would be appropriate for reflecting their economic fundamentals and then maintain the rate. Instead, it was a policy that basically left the exchange rate to the market; only if the gap between the exchange rate and the fundamentals was conspicuously widened and the correction of the gap was conspicuously delayed **as a result of** the free movement of the market, were countries encouraged to cooperate with each other in creating a chance to reverse the trend and correct the gap. In the previous chapter, we saw that the authorities' fear of protectionism was one of the factors that drove forward the change in the operation style of the floating system in the late 1970s. The protectionism that gained power in the early and mid-1980s was also the source of fear that propelled monetary authorities including Baker to bring the cooperative operating style of the floating system to the fore again. The detailed process will be explained below.

(2) Fortification of the Floating System Based on Coordinated Intervention: From the Mid- to Late 1980s

In the midst of the growing protectionism, Baker and Finance Minister Noboru Takeshita met the day after the Tokyo G10 summit in June 1985. According to Takeshita, they reached the conclusion that they “needed to correct the trend toward a high dollar and low yen in order to solve the U.S.-Japan trade problem, and it was a common interest for both countries.”⁵⁷⁸ This was the opinion of both Takeshita, who was concerned about growing protectionism in the U.S., and Prime Minister Yasuhiro Nakasone who was thinking that the high-yen policy was necessary in order to reinforce U.S.-Japan security arrangements and to promote the structural change of the Japanese economy.⁵⁷⁹ Nakasone revealed to Baker his intention to have a comprehensive plan for resolving the imbalance between Japan and the U.S. “because that was the only way to get the US administration to commit to reducing the budget deficit and lowering the interest rate.” And he said that, to facilitate the process, Japan should accept the political risk of a higher yen.⁵⁸⁰ From this, we can see that it was not only by the U.S. that the correction of the trend toward a high dollar and low yen was suggested. Japan actively suggested it as well.

⁵⁷⁷ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 75.

⁵⁷⁸ Takeshita, Noboru. *Shogen Hoshuseiken*. Yomiuri Shinbunsha, 1991, 152.

⁵⁷⁹ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 171.

⁵⁸⁰ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 88.

But, although the U.S. and Japan agreed that the correction of the strong dollar and weak yen was necessary, they had different opinions about how to achieve it. At the meeting with Baker, Takeshita recalls, “At first, even though Treasury Secretary Baker did not deny the effectiveness of market intervention, he stated that it was more natural to increase the U.S. exports and Japan’s imports by using macroeconomic measures related to finance and banking. I replied that coordinated intervention by the U.S. and Japan would work effectively when exchange rates did not reflect the countries’ fundamentals (basic conditions of economy such as the GNP, commodity price, trade balance, etc.), and I also conveyed to him that Japan was ready for it if the U.S. was willing to support it.”⁵⁸¹ Then, Baker asked Takeshita if Japan would boost its domestic demand if the U.S. agreed on a currency realignment. Then, Takeshita proposed to have further discussion of macroeconomic problems later.⁵⁸²

While the difference in approach still existed, a U.S.-Japan unofficial meeting was held at Le Royal Monceau Hotel in Paris in the following month, on July 23rd 1985, to move forward the talks to correct the high dollar. Again at this meeting, the concern over protectionism was pronounced. Deputy Vice Minister for International Affairs Takehiko Kondo who attended this meeting testifies that David C. Mulford, the Under Secretary for International Affairs at the Department of the Treasury, expressed his concern over the situation of the U.S. Congress. Referring to numerous protectionist bills introduced by John Danforth, Dan Rostenkowski, Lloyd Bentsen, and others, Mulford mentioned the possibility of strengthened pressures from the protectionists after Labor Day (September 4th). If the U.S. and Japan could reach agreements on a policy package, he said, the U.S. wanted to develop the issue at G5.⁵⁸³

At this meeting both Japan and the U.S. again showed concern over protectionism and agreed that the correction of the strong dollar and weak yen was necessary, but the aforementioned difference in approach between Takeshita and Baker was also reflected in this Mulford’s comment. According to Kondo, the Japan side “thought that close cooperation between the U.S. and Japan would be sufficient for solving the issue, and that it was not quite necessary to tackle the issue with other G5 countries.”⁵⁸⁴ But the U.S. wanted to use the G5 frame to develop the talks on a larger scale. Moreover, from the fact that Mulford mentioned a “policy package,” it was clear that “for adjusting the exchange rates, the U.S. put more weight on macroeconomic measures while Japan put more weight on coordinated intervention.”⁵⁸⁵ Looking back, Mulford himself testified in a special TV program on NHK in the fall 1995 that, “the U.S. strategy was to draw out policy measures from other countries as much as possible, and use coordinated intervention as a last resort.”⁵⁸⁶

Japan was not particularly against the idea of announcing their measures as a policy package, but the problem was the content of the package. According to Yoichi

⁵⁸¹ Takeshita, Noboru. *Shogen Hoshuseiken*. Yomiuri Shinbunsha, 1991, 152-153; Takita, Yoichi. and Kajima Heiwa Kenkyujo. *NichiBei tsuka kosho - 20-nen me no shinjitsu*. Nihon Keizai Shinbunsha, 2006, 166-167.

⁵⁸² Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 11.

⁵⁸³ Kondo, Takehiko. *Kokusai tsuka to APEC - Nihon taigai kodo ron -*. Okurasho Insatsukyoku, 1996, 27.

⁵⁸⁴ *Ibid.*, 27-28.

⁵⁸⁵ *Ibid.*, 28.

⁵⁸⁶ *Ibid.*, 30.

Fuanabashi, they did not agree on specific macroeconomic policies. Mulford insisted that Japan needed to reform its tax structure. To this, Tomomitsu Oba, then the Vice Minister of Finance for International Affairs, replied that, since the Tax Commission in the Cabinet Office was examining the issue of tax reform, the government was not in a position to interfere with it.⁵⁸⁷ Ultimately, Mulford and Oba did not reach a conclusion. Baker, unsatisfied, wrote to Takeshita urging that Japan take more drastic measures to boost domestic demand and lower taxes.⁵⁸⁸

To take negotiations further, Oba and Mulford met again in Hawaii on August 21st. Japan included in its package plan a further deregulation and liberalization of Japanese capital markets and flexible implementation of monetary policy. But again, Mulford attempted to persuade Japan to lower its tax rates.⁵⁸⁹ Because Japan could not accept this, they replied that they would not include the issue of tax reduction in the package and announce Japan's tax policy as a separate matter later.⁵⁹⁰ Thus the difference in approach still remained unresolved.

However, as the U.S. advanced its negotiations with Japan, Britain, Germany, and France for the correction of the high dollar, the U.S. felt the difficulty of finding common ground for macroeconomic measures, and thus gradually shifted its weight of discussion to coordinated intervention that would have an immediate impact. Therefore, Baker tried to persuade President Reagan and his aides to employ coordinated intervention for dollar depreciation, and it gained President's approval. Then Baker told Japan side that he wanted to convene a G5 summit in September 1985.⁵⁹¹

So far, we have seen the perceptions of high government officials, but the private sector also agreed that the high dollar was in need of rectification. It is understandable that the U.S. business community wanted a lower dollar because it would promote their exports, but the Japanese business community was also ready to accept a higher yen and lower dollar. For example, when the four top LDP officials and the leaders from the four major economic organizations held a meeting on September 11th 1985, LDP Policy Research Council Chairman Masayuki Fujio stated the need for a summit meeting to correct the undervaluation of the yen. Although he was expecting strong opposition from the business community, all the business leaders agreed, including Yoshihiro Inayama, Chairman of the Japan Federation of Economic Organizations (Keidanren), who said that "a drastic move is necessary." It is said that there was a sense of crisis among them that the situation would lead to a trade war if no measures were taken, and that yen appreciation was a powerful card they had for reducing trade imbalance.⁵⁹² In this way, the fear of trade conflict and protectionism pushed forward the change in the currency policy. According to the analysis by Tadashi Kano, another background factor was that Japan had learned to make the best use of the merits of the strong yen after the shift to the floating system; the amount of foreign direct investment increased and the technique to

⁵⁸⁷ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 12.

⁵⁸⁸ *Ibid.*

⁵⁸⁹ *Ibid.*

⁵⁹⁰ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 175.

⁵⁹¹ Takeshita, Noboru. *Shogen Hoshuseiken*. Yomiuri Shinbunsha, 1991, 153.

⁵⁹² Nihon Keizai Shinbunsha ed. *Kensho Baburu Han'i naki ayamachi*. Nihon Keizai Shinbunsha, 2000, 25.

hedge exchange risk improved. These background elements made the Japanese ready to accept a higher yen.⁵⁹³

Against this backdrop, the G5 summit of finance ministers and central bank governors was held at the Plaza Hotel in New York on September 22nd 1985 (G5: Japan, the U.S., Britain, France, West Germany). What was emphasized in the summit was their cooperative action against protectionism. According to Yoichi Funabashi, during the preparatory London G-5D meeting, Mulford had proposed that the mutual pledge to fight protectionism should be assigned a high priority and be expressed in an independent section of the announcement. Section 11 warned, therefore, that “protectionist pressures, if not resisted, could lead to mutually destructive retaliation with serious damage to the world economy: world trade would shrink, real growth rates could even turn negative, unemployment would rise higher, and debt-burdened developing countries would be unable to secure the export earnings they vitally need.” At the behest of the U.S. team, each country declared its determination to resist protectionism at home.⁵⁹⁴ In short, the concern over protectionism was an important factor that motivated their coordinated intervention.

