



JAPAN  
AND THE CRISIS IN  
INTERNATIONAL FINANCE

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## FOREWORD

*It has always been the view of the Economic Research Council that the import/export trade of each country must in the long run be held in equilibrium because if one country persists in seeking a favourable balance of trade it can only do so at the expense of an unfavourable balance in other countries, and if this is carried too far it will inevitably lead to anxiety and in the end to violent conflicts of interest.*

*The Economic Research Council sponsored the publication of this report by Professor Allen because Japan is a classic example of a country which disregarded this truth. Japan chose deliberately to promote its Exports by every possible means at the expense of its Imports. As a result, year after year, it has achieved an astonishingly favourable balance which has been used by Japan to build up a vast holding of U.S. dollars. So long as this Japanese holding of dollars remains unused for any commercial purpose it cannot help being regarded as a threat to the currency system of the Western world, since it gives Japan the power suddenly to demand conversion of vast sums of dollars into other currencies which would dangerously disturb the world money markets.*

*We do not wish to imply that Japan has any evil intentions: We merely make the point that in our view governments should seek to secure that import/export trade is in equilibrium because the consequences of accumulating an excessively favourable or an excessively unfavourable balance are so disturbing to other countries.*

*At the end of World War II. Japan was in a state of chaos but the U.S. immediately embarked on a vast and most generous campaign designed to put Japan on its feet again and make it self-supporting. To this end American Companies were encouraged to co-operate with Japanese manufacturers*

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*with the object of imparting to them the latest American manufacturing techniques and the American Government, as well as the American industry, made huge loans to Japan.*

*In other words the U.S. made dollars available to Japan by purchasing Japanese Yen and was willing to hold the Japanese Yen until such a time as exports from Japan exceeded imports and so enabled Japan to buy back the Yen.*

*The Japanese Authorities quite properly endeavoured to achieve as great an export surplus as possible in order to pay back the debt to America—in other words, to buy back the Yen held by America.*

*The efficiency and the determination with which Japan restored its economy impressed the world and by 1965 Japan started to accumulate foreign currency. In short, after Japan had succeeded in paying off its indebtedness to America it continued, by various devices, to maintain an excessively favourable import/export balance—it persistently exported a great deal more than it imported and as a result accumulated foreign currency, in particular dollars.*

*At first it seemed understandable that Japan should wish to build up a substantial reserve of foreign currency but when Japan continued this policy until it had accumulated a fantastic holding of dollars it suddenly became a source of anxiety to the U.S. and the European Countries.*

*It cannot be to the advantage of Japan persistently to export more than she imports and to use the surplus to purchase dollars. Dollars in themselves are of no use to the people of Japan so it simply means that such a surplus represents work by the Japanese people which has been sent abroad in exchange for nothing which is of any value to them until those dollars are spent to purchase goods which benefit the Japanese people.*

*Since the Japanese Government persisted in increasing its massive holding of dollars, America naturally began to have misgivings about Japanese intentions because so vast a holding of dollars could easily be used to upset the international money market.*

PATRICK DE LASZLO  
Chairman

July 1972

The international monetary crisis, which came to a head with what the Japanese call the "Nixon Shock" on August 15th 1971, drew immediate attention to Japan's financial position. In the United Kingdom, for a decade at least, we have been well aware of the rapid pace of that country's industrial growth. But few of us had realised what a resounding impact the expansion of her economy, and especially of her export trade, had made on the world's financial system. Hardly anyone had understood how the international economic position of the United States was being affected by the expansion.

The various measures introduced by President Nixon in August last year were designed primarily to alleviate the complex of troubles with which the American economy was afflicted—inflation, stagnating production and a strongly adverse balance of payments. Yet there can be no doubt that two of the President's most important acts of policy, namely the 10 per cent import surcharge and the "floating" of the dollar were directed mainly against Japan.

Japan, it was widely believed, was the chief culprit among the countries whose commercial and financial policies had contributed most to the derangement of the American economy. The measures adopted in August are to be regarded as the culmination of a long series of disagreements between the two governments, disagreements which protracted negotiations failed to resolve.