However, at the beginning of the Plaza meeting, even though they agreed on the need for coordinated intervention to contain protectionism, they had not reached an agreement regarding the share of the intervention burden. For example, West Germany was hesitant to shoulder a heavy burden. According to Takeshita and the journalist Funabashi, the reason for the hesitation dated from January 1985, when the G5 agreed in Washington to attack “disorder” in the markets, a statement that West German government interpreted as a pledge to implement coordinated interventions. Thus the West German authorities went on to make massive dollar-selling intervention in February, but meanwhile, the U.S. sold only 659 million dollars against foreign currencies, and Japan made no intervention at all. Thus, West Germany contended that the Bundesbank had already assumed a disproportionate share of the intervention burden before the Plaza, a share that should be factored into the new strategy.⁵⁹⁵ According to Deputy Vice Minister for International Affairs Takehiko Kondo who attended this summit, British Finance Minister (Chancellor of the Exchequer) Nigel Lawson also attempted to take only a small share, referring to the shortage in their foreign currency reserve. On the other hand, French Finance Minister Pierre Bérégovoy showed more positive attitude than expected.⁵⁹⁶

In the midst of this dissonance, a statement by Takeshita surprised the representatives of other G5 countries. Regarding it, FRB Chairman Paul Volcker, who attended the meeting, testifies as follows: “Inside the meeting itself, the most startling thing to me was that Noboru Takeshita, then the Japanese finance minister and afterwards prime minister, volunteered to permit the yen to fall [what Volcker meant was ‘rise’] by more than 10 percent. He was far more forthcoming than we had expected him to be; Toyoo Gyohten explains that the Japanese were alarmed by growing protectionist pressures in the United States and were ready to accept a huge appreciation of the yen in the hope that those

⁵⁹³ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 174.

⁵⁹⁴ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 16.

⁵⁹⁵ Takeshita, Noboru. *Shogen Hoshuseiken*. Yomiuri Shinbunsha, 1991, 155-156; Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 27-28.

⁵⁹⁶ Kondo, Takehiko. *Kokusai tsuka to APEC - Nihon taigai kodo ron -*. Okurasho Insatsukyoku, 1996, 36.

pressures would be diverted. Takeshita's attitude I'm sure surprised others as well, and it was a very important influence on the success of the meeting. A primary concern of the Europeans was not their exchange rate against the dollar, which they recognized as being way overvalued, but against the yen. The larger the appreciation of the yen, the more relaxed they were about their own competitive position."⁵⁹⁷

It was not only Takeshita among Japanese participants who had this fear of protectionism. For example, Satoshi Sumita, then the Bank of Japan Governor who attended the summit, testifies as follows: "the U.S. fiscal deficit and trade deficit caused by the strong dollar were grave issues. If no measures were taken, the U.S. economy would collapse and the status of the dollar as a currency of settlement would not be sustained ... So I also thought that we needed to accept a higher yen in order to protect both the U.S. economy and the international currency regime. No one actually voiced it clearly, but I think everyone shared the same thought."⁵⁹⁸ In hindsight, this perception was not quite correct, considering the fact that the status of the dollar as a key currency and the international currency regime based on the dollar did not collapse despite the continued expansion of the U.S. deficit in the 1990s and 2000s. But, at that time, the Japanese government and the Bank of Japan were convinced that the situation implied a severe crisis for the currency regime,⁵⁹⁹ and this fear led to Japan's positive and active attitude toward coordinated intervention.

Although not as cooperative as Japan, West Germany also shared the sense of crisis. According to a senior German official, "The key factor [of West Germany's cooperation] was our deep fear of a hard landing of the US dollar. If unchecked, the dollar would have gone into a free fall. And we did not want to have its reverse consequences for the world economy."⁶⁰⁰ This sense of crisis was the prerequisite for the Plaza meeting.

Due to such sense of crisis and Japan's willingness to shoulder a large burden, agreements were made at the end, and a joint announcement to correct the exchange rates was made on September 23rd (This is called the Plaza Agreement/Plaza Accord). It is said that the target that was agreed behind closed doors was the devaluation of the dollar by 10-12%.⁶⁰¹ And joint intervention began in order to achieve the target. From September 23rd to October 1st, G5 members' dollar-selling intervention amounted to approximately 2.7 billion dollars. Of which, 1.25 billion dollars were sold by Japan, 635 million dollars by France, 408 million dollars by the U.S., 247 million dollars by West Germany, and 174 million dollars by Britain. As a result, against the dollar, the yen rose by 11.8%, both the Deutsche mark and French franc rose by 7.8%, and the British pound rose by 2.9%.⁶⁰² The yen rate, which was 242 yen per dollar before the Plaza Agreement, soared to 216 yen in ten days after the Plaza Agreement.

⁵⁹⁷ Volcker, Paul. and Gyohten, Toyoo. *Changing Fortunes*. Times Books, 1992, 244-245.

⁵⁹⁸ Nihon Keizai Shinbunsha ed. *Kensho Baburu Han'i naki ayamachi*. Nihon Keizai Shinbunsha, 2000, 83-84.

⁵⁹⁹ Takemori, Shunpei. *Sekai defure wa mitabi kitaru (ge)*. Kodansha, 2006 (2009 edition), 296.

⁶⁰⁰ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 109.

⁶⁰¹ Zaimusho zaimu sogo seisaku kenkyujo zaiseishishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do (dai 7-kan) Shiryo Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2004, 359, 363.

⁶⁰² Volcker, Paul. and Gyohten, Toyoo. *Tomi no kobo - En to doru no rekishi* -. Toyo Keizai Shinposha, 1992, 371.

There was market resistance, but both the FRB and the Bank of Japan continued to intervene forcefully. The FRB even made its first direct intervention in the Tokyo market to discourage the dollar-buying market forces by demonstrating the solidarity of central banks. As for Japan, while continuing the intervention operation, it announced on October 15th a stimulus package to increase domestic demand, and with the announcement, to discourage the ongoing yen-selling pressure. However, the market resistance did not die down. When the dollar showed a sign of rebound in the second half of October, the U.S. sold 797 million dollars against the mark. Against the yen, it sold 483 million dollars during the six weeks following the Plaza Accord.⁶⁰³ After these efforts, finally, the trend of dollar depreciation and yen appreciation began to settle from late October.

Between the Plaza Agreement in September and the end of October, the U.S. spent the total amount of 3.2 billion dollars for intervention, and Japan spent 3 billion dollars. 3 billion dollars were used by West Germany, France, and Britain all combined, and 2 billion dollars were spent by all other member countries of G10.⁶⁰⁴ As a result, by late October, the dollar rate fell by 13% against the yen, 10.5% against the Deutsche mark, compared to the dollar rate before the Plaza Agreement. This meant that the unofficial target of 10-12% dollar depreciation was achieved, and that the intervention strategy adopted by the Plaza Agreement proved successful, at least at this point.

The reasons for the success of the coordinated intervention based on the Plaza Agreement somewhat overlap with the reasons for the success of the dollar-defense policy of late 1978. The difference was that, this time, there was no announcement of the amount of intervention, and moreover, even the word “intervention” was never used in the joint statement of the Plaza Agreement. The U.S. side was strongly against including the word *intervention* because they thought that deliberate ambiguity in the communique would arouse nervousness in the markets and create a strong effect.⁶⁰⁵ However, whether they included the word or not, the virtual content of cooperation was coordinated intervention. The reason for the success of the Plaza Agreement that overlapped with the success of the dollar-defense policy was that the contents of coordinated intervention were prearranged before announcement, and they were announced to the world as one comprehensive measure, giving the market an impression that the intervention was a gigantic collective will. Each country’s individual measures were becoming increasingly powerless against the force of expanding international capital movement and the force of the market, but as soon as countries revealed their concerted will to implement large-scale interventions, speculators judged that the market trend might reverse. Other reasons for the success were that the dollar was already beginning to decline even before the Plaza Agreement, and that there was a shared feeling among the market participants that the dollar was very much overvalued.

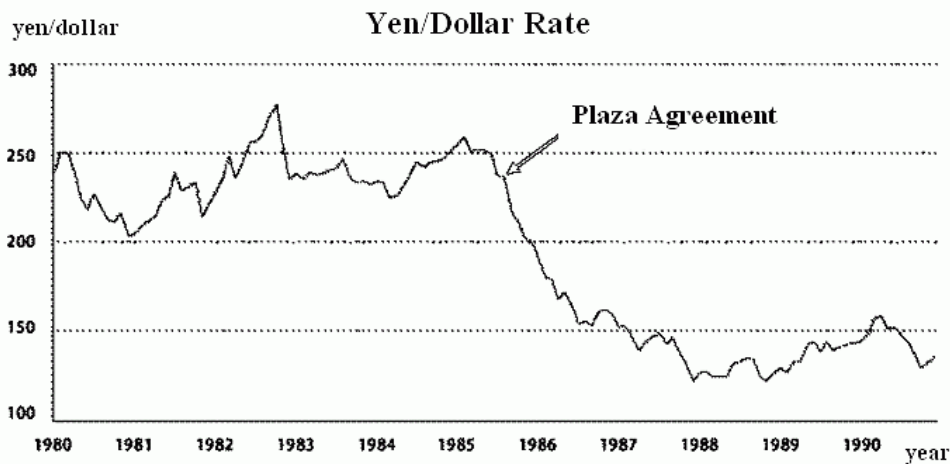
At first glance, the coordinated intervention based on the Plaza Agreement may seem to have symbolized a return to the fixed-rate system-like operation style of the floating

⁶⁰³ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 23.

⁶⁰⁴ Zaimusho zaimu sogo seisaku kenkyujo zaiseishishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do (dai 7-kan) Shiryō Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2004, 363.