The disagreements turned on Japan's foreign trade and exchange policy. For some years before 1971 she had achieved a large export surplus to the United States chiefly because of a steep rise in sales of manufactured goods to that market. As this export surplus to the United States was paralleled by what had taken place in Japan's foreign trade as a whole, the result was a steep increase in her reserves which are held mainly in dollars. The obverse of these trends was, of course, a worsening in the United States' balance of payments and a shrinkage in her reserves.

It was commonly thought in America that Japan had deliberately manipulated her controls over foreign trade and exchange in order to stimulate her exports and restrict her imports. While the products of Japan's technologically advanced industries were flooding the American market, American manufacturers were prevented by those controls from competing effectively in Japan or from participating directly in industrial enterprise in that country. Japan was charged with refusing to admit that she had now joined the ranks of the economically highly developed countries and that she no longer needed the props justified in the days of her weakness. She insisted on maintaining what had become, by reason of her remarkable industrial development, a much undervalued yen. She was accused of doing this without regard for the interests of her trading partners or for her obligations under the G.A.T.T. or the I.M.F.

The Americans were especially angry because her controls over the import of manufactured goods meant that a very high proportion of the United States' exports to her consisted of primary products, a condition not to be tolerated by the greatest industrial country of the world. At the same time the refusal to allow more than a limited participation of foreign investors and industrialists in industry in Japan was deemed to be contrary to obligations to her trading partners and a breach of the rules of O.E.C.D. American attempts to persuade Japan to liberalise her policies at an acceptable rate or to curb the rise in her exports to the United States met with stubborn opposition, and this, together with the deterioration in the American payments position during the first half of 1971, brought the sharp reaction in August.

### The Background: America's Contribution to Japan's Recovery

In order fully to understand the problem it is necessary to view it in perspective. Let us, therefore, glance at the course of Japan's post-war development and, particularly, at the part played by the United States in her recovery from the economic chaos left by the war. In the early post-war years

Japan's very survival depended on the food and raw materials supplied as "aid" by the United States, for at that time her export trade was very small and she had no means of earning the foreign exchange required. After the beginning of the "Cold War" and especially after the establishment of Communist government in China in 1949. Japan became an essential base for the deployment of American power in the Far East, and the United States exerted herself to rehabilitate the Japanese economy. This policy was pursued even more vigorously after the outbreak of the Korean War in June 1950.

The Occupation of Japan ended in the spring of 1952 and with it American "aid". But from then onwards there was a steep increase in dollar expenditure on the maintenance of American troops at Japanese bases and on the purchase of Japanese goods and services by American soldiers and civilians in the Far East.

This "special procurement expenditure" played a dominant role in Japan's recovery. During the greater part of the 1950s Japan's exports remained far smaller than in pre-war

TABLE 1

Value of Exports, Imports, Aid and "Special Procurement" (in million U.S. dollars)				
Year	Exports (f.o.b.)	Imports (c.i.f.)	Aid	Procurement
1947	174	526	404	—
1948	258	684	461	—
1949	510	905	535	—
1950	820	974	361	149
1951	1,355	1,995	164	592
1952	1,273	2,028	—	824
1953	1,275	2,410	—	809
1954	1,629	2,399	—	596
1955	2,011	2,471	—	557
1956	2,501	3,230	—	595
1957	2,858	4,284	—	549
1958	2,876	3,033	—	482
1959	3,456	3,599	—	458
1960	4,055	4,491	—	549

days and it was only by the use of the "special procurement" dollars that she was able to finance the imports needed for the re-equipment of her industries. Between 1951 and 1955 inclusive, these dollars paid for nearly a third of her total commodity imports. These receipts were especially important because then, as since, she had a heavy annual deficit on shipping and most other items in her invisible trade.

The Americans also helped to bring Japan's industrial technique up to date. During the war she had fallen behind the West. Now she strove, by means of technical agreements between Japanese and American firms, to acquire the "know-how" necessary to close the technological gap. Orders from the American forces stationed in Japan provided the initial stimulus for several of Japan's new industries (e.g. commercial vehicles), and American commercial organisation was used to promote the sales of Japanese goods abroad.