⁶⁰⁵ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 14.

system. But, like the dollar-defense policy of 1978, the operation style of the floating system around the time of the Plaza Agreement was fundamentally different from it: During the time when the floating system was operated in the style of the fixed-rate system, countries sought to maintain their exchange rates within a certain range. That is to say, they **determined in advance** what exchange rate would be appropriate for reflecting their economic fundamentals, and then attempted to keep the rate. But the coordinated intervention after the Plaza Agreement was different from such approach in that the Plaza strategy was not based on the idea that the exchange rate should be kept within a predetermined range. Rather it was an attempt to speed up the reversal of the foreign exchange market trends, which was expected to occur sooner or later because the exchange rate seemed quite at variance from the real economic situation (even though they had agreed to raise the yen rate at least by 10%, there was no agreement on the upper limit of yen appreciation). Therefore, the coordinated intervention based on the Plaza Agreement was not something that symbolized a “return” to the fixed-rate system-like floating system, but rather, it signified a shift to a policy that prepared for internationally coordinated intervention in excessive cases, upon basically affirming the logic of the market and the merits of the floating system. In short, this operation style of the floating system, which was created at the time of the dollar-defense policy of 1978, was reaffirmed as necessary and adequate, and was put into practice again through the Plaza Agreement. As Volcker expressed it, the Plaza Agreement was “a mirror image of the emergency dollar defense package of November 1978.”⁶⁰⁶



However, even though this operation style of the floating system worked to correct the gap between exchange rates and the trade and capital competitiveness, it was not something that resolved the fundamental source of the problem that was generating the gap, namely, the expanding scale of international capital movement. The fact that the reversal of the market trend was at last achieved through coordinated intervention implied that the scale of international capital movement had grown so large that it became

⁶⁰⁶ Volcker, Paul. and Gyohten, Toyoo. *Changing Fortunes*. Times Books, 1992, 229.

difficult to tame the market without such coordinated intervention. And this in turn implied that, in order to change the direction of the exchange market trend again, another large-scale internationally coordinated intervention was necessary. For instance, the appreciation of the yen and the depreciation of the dollar, which was induced by the Plaza Agreement, progressed beyond the expectation of many, but the excessive yen appreciation and dollar depreciation remained uncontrollable until the major countries made another large-scale coordinated intervention again.

It is true that there were some at the Plaza meeting who were concerned about the possibility of such an uncontrollable situation. For example, the Bundesbank Governor Karl Otto Pöhl stated that “It is very hard to trigger an avalanche, but once it starts, it is much harder to stop.” According to a participant in the meeting, Pöhl urged that the five countries “move [the dollar] down step by step.”⁶⁰⁷ Volcker also showed the same concern. He was particularly anxious that dollar depreciation would reduce capital inflows to the U.S., requiring a rise in interest rates as a result. He was constantly aware of the ominous implications of the U.S. debtor status for monetary and overall economic policy.⁶⁰⁸ But it wasn’t a majority view to worry about the possibility of a steep and uncontrollable fall of the dollar,⁶⁰⁹ as a senior Treasury official testified that “[These factors] were never a concern to me because in my view, we could depreciate the currency without the threat of raising interest rates and without scaring away investors because the fundamentals in the United States were still very strong, very sound ... I thought the market was ... with us.”⁶¹⁰ According to the Bank of Japan Governor Sumita, the Japanese side too had “no voice at all that concerned over the possibility of excessive yen appreciation.”⁶¹¹ In other words, the Plaza Agreement was pressed forward without any preparation for the possibility of excessive dollar depreciation and excessive yen appreciation.

But, in the first place, the coordinated intervention after the Plaza Agreement was not something that aimed at containing the exchange rates within a predetermined range. Its purpose was to basically leave the exchange rate to the market and then correct the exchange rate if it deviated too much from the fundamentals. Thus, it was natural that the G5 countries did not set a defense line for exchange rates, because then it would mean a return to the fixed-rate system-like operation style of the floating system.

As Volcker and Pöhl feared, after the Plaza Agreement, the dollar and yen exchange rates changed drastically as shown in the figure above. The Bank of Japan was said to have a perception that “200 yen level was acceptable,”⁶¹² but there was no preparation for containing the rage of fluctuation within that level. The yen rate, which was 202-204 yen per dollar in December 1985, soared to 191 yen by late January 1986. One of the

⁶⁰⁷ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 25.

⁶⁰⁸ *Ibid.*

⁶⁰⁹ Volcker, Paul. and Gyohten, Toyoo. *Changing Fortunes*. Times Books, 1992, 255.

⁶¹⁰ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 25.

⁶¹¹ Nihon Keizai Shinbunsha ed. *Kensho Baburu Han'i naki ayamachi*. Nihon Keizai Shinbunsha, 2000, 27.

⁶¹² NHK shuzaihan. *Sengo 50-nen - Sono toki nihon wa (dai 6-kan)*. NHK Shuppan, 1996, 76-77; Zaimusho zaimu sogo seisaku kenkyujo zaiseishishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do (dai 7-kan) Shiryo Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2004, 358.

reasons for this hike was the descending price of oil at the time. The market judged that Japan, which depended on imported oil, would acquire more trade competitiveness by taking advantage of the lower price of oil.⁶¹³ Another factor was that there was a news report in late January that Finance Minister Takeshita showed his willingness to accept 190 yen level.⁶¹⁴ In addition, Commerce Department trade figures released on January 30th showed that the American deficit with Japan in 1985 had reached 50 billion dollars, and this too stimulated the rise of the yen and the fall of the dollar.⁶¹⁵ But the yen appreciation did not stop there. The yen rate, which was 191 yen per dollar in late January, soared to 177 yen by February 19th.

As the yen rose sharply, a deep concern over the damage to the export industry started to spread in the Japanese private sector. When the yen exceeded the 200 yen level, a sense of recession spread to the heavy industries like steel and shipbuilding. As the yen exceeded even the 180 yen level, it began to impact export-oriented manufacturing industries like electric appliance manufacturing and autos.⁶¹⁶ For instance, Toyota Motor Corporation expressed a sense of crisis, saying “there would be about 43 billion yen deficit if the yen rose 10 yen” (*Nihon Keizai Shimbun*, 2 November 1985), and Hitachi, Ltd. Commented, “200 yen is the break-even point” (*Nihon Keizai Shimbun*, 4 February 1986). Other examples of such articles are “The consumer confidence will go down further if the sense of recession spreads in and around export industry due to the high yen” (*Nihon Keizai Shimbun*, 2 December 1985), and “Cold wave of the high yen hit. Freezing Inadani region. The production area of the electronic parts reached the limit of power in resisting recession” (*Nikkei Business*, 20 January 1986). In this way, articles that explained and warned of the negative impact of the strong yen began to appear.

In such a situation, in order to stabilize the yen-dollar rates and improve the U.S. international balance, Baker continued to press U.S. trading partners to stimulate their domestic economies by various methods including interest rate policy.⁶¹⁷ However, the U.S. too was under the pressure to reduce its interest rate. During this time there were heightening voices from within that requested a reduction of the official bank rate, in order to boost the sluggish domestic economy and to acquire votes in the election; it was an election year.⁶¹⁸ Ultimately, in March 1986, the U.S., West Germany, and Japan implemented a coordinated reduction of interest rate. The reason they coordinated it was that there was a possibility that an individual reduction of interest rate might change the trend of capital movement and the trend of dollar depreciation and yen appreciation. On March 6th, West Germany lowered its official bank rate from 4% to 3.5%, the next day, Japan lowered it from 4.5% to 4%, and the U.S. lowered it from 7.5% to 7%.

Then, witnessing the coordinated action, the market further advanced the dollar-selling and the yen-buying in expectation of a continued trend of weak dollar and strong yen. As

⁶¹³ Funabashi, Yoichi. *Tsuka retsuretsu* (Japanese version of *Managing the Dollar*). Asahi Shimbun, 1992, 220.

⁶¹⁴ *Nihon Keizai Shimbun*, 24 January 1986 (evening edition).

⁶¹⁵ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 46.

⁶¹⁶ Zaimusho zaimo sogo seisaku kenkyujo zaiseishishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do (dai 7-kan) Shiryō Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2004, 367.

⁶¹⁷ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 48.

⁶¹⁸ *Ibid.*, 47-48.

a result, the yen rate, which stayed around the 180 yen level in February, rose to the 170 yen level in March. The U.S. side must have been satisfied with the trend, but at this point, the Japanese government started to feel that the yen had risen too high. Although Japanese authorities did not think that the yen rate should be kept within a certain range, they started to feel that it was necessary to correct the yen rate through coordinated intervention again because the yen rate seemed to be largely diverging from Japan's actual trade competitiveness.

The yen's further rise in late March impelled Finance Minister Noboru Takeshita to telephone Baker and request a coordinated intervention to stabilize the currencies. Baker declined, explaining that opposition to such "reverse" intervention remained strong in the administration. Instead, the Treasury allowed the Bank of Japan to intervene in the New York market through its account at the New York Federal Reserve Bank and promised not to oppose this unilateral intervention publicly. And then, on March 19th, the Bank of Japan intervened in the New York market. It was the first attempt since the Plaza to reverse the rise of the yen.⁶¹⁹ On April 1st, the intervention was conducted in the Tokyo foreign exchange market as well. In sum total, dollar-buying intervention amounted to 60 million dollars.⁶²⁰

But Japan's unilateral intervention was not effective enough to stop the appreciation of the yen. To such Japan's efforts, Under Secretary of State for Economic and Agriculture Affairs Allen W. Wallis stated, "I doubt that Japan's intervention had much effect on the market. The market for foreign exchange is huge. Analysis and experience show that [by intervening in the market] governments really just throw their money away."⁶²¹ As he stated, the foreign exchange market had become gigantic. For example, according to the survey organized by the Federal Reserve Bank of New York and conducted by the central banks of Japan, the U.S., and Britain in March 1986, the daily volume of transactions in the foreign exchange market was 48 billion dollars in Tokyo, 58.5 billion dollars in New York, 90 billion dollars in London, thus 196.5 billion dollars in total. The annualized volume amounted to over 49 trillion dollars, more than 16 times the amount transacted for the global trade of goods and services.⁶²² As for the Tokyo foreign exchange market, the transaction volume in March 1986 was about four times the transaction volume in April 1983 (according to the estimation of the Federal Reserve Bank of New York). This expansion occurred because "the principle of actual demand" for forward exchange transaction was abolished in April 1984, and then it became possible to buy or sell foreign currencies with no backing of trade and capital transaction.⁶²³

Because of such growth in the exchange market, it had become difficult to change the market trend solely by unilateral intervention. Thus, in order to correct the strong yen, Japan needed a coordinated intervention with other countries. At the IMF Interim Committee held in Washington on April 8th 1986, Takeshita said to Baker again that coordinated intervention was necessary for the stabilization of the yen. And at the U.S.-Japan summit held at Camp David on April 12th and 13th, Prime Minister Nakasone also

⁶¹⁹ *Ibid.*, 152.

⁶²⁰ Zaimusho zaimu sogo seisaku kenkyujo zaiseishishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do (dai 7-kan) Shiryo Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2004, 370.

⁶²¹ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 153; Asahi Shimbun, 21 March 1986.

⁶²² Miyazaki, Yoshikazu. *Doru to en - Sekai keizai no atarashii kozo* -. Iwanami Shinsho, 1988, 4-5.

⁶²³ *Ibid.*, 156-157.

appealed to Reagan about the necessity of currency stabilization. But the U.S. side refused to make any coordinated intervention.⁶²⁴ Instead, the U.S. rather requested policy coordination and the expansion of domestic demand in Japan.

Furthermore, FRB requested a coordinated cut of interest rate by the U.S. and Japan. Volcker expressed concern over the prospects for U.S. economic growth in the second quarter (April-June). He also indicated that the FRB was inclined to cut the discount rate (that is, the official bank rate) again, and appealed to Bank of Japan Governor Sumita to cut the Japanese discount rate simultaneously to maintain the exchange rate.⁶²⁵ Because the strong yen and resulting deflation effect were threatening the Japanese economy, Japan accepted the request. The Japanese authorities judged that a rate cut would induce domestic demand expansion which would help the industries that were having difficulties in exporting. Also, there was a possibility that a reduction of interest rate would lower the demand for the yen, and thereby correcting the strong yen. Thus, on April 21st 1986, Japan lowered its official bank rate from 4% to 3.5%, and the U.S. from 7% to 6.5%. Since the beginning of the year 1986, out of the fear of economic damage that would be caused by strong yen (the yen rate, which was 240 yen per dollar before the Plaza Agreement, had soared to 166 yen by April 24th 1986, an increase of over 70 yen in 7 months), Japan had been lowering its official bank rate from 5% to 4.5% in January, then to 4% in March. The official bank rate of 3.5% in April was decided on top of these consecutive rate cuts.

In this situation, the Tokyo summit was held on May 4th and 5th 1986. There, the member countries discussed long-term policy coordination such as the introduction of indicators for objective policy surveillance on the member countries. However, there was no move on correcting the strong yen which Japan urgently needed. Moreover, the market judged that, if the surveillance was put into practice, there would be more pressure on Japan to raise the yen rate and reduce its trade surplus. Such anticipation and no action by major countries to correct the market trend invited further yen-buying in the market.⁶²⁶ As a result, after the summit, on May 6th, the yen rate at the Tokyo foreign exchange market started from 165.75 yen per dollar, which was 4.95 yen higher than the previous week. And on May 9th it rose to 161 yen and to 159.99 yen on the 12th.

And as the depreciation of the dollar against the yen accelerated, the U.S. began to show a little change of attitude. In his testimony to the Senate Finance Committee on May 13th, Baker stated that the dollar had more than fully offset its earlier appreciation against the yen. The market instantaneously responded to what it interpreted as a gesture to abate the pressure on the yen, by selling the yen and buying the dollar.⁶²⁷ Occasioned by this, the yen rate fell to around 175 yen by early June. The journalist Yoichi Funabashi explains that Baker made that move in order to politically support Prime Minister Nakasone who had been cornered by the continued progress of yen appreciation.⁶²⁸

⁶²⁴ Zaimusho zaimu sogo seisaku kenkyujo zaiseishishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do (dai 7-kan) Shiryo Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2004, 320.

⁶²⁵ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 50.

⁶²⁶ Miyazaki, Yoshikazu. *Doru to en - Sekai keizai no atarashii kozo -*. Iwanami Shinsho, 1988, 66.

⁶²⁷ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 155.

⁶²⁸ Funabashi, Yoichi. *Tsuka retsuretsu* (Japanese version of *Managing the Dollar*). Asahi Shimbun, 1992, 226.

But the depreciation of the yen did not last long. The yen started to rise again from the beginning of June 1986, and reached 155-157 yen per dollar by late July. Japan continued to implement intervention, but the yen-buying pressure was so large that it could not be contained by one country. Reflecting on this issue, Takeshita later testified, “Actually I myself had not expected the rise of the yen to be as drastic as that. I was thinking of raising the yen by 10% at the beginning and then raise it gradually over a year.”⁶²⁹ Similarly, Kiichi Miyazawa, who took over the position of Finance Minister from Takeshita in July 1986, also testified that it had become impossible to manipulate the market by Japan’s unilateral intervention alone.⁶³⁰ Shunpei Takemori, a professor at Keio University later criticized such accounts, saying, “the idea that the exchange rate can be fine-tuned is an easygoing view ... I wonder if Takeshita knew that the volume of foreign exchange transaction had expanded to the point that only a few days of transactions generated a volume that equaled the amount of the annual national income of Japan.”⁶³¹ As Takemori pointed out, the foreign exchange market had grown to the point that it became very difficult for one government to control the market at will. For example, as for Japan, after the deregulation of the conversion of foreign funds into yen in April 1984, the annual net amount of stock acquisition (the difference between the amount of stock purchased and the amount of stock sold) in overseas markets, which was 990 million dollars in 1985, increased to 7.05 billion dollars in 1986 (and to 16.87 billion dollars in 1987), and the annual net amount of public and corporate bonds (and others) acquisition, which was 53.5 billion dollars in 1985, increased to 93 billion dollars in 1986.⁶³² The volume of transaction in the world’s foreign exchange markets including Tokyo was growing enormously, reflecting the increase in the amount of investment capital.

In such a circumstance, the appreciation of the yen and the depreciation of the dollar continued. However, despite the expectation that the U.S. economy would take an upturn because of the weakened dollar, there was no sign of improvement in its trade balance, and uncertainty over the economy was mounting up. There, the U.S. came up with the idea of stimulating the domestic economy by another interest rate reduction, and requesting Japan and West Germany to lower their respective interest rates to boost the U.S. and the world economies. This idea seemed politically motivated as well. There was a midterm election in the U.S. in that year, and an expansionary policy was expected to be helpful for gaining votes. Therefore, the U.S. called out to Japan and West Germany for a coordinated rate reduction. But this time, they did not positively respond. Then, in order to at least boost the domestic economy, the U.S. alone lowered its official bank rate twice on July 10th and August 21st 1986 by 0.5% each, to lower it to 5.5%.⁶³³

However, even though the request to Japan and West Germany was turned down once, the U.S. did not withdraw its request. Baker, who wanted to win concessions from them, suggested a meeting with Miyazawa to request domestic demand expansion policies including interest rate reduction. Miyazawa also sought a meeting with Baker to request coordinated intervention. Consequently, on September 6th 1986, Miyazawa and Baker

⁶²⁹ Takeshita, Noboru. *Shogen Hoshuseiken*. Yomiuri Shinbunsha, 1991, 159.

⁶³⁰ Nihon Keizai Shinbunsha ed. *Kensho Baburu Han'i naki ayamachi*. Nihon Keizai Shinbunsha, 2000, 71-72.

⁶³¹ Takemori, Shunpei. *Sekai defure wa mitabi kitaru (ge)*. Kodansha, 2006 (2009 edition), 336.

⁶³² Miyazaki, Yoshikazu. *Doru to en - Sekai keizai no atarashii kozo -*. Iwanami Shinsho, 1988, 27.

⁶³³ Funabashi, Yoichi. *Tsuka retsuretsu* (Japanese version of *Managing the Dollar*). Asahi Shimbun, 1992, 72.

met in San Francisco. Miyazawa recalls the conversation as follows: “I said to Baker that ... ‘it is important that you agree to stabilize the exchange rates first,’ and that it was a prerequisite for stimulating Japan’s domestic demand. He told me, ‘alright, but you need to lower the interest rate.’ I replied, ‘it is not my job but I will make a request to the Bank of Japan Governor.’”⁶³⁴ Also, at the meeting, Miyazawa expressed that he was thinking of implementing 3 trillion yen-scale economic measures to boost domestic demand.

Then, after the meeting, at Miyazawa’s initiative, comprehensive economic measures that involved 3.6 trillion yen were adopted. However, at the time, the Ministry of Finance bureaucrats were focused on balancing the budget and did not want to increase government expenditure. Therefore, even though the budget amount itself seemed large, the contents were without much substance. For example, the 540 billion-yen budget for public investment included advanced execution of the next year’s budget of 410 billion yen for the recovery of areas hit by natural disaster. Thus, the actual budget increase was only 130 billion yen.⁶³⁵ However, at this point, neither Miyazawa nor the U.S. realized that the comprehensive economic measures were without much substance.

But it was not all that the U.S. wanted. The U.S. also wanted Japan’s interest rate to be reduced. Thus, on September 26th, right before the G5 meeting, Volcker requested a rate cut to the Bank of Japan Governor Sumita. But, since Sumida showed a cautious stance at the time, Volcker handed the problem on to Baker, and then Baker requested a rate cut to Miyazawa.⁶³⁶ But even after this, Sumita was not able to decide on a rate reduction. It was because the Deputy Governor Yasushi Mieno and others in the Bank of Japan were against it.⁶³⁷ They were wary of the signs of asset inflation as exemplified by the increase in the land prices of the business district in Tokyo by 40.5% over the previous year. But the rate cut was decided by a strong request from Miyazawa, and it was announced later in the U.S.-Japan joint statement.