## Japan-United States Trade

It followed from Japan's dependence on receipts from "special procurement" that her commodity trade with the United States should have long been unbalanced in the latter's favour and that a very high proportion of Japan's imports should be supplied by the Americans. These features of the trade remained unchanged throughout the 1950s. In 1954, for instance, 46 per cent of Japan's imports came from North America and 35 per cent from the United States alone. In 1960 the corresponding proportions were 43 per cent and 34 per cent. Even after the volume of Japan's export trade had risen above the pre-war level (as it did for the first time in 1959), sales to the United States remained far smaller than purchases, if one excludes "special procurement" from the calculations. Consequently, Japan's debit balance on her commodity trade continued to be substantial. Between 1952 and 1962 it amounted in all to 5,274 million dollars. Even in the latter part of that period the value of Japan's exports to the United States represented only about three-fifths of her imports from that country. In addition, there were large

deficits on the invisible trade, for shipping services, royalties and interest payments.

**TABLE 2**

Japan's Trade with the United States (Value of trade in million U.S. dollars)		
<i>Year</i>	<i>Exports</i>	<i>Imports</i>
1954	276.7	846.9
1957	604.5	1,623.1
1960	1,101.6	1,553.5
1962	1,400.2	1,808.9
1964	1,841.4	2,336.0

## Controls over Trade and Foreign Exchange

Throughout the 1950s Japan maintained rigid controls over exchange dealings and foreign trade. These controls were deliberately employed for the purpose of stimulating exports and limiting imports to the materials, fuel and equipment essential for her industrial growth. This is not the place for a detailed description of the methods, but a brief outline may be permissible. All imports were subject to licensing and the allocation of foreign exchange to applicants was subject to the limits set by the bi-annual exchange budgets. The system was used to discriminate against imports from countries with "hard" currencies and in favour of imports from countries whose purchases of Japanese goods, under bi-lateral agreements, depended on the amount of their sales to Japan. A "link" system was also introduced by which import licences for raw materials were granted on condition that the grantee exported a given quantity of manufactures. Tax discrimination was exercised in favour of export industries and export bills were discounted by the Bank of Japan at low rates of interest. These are only a few of the devices used at that time.

Japan could justify the controls by reference to her exiguous foreign exchange reserves and to her weakness as a competitor in international markets. In the middle 1950s,

for instance, she was held to be a "marginal" supplier of many classes of goods, obtaining orders from abroad only when foreign exporters were too busy to give quick deliveries.

The controls were also an important instrument of general economic strategy. After the war the Government and the people perforce renounced their former political ambitions and concentrated their energies on economic, especially industrial, growth, almost to the exclusion of other purposes. This strategy involved heavy investment in industrial equipment and the maintenance of a high pressure of demand. From time to time the policy caused Japan's costs to get out of line with those of her competitors and led to large deficits in the balance of payments. Whenever this happened the financial authorities introduced ruthless deflationary measures (chiefly the contraction of credit to industry) which brought costs and prices down and succeeded in quickly restoring equilibrium. At such times the trade and exchange controls were enlisted as powerful auxiliaries in the process.

As Japan was judged to be economically weak in this period her trading partners were tolerant of these controls, the more so because they themselves were still discriminating against Japanese goods. The Americans, in particular, supported her as their most promising protégé whose stability and progress were essential to their Far Eastern strategy.

In October 1953 Japan was admitted to the provisional membership of the G.A.T.T. and in September 1955 to full membership. Many countries thereupon accorded her "most favoured nation" treatment and tariff concessions were negotiated with several of them. Yet some of her most important customers (or potentially important customers) continued to discriminate against her exports by invoking Article 35 of the G.A.T.T. Others, whose manufacturers were liable to protest against any sharp rise in imports of Japanese goods, successfully pressed the Japanese Government to restrict exports of certain classes of goods by "voluntary" export quotas. This applied to several classes of goods exported to the United States. Thus trade was hampered by artificial restrictions on both sides, and the experience certainly affected the subsequent Japanese attitude towards liberalisation.