Nonetheless, this objection from the domestic faction in the Bank of Japan was right in fact. As it turned out, the consecutive rate reductions became a basis for Japan’s bubble economy. Miyazawa recalls that “the thing I was most concerned about was the exchange rate, and we policy makers did not think about when to raise the official bank rate again (in order to prevent bubble economy).”⁶³⁸ Thus, the top officials like Miyazawa, out of fear of the economic damage that the strong yen might bring, could not see the development of other important issues other than the exchange rate. It was because the trade surplus was a major pillar of the Japanese economy then. Out of fear of the rising yen, Japan, desperately wanting to implement coordinated intervention to correct the trend of strong yen, accepted the unreasonable demand from the U.S. to cut interest rates and expand domestic demand. But in reality, as became apparent later, the Japanese export industry as a whole was strong enough to survive even a higher yen. But, the Japanese authorities, without carefully calculating the appropriate yen level that would fit Japan’s trade competitiveness, were just overwhelmed by the unexpected speed of the

⁶³⁴ Nihon Keizai Shinbunsha ed. *Kensho Baburu Han’i naki ayamachi*. Nihon Keizai Shinbunsha, 2000, 72.

⁶³⁵ NHK shuzaihan. *Sengo 50-nen - Sono toki nihon wa (dai 6-kan)*. NHK Shuppan, 1996, 125-6.

⁶³⁶ Funabashi, Yoichi. *Tsuka retsuretsu* (Japanese version of *Managing the Dollar*). Asahi Shimbun, 1992, 77.

⁶³⁷ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 185.

⁶³⁸ Mikuriya, Takashi and Nakamura, Takafusa. eds. *Kikisho Miyazawa Kiichi kaikoroku*. Iwanami Shoten, 2005, 282-3.

yen's rise, and out of fear that domestic industries would be stymied, implemented excessive rate cuts and kept the interest rate at a low level for a long time. But, because the trade competitiveness of Japanese industries was actually quite high in reality, such a move by the monetary authorities served as a base for Japan's bubble economy, as will be described in detail later.

Based on the U.S.-Japan negotiation described above, the Miyazawa-Baker Joint Statement was made on October 31st 1986. In it, Japan promised to (1) submit a supplementary budget to the Diet to provide a substantial stimulus to the Japanese economy (2) implement as soon as possible a tax reform plan including reductions in the marginal tax rates for both personal and corporate income to stimulate investment and business activity (3) reduce Japan's discount rate from 3.5% to 3%. The U.S. side promised a full commitment to significant and steady reductions in the U.S. budget deficit, enactment of a tax reform plan, and resistance to protectionist pressures.⁶³⁹ And the Miyazawa-Baker communique stated that they "shared the view that exchange rate instability can jeopardize stable economic growth" and that they "expressed their mutual understanding that with the actions and commitments, the exchange rate realignment achieved between the yen and the dollar since the Plaza Agreement is now broadly consistent with the present underlying fundamentals."

Until then, the U.S. was refraining from committing to the stabilization of the yen rate because they were cautious about the possible return to the trend of a strong dollar. But, they began to worry that any more depreciation of the dollar might induce inflation in the U.S. and outflow of foreign capital from the country. It was against this backdrop that the U.S., as seen above, finally decided to embark on stabilizing the exchange rates, after confirming Japan's decision to lower the official bank rate.

Probably thanks to the joint statement, the yen appreciation stopped temporarily and the yen rate stayed around 160 yen per dollar between November and December 1986. However, as there began to appear gloomy forecasts for the U.S. domestic economy and the credibility of the dollar fell further, there began a massive buying of the Deutsche mark in January 1987, and it stimulated the yen-buying as well. On January 14th 1987 the New York Times reported that an U.S. top official wanted the dollar to decline further.⁶⁴⁰ This too stimulated further depreciation of the dollar against the yen and the mark. As a result, on January 19th, the yen rate rose to 149.98 yen per dollar. Even though the U.S. and Japan had agreed to stabilize the exchange rates as seen above, it is said that the U.S. side made that remark because it felt that Japan was not proceeding with domestic demand expansion as expected.⁶⁴¹

In response to the U. S., Miyazawa flew to Washington on January 21st 1987 and met with Baker again. Based on their talk, they announced yet another joint statement, which reconfirmed that, "the yen-dollar exchange has been broadly consistent with underlying fundamentals."⁶⁴² In this way, they expressed their will to stabilize the dollar and yen rates at where they were then. By this, the U.S., which was showing an ambiguous

⁶³⁹ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 160.

⁶⁴⁰ "Officials say U.S. seeks bigger drop for weak dollar," *The New York Times*, 14 January 1987.

⁶⁴¹ Takita, Yoichi. and Kajima Heiwa Kenkyujo. *NichiBei tsuka kosho - 20-nen me no shinjitsu*. Nihon Keizai Shinbunsha, 2006, 235-236.

⁶⁴² Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 166.

attitude, publicly announced again that it wanted to stabilize the exchange rates. However, Japan paid the price for making the U.S. clarify its stance. Before leaving for Washington, Miyazawa decided to use rate reduction as a bargaining chip and persuaded Sumita. At the meeting with Baker, Miyazawa stated that he could not return to Japan unless the U.S. side promised to work to stabilize the yen rate at 150 yen per dollar, and then he put the bargaining chip on the table.⁶⁴³

On January 28th 1987, based on the policy announced in the aforementioned joint statement on January 21st to keep the status quo, the U.S. monetary authorities at last intervened in the market to curb further decline of the dollar against the yen. The Federal Reserve Bank of New York made a dollar-buying intervention that amounted to 50 million dollars,⁶⁴⁴ which was the first dollar-buying intervention by the U.S. since the Plaza Agreement.⁶⁴⁵ Probably thanks to this intervention, the dollar-yen rates stably fluctuated for a while, around 153 yen per dollar from late January. On the other hand, in Japan, Miyazawa asked the Bank of Japan for a rate reduction based on the deal made in the above meeting, and the Bank of Japan reduced the official bank rate from 3% to 2.5% on February 23rd 1987.

And during this period, the status quo policy of Japan and the U.S. began to shift from the bilateral level to the multilateral level. In other words, on February 22nd 1987, G7 was held at Louvre (it was virtually G6 without Italy), and Louvre Agreement/Louvre Accord was made. The agreement regarding the issue of the exchange rate was as follows: "Further substantial exchange rate shifts among their [the major countries'] currencies could damage growth and adjustment prospects in their countries. In current circumstances, therefore, they agreed to cooperate closely to foster stability of exchange rates around current levels." The member countries agreed to provide 4 billion dollars for the intervention and to assign a third of the amount of intervention each to the U.S., Japan, and Europe.⁶⁴⁶

But, to keep the status quo was to contain the exchange rate fluctuation within a certain range, and thus the agreement at Louvre contained the paradigm of the fixed-rate system. In fact, at the Louvre meeting, it was agreed to voluntarily intervene in the market if the exchange rates changed above or below the predetermined standard rate by 2.5% and to make that intervention mandatory in case the exchange rates changed by more than 5%. In short, a partial return to the fixed-rate paradigm was seen. However, although there was an argument about what that "standard rate" should be, it was left ambiguous at the meeting.⁶⁴⁷ And, even if they had tried to control exchange rates by setting standard rates, such a fixed-rate system-like operation of the floating system was no longer sustainable.

In fact, it soon became clear that keeping the status quo was impossible. Probably thanks to the Louvre meeting, the dollar, the yen, and the Deutsche mark temporarily

⁶⁴³ Funabashi, Yoichi. *Tsuka retsuretsu* (Japanese version of *Managing the Dollar*). Asahi Shimbun, 1992, 81.

⁶⁴⁴ Zaimusho zaimu sogo seisaku kenkyujo zaiseishishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do (dai 7-kan) Shiryo Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2004, 377.

⁶⁴⁵ Funabashi, Yoichi. *Tsuka retsuretsu* (Japanese version of *Managing the Dollar*). Asahi Shimbun, 1992, 241.

⁶⁴⁶ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 187.

⁶⁴⁷ Zaimusho zaimu sogo seisaku kenkyujo zaiseishishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do (dai 7-kan) Shiryo Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2004, 380.

remained stable between late February and mid-March, but when data showing signs of economic stagnation in the U.S. were released one after the other, such as that the trade deficit for the year 1986 was the largest ever, the confidence in the dollar was shaken again,⁶⁴⁸ and the yen rate soared to the 140-yen level after March 24th. Moreover, the U.S. sanctions on 300 million dollars worth of Japanese products for the violation of a semiconductor agreement on March 27th fueled protectionist fears in the United States,⁶⁴⁹ and accelerated the dollar-selling by Japanese exchange banks, trading companies, export companies, life insurance companies, and mutual funds, etc. The dollar-selling at the Tokyo foreign exchange market on the 27th amounted to 6.18 billion dollars. In response, the Japanese monetary authorities made a 2 billion dollars yen-selling and dollar-buying intervention on the same day.⁶⁵⁰ The estimates are that during the first quarter of 1987, the Bank of Japan conducted market operations totaling 16 billion dollars. Between March 23rd and April 6th, the New York Federal Reserve Bank also bought dollars against the yen daily, for a total of about 3 billion dollars. The operations were coordinated with the Bank of Japan and several European central banks.⁶⁵¹ But by this time the volume of foreign exchange transactions had tripled compared to the volume at the time of Plaza Agreement, and thus the effects of their intervention had become more limited.⁶⁵²

At this point, the U.S. also began to have strong concerns over the falling dollar. Volcker, who had been in the past worried about the dollar's free fall, cautioned a Senate banking subcommittee on April 7th 1987 that "further sizable depreciation of the dollar could well be counterproductive."⁶⁵³ On the same day, at G5 meeting, Baker also warned of the dollar's further depreciation.⁶⁵⁴ And, at G5, the policy to stabilize the dollar that was agreed at Louvre was reaffirmed, and it was proposed that member countries needed to provide 15 billion dollars for intervention.⁶⁵⁵ But, while Japan pledged to propose an urgent stimulus package of 5 trillion yen (34 billion dollars) later in April, West Germany offered no stimulus measures, for Federal Minister of Finance Gerhard Stoltenberg asserted that West Germany had reached the limit of its growth potential. The U.S. made its familiar pledge to work to reduce its budget deficit.⁶⁵⁶ In response, market participants judged that a reversal of the market trend would not occur, and accelerated the dollar-

⁶⁴⁸ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 188-9.

⁶⁴⁹ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 188.

⁶⁵⁰ Miyazaki, Yoshikazu. *Doru to en - Sekai keizai no atarashii kozo -*. Iwanami Shinsho, 1988, 78-79.

⁶⁵¹ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 188.

⁶⁵² Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 189.

⁶⁵³ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 190.

⁶⁵⁴ Funabashi, Yoichi. *Tsuka retsuretsu* (Japanese version of *Managing the Dollar*). Asahi Shimbun, 1992, 280.

⁶⁵⁵ *Ibid.*, 281.

⁶⁵⁶ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 189.

selling. Between April 7th and 17th, the U.S. monetary authorities made 532 million dollars of dollar-buying,⁶⁵⁷ but the yen rate rose to 137 yen per dollar by April 27th.

If we look at a wider time span, from February to April 1987, the U.S. made approximately 4.06 billion dollars of dollar-buying intervention (of which intervention against the yen was 3.96 billion dollars.⁶⁵⁸) and 30 million dollars of dollar-selling intervention. Also, according to the New York Federal Reserve Bank, the Bank of Japan, the Bundesbank, and other European central banks bought dollars in extraordinary amounts during the same period. While the scale of intervention following the Plaza meeting had been less than half of the agreed amount, intervention after the Louvre exceeded it.⁶⁵⁹

As the appreciation of the yen and the depreciation of the dollar continued despite the large-scale interventions, Prime Minister Nakasone complained to President Reagan at the U.S.-Japan summit held between April 30th and May 1st that the U.S. was not making sufficient efforts to stabilize the exchange market. Baker refuted this, saying that the U.S. had been making 5 billion dollars of dollar-buying intervention from the beginning of the year.⁶⁶⁰ But there was no time left for Japan and the U.S. to quarrel with each other. The yen-dollar rates were drastically changing, and the Omnibus Trade Competitiveness Act was approved at the plenary session of the U.S. House of Representatives on the 30th. It was a strong protectionist bill that included such requests as that of Gephardt, which demanded that countries with large trade surpluses against the U.S. reduce their trade surplus, as well as that of Schumer, which demanded regulations on the securities business of foreign financial institutions in the United States.⁶⁶¹ Against this protectionist move, President Reagan agreed to make efforts to stabilize exchange rates at the Japan-U.S. summit, and Nakasone in return promised a rate cut and domestic demand expansion through increased government expenditure.⁶⁶²

But what was more difficult to achieve was a cooperation between Japan and West Germany, rather than Japan-U.S. cooperation. West Germany intervened even less than France, Britain, and Italy; only 750 million dollars during the three-month period following the Louvre conference. The Bundesbank intervened little because it feared that massive intervention to prop up the dollar would swell West Germany's currency reserves and create excessive liquidity.⁶⁶³

In fact, this was a right judgment. In contrast, Japan was implementing a series of policies that induced a bubble economy. In addition to the consecutive rate cuts, Japan, based on the above-mentioned Japan-U.S. agreement, decided on May 29th 1987 to spend government funds worth 6 trillion yen for the expansion of public works projects

⁶⁵⁷ Funabashi, Yoichi. *Tsuka retsuretsu* (Japanese version of *Managing the Dollar*). Asahi Shimbun, 1992, 280.

⁶⁵⁸ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 190.

⁶⁵⁹ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 191.

⁶⁶⁰ *Ibid.*

⁶⁶¹ Zaimusho zaimu sogo seisaku kenkyujo zaiseishishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do (dai 7-kan) Shiryo Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2004, 384.

⁶⁶² Araki, Nobuyoshi. *En - Ichioku nin no kokusai kin'yu*. Nihon Kanzei Kyokai, 1989, 31.

⁶⁶³ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 191.

and tax cuts. Although the bureaucrats in the Ministry of Finance, who wanted to launch fiscal reconstruction, resisted such expansionary policies by suggesting the limit of fiscal burden they can have (cost of public works projects and tax cuts), the expansionary policies were implemented in the end, because the high officials in the Ministry of International Trade and Industry, Ministry of Foreign Affairs, and the Liberal Democratic Party claimed that it was necessary to increase government expenditure in order to boost the receding Japanese economy and to meet the U.S. request for Japan's domestic demand expansion.⁶⁶⁴ The effects of those expansionary measures appeared soon; from July, the domestic demand increased at annual rate of 9.9%, and the real GNP grew by over 8%. However, simultaneously, the rise in the price of land and stocks was also speeding up. In this way, the excessive fear of the strong yen brought about policies that encouraged excessive domestic demand expansion, and this in turn caused a bubble economy.

At this point, the Bank of Japan, which had been reluctant to raise the interest rate out of fear of triggering further appreciation of the yen, began to be wary of the bubble and began to look for a chance to raise the interest rate by the end of the year.⁶⁶⁵ But the U.S. demanded from Japan and West Germany a further rate cut. This was because Federal Reserve Chairman Greenspan feared that, if other countries raised their interest rates and reduce the differential between the U.S. and their interest rates, it would be difficult for the U.S. to contain capital outflow and curb the trend of dollar depreciation. Also, an interest-rate raise in those countries could shrink their domestic demand.⁶⁶⁶ Concerned about inflation and capital outflow from the U.S. that would be caused by excessive depreciation of the dollar,⁶⁶⁷ Greenspan had already raised the official bank rate, which had been consecutively lowered ever since 1984, by 0.5 % up to 6.0% on September 4th 1987.

But, ignoring the U.S. request, the Bundesbank raised the minimum interest rate for 28-day buying operations by 0.1% from 3.5% to 3.6%, claiming that there was a sign of inflation caused by the policy coordination (domestic demand expansion) after the Plaza Agreement.⁶⁶⁸ Then, the market began to project that Japan too might raise the interest rate in order to curb inflation and that the U.S. might raise the interest rate as well to widen the interest-rate differential. Such projection of interest-rate raise heightened the fear of economic downturn that might result from the high interest rates. The prospect for the U.S. economy was unclear with the mounting trade deficit. Also, when Baker protested against the Bundesbank for their interest-rate raise, President of the Bundesbank Pöhl replied that there might be another raise.⁶⁶⁹ And this gave the market an impression that the policy coordination agreed at the Louvre meeting had collapsed. In

⁶⁶⁴ For details, see Funabashi, Yoichi. *Tsuka retsuretsu* (Japanese version of *Managing the Dollar*). Asahi Shimbun, 1992, 143-150.

⁶⁶⁵ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 191.

⁶⁶⁶ Kubota, Isao. *Shogen Miyazawa dai ichiji [1986-1988] Tsuka gaiko*. Nishi Nippon Shinbunsha, 2008, 178.

⁶⁶⁷ Araki, Nobuyoshi. *En - Ichioku nin no kokusai kin'yu*. Nihon Kanzei Kyokai, 1989, 35; Takita, Yoichi. and Kajima Heiwa Kenkyujo. *NichiBei tsuka kosho - 20-nen me no shinjitsu*. Nihon Keizai Shinbunsha, 2006, 257.

⁶⁶⁸ Miyazaki, Yoshikazu. *Doru to en - Sekai keizai no atarashii kozo* -. Iwanami Shinsho, 1988, 16.

⁶⁶⁹ *Ibid.*, 21, 72.

addition, when Baker suggested that the U.S. would not implement coordinated interest-rate raise even if West Germany raised its official bank rate, and thus that the U.S. might not interfere even if the market moved toward the depreciation of the dollar against the mark,⁶⁷⁰ foreign investors started to further withdraw their funds from the United States (as of 1987, 13.2% of the total transactions at the New York Stock Exchange owed to purchases by foreign investors.⁶⁷¹).

It is not very clear to what degree each of the above factors influenced the situation, but what was clear was that the U.S. was in a gridlock where raising the interest rate would increase investors' fear of a recession in the U.S. and incur a selling of their investment in the U.S. and the dollar, whereas not raising the interest rate would also incur a selling of their investment in the U.S. and the dollar because no action would lead to a further depreciation of the dollar. And this gridlock situation led to the crash in the stock market. The Dow Jones Industrial Average continued to drop from October 6th and it finally plunged on October 19th by 22.6% from the day before (this is called the Black Monday). Some point out that, in addition to the above factors, computerized automatic selling orders were also one of the reasons for the plunge.

After Black Monday, the concern over recession mounted in the U.S., and the opposition to the interest-rate raise and support for the rate cut increased, causing a vicious cycle of further depreciation of the dollar. In such a situation, some began to criticize that keeping the Louvre agreement would cause a recession because the Louvre agreement forced a higher interest rate for the United States.⁶⁷² For example, Martin Feldstein, former Chairman of the Council of Economic Advisors (CEA), stated in the November 9th 1987 issue of *The Wall Street Journal* that the U.S. should “explicitly but amicably abandon the policy of international policy coordination.”⁶⁷³ FRB also feared a recession, and thus increased the money supply to induce the drop in the interest rate. From October 22nd to November 4th, the money supply through buying operations reached 9 billion dollars, and consequently the interest rate fell by around 1.5%.⁶⁷⁴ Also in Japan, the fear of the strong yen as well as the global recession that might be caused by Black Monday heightened, and in such a situation, the Bank of Japan missed the timing to raise the official bank rate.⁶⁷⁵

As a result of Black Monday and the interest rate reduction in the U.S., the dollar-selling accelerated, and the U.S. implemented a dollar-buying intervention of 395 million dollars against the Deutsche mark, and 65 million dollars against the yen, between 27th and 29th of October.⁶⁷⁶ But, the confidence in the dollar did not recover, and the dollar-yen rate, which was 142 yen per dollar in mid-October, became 138 yen per dollar by the end of October. In response, the U.S. made further dollar-buying interventions from

⁶⁷⁰ *Ibid.*, 21.