## Industrial Recovery

By 1960 Japan had accomplished a remarkable industrial recovery. Industrial production was then about three times greater than in the middle 1930s, and it was still advancing at a high rate, having doubled in the previous six years. This advance had been attended by a structural transformation. Before the war Japan's industry had specialised in textiles (especially cotton and silk), and her export trade had largely depended on that class of manufactures together with a variety of miscellaneous consumption goods. Now her industry was rapidly assuming a structure similar to that found in Western Europe and North America. The most prominent manufacturing industries had become the metal, chemical and engineering industries, that is to say, the technologically advanced, capital-intensive sector. Steel, electronics, synthetic textiles and shipbuilding were active in the export markets.

Many factors, economic, administrative, technical, social and political had contributed to Japan's recovery. The underlying cause has already been referred to, a concentration of effort on economic growth in co-operation with her benevolent victors. Even had she wished to re-arm and to pursue an active foreign policy, she was precluded by the Peace Treaty of 1951 from re-establishing her military power; her troops were, in fact, limited to a small Defence Force. So her expenditure on defence remained very small, about 1 per cent of the national income. At the same time she was in no position to create a Welfare State. So her resources, material and personal, could be devoted almost exclusively to building up her industry. This single-hearted pursuit of a clearly perceived purpose is the key to her success.

She sought out and imported the most up-to-date techniques for her new manufactures. She was able to assimilate those techniques because her educational system provided her with an adequate supply of competent, well-trained technicians and managers.

The development of the new, science-based industries required the provision of much new capital. This was made possible by the high rate of saving and investment. For the last twenty years Japan's gross investment has represented

about one-third of her G.N.P., and her rate of personal saving has been the highest in the world. These savings enabled the monetary authorities to maintain a strong demand and industry to invest lavishly in new plant, without engendering inflationary pressure. During the last two decades manufacturing prices have risen very little, and for the first half of that period even consumer prices were stable. This was a remarkable achievement since wages rose very steeply. Productivity, of course, rose even faster.

It is not only the quantity of investment but also the quality of it that determines rates of growth. Japan directed a high proportion of all new investment into uses which yielded returns quickly in marketable goods. She turned her back on risky, "prestige" projects. Nor did she squander resources in bolstering up decaying industries. It was possible for the Government to guide investment into the preferred channels because manufacturers depended heavily on the banking system (indirectly on the Bank of Japan and directly on the official investment banks) for liquid resources to finance expansion.

TABLE 3

The Rise in the National Income and in Industrial Production		
Year	Annual Rates of Increase in G.N.P. (Real) (Percentage increases on previous year)	Index of Industrial Production (Mining and Manufacturing) (1965=100)
1960	15.4	57.8
1961	15.5	69.0
1962	7.3	74.8
1963	7.7	83.3
1964	13.8	96.4
1965	4.0	100.0
1966	9.7	113.2
1967	13.2	135.2
1968	14.4	159.2
1969	12.1	185.9
1970	10.9	215.9
1971	6.1	226.6

## The Labour Supply

A factor which made a major contribution to the magnitude of the industrial advance was the substantial increase in the supply of labour available to modern industry. The number of persons in employment rose by nearly 2 per cent a year between 1950 and 1967, while the number in non-agricultural employment rose by 4.3 per cent a year. The latter rate of growth can be explained by the fact that at the beginning of the period a very high percentage of occupied persons was engaged in agriculture (nearly 50 per cent). During the decade after 1955 about 5 millions of these agricultural workers were transferred to industrial employments. Agriculture was able to maintain, and even to increase its output, despite the decline in its labour force, by means of extensive mechanisation. Small-scale industry, which had always employed the majority of Japan's industrial workers, has also provided modern industry in recent years with many recruits.

TABLE 4

Distribution of Occupied Population (in thousands)				
Year	Total	Agriculture Forestry and Fishing	Manufacturing and Construction	Other Industries
1950	35,524	17,108	7,221	11,195
1960	44,340	13,400	11,990	18,950
1971	51,140	8,140	17,940	25,060

Certain features of Japan's economic and social organisation deserve to be stressed, if we are to grasp the causes of her achievement. For instance, the economy has remained highly competitive in character. This applies not only to the small-scale sector where costs and prices have been very flexible, but also to that part of industry that has been dominated by great business groups, the old *zaibatsu* and newcomers to the scene. Each group, which can be



regarded as a "conglomerate", has been in keen rivalry with the others. Whenever new industries appear, it exerts itself to obtain a due share of them. Attempts to control prices by cartels have nearly always proved ineffective.