⁶⁷¹ Treasury Bulletin, Fact Book (NYSE).

⁶⁷² Funabashi, Yoichi. *Tsuka retsuretsu* (Japanese version of *Managing the Dollar*). Asahi Shimbun, 1992, 315-316.

⁶⁷³ Funabashi, Yoichi. *Managing the Dollar: From the Plaza to the Louvre*. Institute for International Economics, 1988, 211.

⁶⁷⁴ Araki, Nobuyoshi. *En - Ichioku nin no kokusai kin'yu*. Nihon Kanzei Kyokai, 1989, 40.

⁶⁷⁵ Takita, Yoichi. and Kajima Heiwa Kenkyujo. *NichiBei tsuka kosho - 20-nen me no shinjitsu*. Nihon Keizai Shinbunsha, 2006, 259-260.

⁶⁷⁶ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 192.

November 2nd to 10th, spending 40 million dollars against the mark, 38 million dollars against the yen, and 109.5 million dollars in total.⁶⁷⁷ But, with the news at the beginning of December that the U.S. trade balance in October recorded a larger than expected deficit, the dollar-yen rate shifted to the 120 yen level in mid-December. If we see the purchasing power based on the price of industrial products in 1987, the appropriate rate for the yen was 152 yen per dollar in 1987.⁶⁷⁸ By this time the yen had become clearly overvalued.

While the depreciation of the dollar against the yen proceeded, the G7 summit was held again on December 23rd 1987 to reconstruct the failing policy coordination. Judging that any more depreciation of the dollar would be counterproductive, the G7 countries agreed to have a policy coordination that aimed at keeping dollar-yen rates within the range between 125 and 135 yen per dollar.⁶⁷⁹ This is called the Christmas Agreement/Christmas Accord. Like the Louvre Agreement, this one also tried to contain the exchange rate fluctuation within a certain range, and in that sense, this agreement also contained the fixed-rate paradigm. Although the market-oriented but non-laissez-faire style operation of the floating system had become a standard operation style through the dollar-defense policy of 1978 and the Plaza Agreement, sometimes the fixed-rate system-like operation style of the floating system temporarily reemerged in certain circumstances as was the case in the Louvre Agreement and Christmas Agreement (when the situation stabilized, the countries returned to the standard operation style).

However, despite the above move by the G7, the dollar-selling continued because the market judged that the Christmas Agreement only called for the stabilization of exchange rates and had no substance to back up that call.⁶⁸⁰ As a result, the yen-dollar rates became around 122 yen per dollar by late December 1987. Then, as the exchange rate approached 120 yen per dollar, the monetary authorities of the G7 implemented a strong coordinated intervention.⁶⁸¹ The U.S. in particular actively intervened. The U.S. made 1.77 billion dollars of dollar-buying intervention between December 16th and 31st 1987, 685 million dollars between January 4th and 15th, and 300 million dollars on January 21st. In total, the amount of the dollar-buying interventions made by the U.S. authorities between November 1987 and January 1988 amounted to 4.14 billion dollars, of which 2.39 billion dollars were against the mark and 1.75 billion dollars against the yen.⁶⁸² In the meantime, Japan was also making intervention. As a result of its continued intervention operations by then, Japan's foreign currency reserves had swollen to 83.821 billion dollars by late February 1988.⁶⁸³ After this, major countries made interventions again when the yen rate rose over 125 yen per dollar in April.

At last, after all these efforts, the dollar-selling began to slow down. In addition to the above coordinated interventions, the improvement in the U.S. trade balance is said to have had positive influence. By April 1989, the dollar-yen rates stayed stably between

⁶⁷⁷ *Ibid.*

⁶⁷⁸ Araki, Nobuyoshi. *En - Ichioku nin no kokusai kin'yu*. Nihon Kanzei Kyokai, 1989, 15.

⁶⁷⁹ *Ibid.*, 16.

⁶⁸⁰ Zaimusho zaimu sogo seisaku kenkyujo zaiseishishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do (dai 7-kan) Shiryo Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2004, 387.

⁶⁸¹ Araki, Nobuyoshi. *En - Ichioku nin no kokusai kin'yu*. Nihon Kanzei Kyokai, 1989, 16.

⁶⁸² FRBNY Quarterly Winter 1987-88, 54-9.

⁶⁸³ Araki, Nobuyoshi. *En - Ichioku nin no kokusai kin'yu*. Nihon Kanzei Kyokai, 1989, 65.

120 and 130 yen per dollar. , After a long 2.5 years, the trend of dollar depreciation and yen appreciation that started since the Plaza Agreement finally came to a halt.

But it was after many problems were already generated that the turmoil halted. And as seen above, many of those problems had been aggravated because of the wrong responses by major countries. We have seen what those wrong responses were, but it will be revisited below, with some new additional points.

One of the wrong responses was as follows. The countries did not face the reality that the characteristics of the floating system had changed over time; the exchange rate came to reflect a country's capital balance, rather than its trade competitiveness, as international capital movement expanded. Fettered by the phenomenon of the past when the exchange rate under the floating system reflected a country's trade competitiveness, they forcefully tried to make the exchange rate match a country's trade competitiveness through coordinated interventions. However, it was only a matter of luck if the trend in exchange rate through intervention would return it to where it would reflect the country's trade competitiveness, because a country's trade competitiveness was not the only criterion for international capitals movement. Thus, at the Plaza meeting, major countries should have based their policy not only on the strategy to reverse the trend of the market but also on the strategy for the case where the reversed exchange rates moved far beyond the expected range.

Another wrong response was that, when the yen soared more than expected, the Japanese monetary authorities consecutively lowered the official bank rate and largely increased the government expenditure in order to prevent a high-yen recession. These caused an excessive expansion of domestic demand, and thus invited an economic bubble. In addition, the increased supply of the yen caused by the yen-selling and the dollar-buying is also said to have contributed to the creation of the bubble. The yen that was supplied through the intervention were 4.35 trillion yen in the fiscal year of 1986 and 3.48 trillion yen in 1987. These contributed to an increase in each year's money supply by 1.4% and 1% respectively.⁶⁸⁴ The Bank of Japan surely made some efforts to absorb the excessive money supply as much as possible. For example, they absorbed the yen currency by selling short-term government securities on January 13th and 14th 1987. Each day, they sold 300 billion yen-worth of securities. But, in a period when large-scale dollar-buying interventions continued over a long period, there was a limit to the amount of money they could absorb through selling-operation. The remaining excessive money piled up in the market, resulting in an excess money phenomenon.⁶⁸⁵ Yoshikazu Miyazaki, a professor at Kyoto University, pointed out that problem and stated, "Speculative investment in stock and land that became prominent in Japan can be seen as ... the negative consequence of intense dollar-buying interventions that were made for the suppression of yen appreciation."⁶⁸⁶ The annual increase rate of the money supply including the increase caused by intervention was 7-8 % in the mid-1980s but it jumped to 11-12% between 1987 and 1988.⁶⁸⁷ As a result of the above factors, namely the raise in

⁶⁸⁴ Mitsuhashi, Tadahiro and Uchida, Shigeo. *Showa Keizai shi (ge)*, Nihon Keizai Shinbunsha, 1994, 199.

⁶⁸⁵ Miyazaki, Yoshikazu. *Doru to en - Sekai keizai no atarashii kozo* -. Iwanami Shinsho, 1988, 57-58.

⁶⁸⁶ *Ibid.*

⁶⁸⁷ Zaimusho zaimu sogo seisaku kenkyujo zaiseishishitsu ed. *Showa Zaiseishi - Showa 49-63 nen do (dai 7-kan) Shiryō Kokusai kin'yu, Taigai kankei jiko, Kanzei gyosei*. Toyo Keizai Shinposha, 2004, 304-305.

the official bank rate, the increase in government expenditure, and the increased supply of the yen, the domestic economy expanded excessively. For instance, between 1987 and 1989, the land price in urban areas hiked by 102.6%, and the average stock price increased by 94%.

But despite such signs of a bubble, Japan kept the official bank rate at 2.5% until May 1989. The decision to keep the interest rate at a low level is said to be partially influenced by the pressure from the U.S. which was opposed to Japan's interest rate raise,⁶⁸⁸ but we can say that the fact that Japan itself was wary of the strong yen made it easy to accept that pressure. For instance, referring to the case where the U.S. withheld demands for domestic demand expansion or higher exchange rates since 1988, and also the case where the U.S. tolerated and accepted West Germany's interest rate raise in 1988, Yoshiko Kojo, a professor at the University of Tokyo, argues that it was because of the dominant anti-yen appreciation opinions in Japan, rather than the pressure from the U.S. that the policy options of the Japanese government and the Bank of Japan were limited at the time.⁶⁸⁹ Eisuke Sakakibara, who served as a Vice Minister of Finance for International Affairs in the 1990s, also testifies that the monetary authorities stimulated domestic demand primarily for the purpose of curbing the appreciation of the yen.⁶⁹⁰ Similarly, Tadashi Kano described that the efforts to maintain the interest rate at low level was "a product of the persisting high-yen phobia."⁶⁹¹

Another wrong response was the following. Although the ongoing strong yen did not reflect the capital competitiveness of Japan (in other words, it was not because Japan had particularly high capital and financial competitiveness that capitals flowed into Japan, the yen soared, and the excess money phenomenon emerged), Japanese monetary authorities and financial institutions did not feel a sense of crisis about the ungrounded excess money phenomenon, and did not make efforts to renew their financial system to make it a grounded phenomenon.