The system of industrial relations has shown itself to be congenial to a policy of growth. The trade unions, which grew up after the war with American encouragement, assumed a form characteristic of Japan's social arrangements. The focus of power is the "enterprise union", that is, a union representative of the employees of a particular enterprise irrespective of their occupation. There are few craft or industrial unions, and demarcation and jurisdictional disputes are almost unknown. The workers forge strong ties with the firms that employ them. A recruit taken on by a firm when he leaves school is virtually guaranteed a job for life. His employer assumes onerous responsibilities for his welfare and, in return, expects and generally receives loyal co-operation from him. There are, of course, blemishes in the system, but these have been tolerated in a period in which real wages have risen spectacularly; during the last decade, for instance, they have doubled.

## The "Japanese Miracle" during the 1960s

During the 1960s Japan achieved the position of the second greatest industrial producer in the non-Communist world. Her pre-eminence in certain industries, such as ship-building and some types of electronic goods, was confirmed, and she built up quickly a number of new industries in which her performance had hitherto been modest. These included motor vehicles, synthetic textiles, petro-chemicals and machine tools. She constructed a great mercantile marine, now the largest in the world (after the "flags of convenience"). Her avowed ambition is to draw level with the United States as an industrial producer, and if her remarkable rate of growth continues, she may well achieve that purpose before the end of the century.

The 1960s were also notable for the rapid advance in her export trade. Throughout that decade the trade grew at

twice the rate of growth of international trade as a whole. By 1970 it was, in volume, over four and a half times that of 1960. An increasing proportion of it has consisted of the products of the technologically advanced industries; these now make up the bulk of the exports. Whereas in the early post-war years the main markets were found in Asia, in recent times the highly developed countries have been the best customers. The United States has remained the largest market and has taken over 30 per cent of the total exports for many years past.

In the import trade the most conspicuous items have been raw materials and fuel, both coal and oil. During the late 1950s Japan decided to go over to an oil-based economy, and she has since become one of the major customers for the oil of West Asia. It is significant that she has found the high-income countries, especially North America and Australia, cheaper and more reliable sources of both food and raw materials than the countries of the under-developed world. In her international trading relations, therefore, Japan during the 1960s definitely passed into the company of the advanced nations. But her trade presents one significant contrast to that of her chief trading partners. Whereas their trade has become increasingly "horizontal" (that is, an exchange of goods, including manufactures, within the same

TABLE 5

Volume of Japan's Trade (1960=100)		
<i>Year</i>	<i>Exports</i>	<i>Imports</i>
1954	33	49
1959	87	81
1961	108	131
1962	128	129
1963	144	152
1964	178	175
1965	230	177
1966	265	208
1967	278	260
1968	317	284
1969	405	331
1970	461	454
1971	544	462

class). Japan's trade has remained to a large extent "vertical", an exchange of manufactures for primary products. This gives a clue to many criticisms levelled against her commercial policy, which is held to be largely responsible for the peculiar structure of her trade.

The rapidly increasing importance of Japan both as a market and as a source of supply has led some commentators to exaggerate the part that foreign trade plays in her economy. It is true that without the imported fuel, ores, rubber and fibres her industry would be halted. Nevertheless the ratio of exports (and imports) in value to the G.N.P. for many years past has been only of the order of 10 per cent, a far lower proportion than before the war or than that of most Western European countries.

**TABLE 6**

Value of Japan's Trade (in million U.S. dollars)		
Year	Exports (f.o.b.)	Imports (c.i.f.)
1961	4,236	5,810
1962	4,916	5,637
1963	5,452	6,736
1964	6,673	7,938
1965	8,452	8,169
1966	9,776	9,523
1967	10,442	11,663
1968	12,972	12,987
1969	15,990	15,024
1970	19,318	18,881
1971	24,085	19,695

## Liberalisation

When the world became aware of the extent of Japan's economic recovery in the late 1950s, she came under pressure from her fellow-members of the I.M.F. and the G.A.T.T. to liberalise her international trade and payments system. She felt bound to respond. In 1963 she gave up exchange controls over current transactions (as required by

Article 8 of the I.M.F.) and, after accepting Article 11 status under the G.A.T.T., she began to dismantle her quantitative restrictions on imports and some of her devices for encouraging exports. She claimed that by 1967 the proportion of her trade liberalised had reached 93 per cent. This figure is misleading, since the significance of the proportion is affected by the fact that in 1959 (the reference year for the calculations) many types of manufactured goods which overseas suppliers might have sold in Japan were not, in fact, imported at all. She retained tight controls over certain food imports so as to protect her high-cost farmers and also over several classes of "sensitive" manufactured goods. It is contended by her critics that the import restrictions and export subsidies have been replaced by equally effective substitute measures. Tariffs have been raised or tariff schedules manipulated to protect vulnerable markets. American motor manufacturers attribute their small sales in Japan to various "unfair" administrative devices.

In reply to these criticisms one can argue that Japan's tariffs are not high by international standards and were, indeed, reduced after the implementation of "Kennedy Round" agreements. As to other kinds of restrictions, it is difficult to judge whether Japan is a greater offender than other countries. In 1969 the Japanese Ministry of International Trade and Industry, after a detailed survey, concluded that Japan suffered from non-tariff trade barriers erected by the Americans against her goods to a greater extent than the Americans suffered from her restrictions. Among these non-tariff barriers are the "voluntary" quotas already mentioned. The Americans, of course, can support their criticisms by reference to the facts of the reciprocal trade in manufactured goods.

Another complaint about Japan's commercial practices was directed against the restrictions which she placed on foreign investment in Japan and on the participation of foreign firms in Japanese industry. Her policy here is based on the fear that, if freedom were allowed, some Japanese industries might pass under foreign control. Since 1964, when Japan became a member of O.E.C.D., she had been urged to liberalise her rules about investment and so to bring them into conformity with the obligations of the members of

that organisation. Since then the restrictions have been progressively eased, but they have by no means disappeared. Japanese firms can anyhow find their own means of frustrating efforts by foreigners to obtain what they regard as an unacceptably large shareholding. In pursuing this policy the Japanese have been moved not only by nationalistic sentiments, but also by a belief that foreigners do not understand their unique ways, their business relationships or their system of industrial relations.

## The Genesis of the Payments Surplus

The "Japanese problem", as seen from outside, became increasingly serious after 1965 because of the remarkable boom in Japan's production and foreign trade which then began. This boom, it should be noted, took most of the official and business world by surprise. It had been expected by those who were responsible for the famous Income-Doubling Plan of 1960-70 that the rate of economic growth would decline in the latter half of the decade. This decline would occur, so it was believed, because of a shortage of labour and because a rising proportion of new investment would be allocated to the infrastructure. Even when the Plan was revised in the light of experience, the forecast was still for a somewhat lower rate than in the previous period. Thus the Social and Economic Plan for 1967-71 predicted a real growth rate of just over 8 per cent (compared with a 10 per cent rate between 1955 and 1965).

In fact, Japan's economy expanded faster than ever. The boom in international trade that started in 1966 found Japan a low-cost competitor, well equipped to secure a disproportionate share of the rising world demand. Between 1966 and 1970 the value of her exports doubled.

The Planners' miscalculations can be variously explained. First, a larger number of industrial recruits than expected were provided by small firms. Some came from the self-employed (including married women). Secondly, the heavy

investment in new plant during previous years yielded its fruits in higher productivity and, finally, the boom in international trade, especially the American appetite for imports, maintained a very high pressure of demand on the economy.

TABLE 7

Balance of Payments (in million U.S. dollars)					
Year	Exports*	Imports*	Visible Balance	Current Balance	Overall Balance
1965	8,332	6,432	1,901	932	405
1966	9,641	7,366	2,275	1,254	337
1967	10,231	9,071	1,160	-190	-571
1968	12,751	10,222	2,529	1,048	1,102
1969	15,679	11,980	3,699	2,119	2,283
1970	18,969	15,002	3,963	1,970	1,374
1971	23,650	15,750	7,000	5,898	7,677

\*The exports and imports as calculated for the balance of payments differ slightly from those in Table 6.