For example, Haruhiko Kuroda, who worked as the Vice Minister of Finance for International Affairs in the 1990s, describes the situation as follows: "[in the late 1980s,] as interest rates were deregulated and financial business liberalized, the major companies' dependence on banks was naturally reduced. The big corporations already had been able to issue corporate bonds, but on top of that, they were now able to issue the CP to gather short-term capital.⁶⁹² If they could gather necessary capital in the securities market, they did not have to use the banks. Thus, for the big corporations, the banks became not so important anymore ... Then, the banks naturally had to seek new borrowers other than the existing ones. Thus, they started lending a large amount of money to the industries and companies with which they had no business before, such as small and medium-sized companies, the service, distribution, real estate, and resort development industries.

⁶⁸⁸ Umada, Keiichi. "Kawase ante to NichiBei seisaku kyocho." in Shiraishi, Takashi and Umada, Keiichi. eds. *Kawase reto to Nihon keizai - Kokusai keizaigaku no tachiba kara*. Toyo Keizai Shinposha, 1996, 193.

⁶⁸⁹ Kojo, Yoshiko. "Baburu keisei, hokai no haikai toshiten NichiBei keizai kankei." in Matsumura, Michio and Okuno, Masahiro. eds. *Heisei baburu no kenkyu (ge) Hokai hen*. Toyo Keizai Shinposha, 2002, 366-7.

⁶⁹⁰ Sakakibara, Eisuke. *Tsuyoi en wa Nihon no kokueki*. Toyo Keizai Shinposha, 2008, 89.

⁶⁹¹ Kano, Tadashi. *Doru en soba no seiji keizaigaku - Kawase hendo ni miru NichiBei kankei*. Nihon Keizai Hyoronsha, 2006, 192.

⁶⁹² Commercial Paper: unsecured promissory notes that corporations issue to gather capitals in a short period. It became available from 1987 in Japan.

Because the banks lent money to unfamiliar businesses ... they lent it not based on the performance of those companies but based on whether they had collateral. Most of those companies had invested in real estate in one form or the other. At the time, the land price kept rising, and thus the value of the collateral kept rising as well, and because the value of the collateral kept rising, banks could lend more money. In such a situation of monetary relaxation, financial liberalization, and vicious cycle, the bubble swelled.”⁶⁹³

Looking back, Kuroda observes, “In the course of liberalization, financial institutions should have built a number of skills including screening, and the government should have implemented a policy to improve the skills of the banks, but neither was done. There was no structural reform in the economy and the companies did not restructure themselves. What they did was simply a quantitative expansion.”⁶⁹⁴ Of course there were others who pointed out those problems earlier than Kuroda. For example, Masaru Yoshitomi, who served as the Director of the Economic Research Institute in the Economic Planning Agency of Japan, argued that the bubble economy formed because the weakened monitoring functions among the Ministry of Finance, the Bank of Japan, the main financing banks, and the corporations, which occurred concurrently with financial deregulation and monetary relaxation, allowed excessive investments and lending.⁶⁹⁵ In the face of the excess money phenomenon which the yen appreciation accompanied, the monitoring function should have been maintained and bolstered through the improvement of the financial system.

However, Japan allowed the bubble economy to expand by making wrong responses as seen above. At last, from 1989, the monetary authorities embarked on tightening the economy, and the bubble burst that followed made the Japanese economy plunge into a long recession period.

To summarize, as explained at the beginning, in this chapter, we examined the process by which the growing international trade and international capital transactions paralyzed the floating system’s ability to prevent the divergence between the exchange rate and trade competitiveness. We also examined how the paralysis increased the authorities’ fear of the potential damage that the paralysis could cause, propelling their support for the floating system and their development of policies and measures for the fortification of the system. In other words, we studied the shift from the market-oriented *laissez-faire* style floating system to the market-oriented but *non-laissez-faire* style floating system based on internationally coordinated intervention. And, we have observed that, even though the internationally coordinated intervention was successful in changing the trend of the exchange rates at the time around the Plaza Agreement, even such large-scale coordinated intervention ceased to be effective enough to stop the market trend as the scale of international capital movement grew ever greater. Also, we have observed that the fear, which was generated by the deviation of the exchange rate from fundamentals and the uncontrollability of the exchange rate, made it difficult for monetary authorities, politicians, economic experts, business communities, and economic agents to make calm judgments and caused them to make wrong responses.

⁶⁹³ Kuroda, Haruhiko. *Tsuka no kobo - En, doru, yuro, jinmin gen no yukue*. Chuo Koron Shinsha, 2005, 164-165.

⁶⁹⁴ *Ibid.*, 166.

⁶⁹⁵ Yoshitomi, Masaru. *Nihon keizai no shinjitsu - Tsusetsu o koete*. Toyo Keizai Shinposha, 1998.

Conclusion

Since I have provided a summary of each chapter's findings at the beginning of each one, I will not repeat them here. But to express in one sentence, the aim of this dissertation, it was to demonstrate that the expansion of economic scale and potential economic damage as well as fears over the damage have been the persistent engines propelling the formation and transformation of the economic system. To put it another way, this dissertation pointed out that the characteristics of economic systems can be more clearly understood by looking at what kinds of crisis situations and potential damage they have been trying to avoid and overcome.

Even in the 1990s and 2000s, a period beyond the scope of this dissertation, the expansion of economic scale, potential damage, and fears continued to affect the Japanese and other countries' foreign exchange policy and currency system. Basically, 'the floating system based on internationally coordinated intervention' continued, but as the scale of international capital movement grew larger, the frequency and scope of interventions necessary to prevent disruptive exchange rate fluctuations grew larger as well. Moreover, even with frequent interventions, it is becoming increasingly difficult to tame the disruptive fluctuations and thus we are now at a stage where we need to find a new operation style for the floating system. Such developments in the 1990s and 2000s are not dealt with in this dissertation, but I hope to address these in my future research.

There is already an extensive literature on currency systems and foreign exchange policy. The contribution of this dissertation may not be in excavating new materials but rather in explaining changes in the currency system and exchange policy during the postwar decades, not so much as a result of a series of contingent events but as an inevitable process that has been strongly conditioned by such factors as the expansion of economic scale, international capital movement, and fears over potential economic damage. To be sure, in the short term, various contingencies (such as who became the economic brain of an administration, etc.) can strongly affect the shape of a country's and the world's economic system, but in the long term, it does seem inevitable that the scale of the world economy and international capital movement should continue to expand under capitalism, and thus the that currency system must change in the direction of sustaining that scale. In that sense, there is a direction in history, although it is a direction in the broad sense because not all things are determined by economic forces. Arguing for a direction in history has become something of a taboo in the humanities and social sciences, but the actual direction or trend that appears before us should not be ignored just because we are living in such an academic climate.

However, specifying the ever-increasing scale of trade and international capital movement as the motor of change can invite criticism that the approach is too reductive. It is true that there are many other factors that affect the shape of the currency system, such as power struggles among monetary authorities, the relationship between the central bank and the government or between business groups and monetary authorities,

politicians' electoral imperatives and party politics, public opinion and so forth. Shouldn't those factors be considered?

In fact, this dissertation did not ignore those factors. It has frequently mentioned some of them and explained in detail how a variety of actors from different institutions expressed different opinions and argued with one another. Nevertheless, because the dissertation explained that at each critical phase those conflicting opinions and interests ultimately morphed into a shared opinion/interest that took into consideration the pressure of international capital movement, one may wonder whether the conflicting opinions and interests were unduly downplayed in order to depict the expansion of the international economy and capital movement as the engine of change. But it is a fact that convergence of opinion occurred at each critical phase, and, if the intention was to downplay them, there is no need to even mention them in the first place.

Why were they mentioned then? They were mentioned in order to show that the expansion of the international economy and capital movement was a crucial factor to the extent that conflicting opinions and interests became less important in determining the shape of currency system in the face of the market turmoil and potential economic damage that the expansion of capital movement brought. In ordinary times, when there is no impending crisis, conflicting opinions and interests as well as other factors can strongly affect the currency system, and thus it can be said that they are important variables in the short term. However, in the long term, because there is no other way but to tackle the crises that accompany the ever-increasing capital movement, the expansion of international economy and capital movement surfaces as a greater factor in determining the shape of currency system. The same can be said for the role of fear. It goes without saying that various factors other than fear influence policymaking, but it is not unreasonable to think that fear surfaces as a relatively more influential factor during the time of crisis. In other words, fear is not the only important factor in the short term, because other factors also strongly affect the economic system in ordinary times, but crisis and fear work as crucial factors in the long term because there is no other way but to tackle crises in order to avoid or diminish economic damage. After a crisis passes as a result of systemic improvements, other factors will again begin to strongly affect the system. But, when crisis reemerges due to the expansion of capital movement, the system must be changed again in a way that can contain the crisis. In short, **it is from a long term perspective that this dissertation has observed and revealed the decisive influence of crisis, potential damage, and fear on history and the economic system.**

It must be admitted, however, that, although the dissertation explained the process by which the expansion of the international economy and capital movement emerged as a decisive factor in determining the nature of currency system, it did not explain in detail how the expansion of capital movement relatively diminished the influence of other factors as it surfaced. Because such an explanation is almost entirely omitted, the dissertation could have given an impression that it simply ignored the existence of other factors. In order to explain such factors, it would be necessary to examine the process by which those who had been acting based on personal or organizational interests changed their stance and came to act based on the consideration of the pressure of international capital movement, even at the expense of their former interests. From the vast materials I read, I know that such change of stance occurred, but until recently it did not occur to me that such an aspect should be carefully explained in the dissertation itself. It would also

be necessary to analyze at what level the very scale itself of international capital movement under each currency system begins to emerge as the factor that overwhelms all others—to analyze when, in other words, the “tipping point” toward crisis comes. In the future, I hope to strengthen the arguments made in this study by considering such questions.

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