## The Rise in Japan's Reserves

It was the massive increase in exports after 1966 which transformed trading relations between Japan and the United States and contributed largely to bringing about the crisis of August 1971. It has been shown already that throughout the 1950s and early 1960s the United States consistently sold to Japan far more goods than she bought from her. The gap narrowed, however, in the early 1960s and in 1965, for the first time, the balance tilted the other way. 1965 was a year of domestic depression in Japan and, as always in such circumstances, products were diverted to the buoyant export markets. A balance favourable to Japan was maintained in 1966, but in the following year Japan's imports from the United States again exceeded her exports to that country. From then on the balance turned strongly in Japan's favour.

TABLE 8

Japan-United States Trade (in million U.S. dollars)			
Year	Exports to U.S.A. (f.o.b.)	Imports from U.S.A. (c.i.f.)	Export Surplus/+ or Deficit/-)
1964	1,841	2,336	- 495
1965	2,479	2,366	+ 113
1966	2,969	2,658	+ 311
1967	3,012	3,212	- 200
1968	4,086	3,527	+ 559
1969	4,958	4,090	+ 868
1970	5,940	5,560	+ 380
1971 (Jan-July)	4,157	3,125	+1,032
(Aug-Dec)	3,338	1,853	+1,485
			+2,517*

\*In judging the significance of the rise in the export surplus after August 1971 one should remember that the post-August figures are given in dollars that had depreciated steeply in terms of yen.

It should be stressed that there was nothing peculiar about Japan-America trade relationships at this time. As can be seen from Table 7 a similar trend could be observed in respect of Japan's trade with the world as a whole. The Japan-America trade was of special significance simply because of its enormous size. Further, the United States was much affected by the general trend because the growing export surplus led to a rapid increase in Japan's dollar reserves. The extent of the increase can be seen in Table 9. Up to the end of 1967 the reserves amounted to 2,005 million dollars, of which about one-sixth was held in gold and most of the rest in dollars. They had fluctuated around this figure for several years. Since Japan's imports in 1967 were valued at 11,700 million dollars, the reserves could not then be considered excessive, especially when it is remembered that up to recently she was not regarded as a particularly good risk by foreign lenders and could not count on being able to borrow on good terms in order to tide over a deficit in the balance of payments. As the trade surplus increased, the reserves expanded. By December 1970 they were well over twice their size three years earlier, and most of the increase occurred in dollar holdings.

TABLE 9

Gold and Foreign Exchange Reserves (in million U.S. dollars at end of year)	
1965	2,107
1966	2,074
1967	2,005
1968	2,891
1969	3,496
1970	4,399
1971	15,235
1972 (end of April)	16,535

## Resistance to Liberalisation

As the evidence of Japan's massive competitive strength in international trade accumulated, criticism of her policy became sharper, and soon the United States' protectionist lobby was brought into vigorous action. The American government was able to persuade Japan in 1968 to restrict the rise of her steel exports to the United States. But repeated efforts in 1969 and 1970 to induce her to extend "voluntary" export controls to classes of textiles other than those covered by the earlier agreement failed. Indignation at the slow pace of Japan's liberalisation of imports and investment policy mounted with the rising flood of Japanese cars, synthetic textiles and electrical apparatus in the United States' home market. It was intolerable to some Americans, moreover, that the greater part of Japan's purchases from the chief industrial country in the world should consist of food and raw materials rather than finished manufactures. An anti-dumping Bill (the Mills Bill) was introduced into Congress with the object of curbing imports from Japan and this attracted widespread support.

Although a considerable body of opinion among the Japanese economists and officials agreed that more rapid progress should be made with liberalisation, the government and most business men considered that it was improbable that the large favourable trade balance could long be

maintained. There were frequent references to the recurrent balance of payments crises from which Japan had suffered throughout the post-war period. Doubts were expressed about the ability of Japanese industry to sustain competition from American manufacturers if trade restrictions were abolished. Once the international trade boom was over, and the special stimulus given by American purchases in connection with the Viet-Nam war had spent itself, then Japan might find herself again in difficulties.

Others took the line, for which there was more justification, that the liberalisation of trade and investment, far from reducing Japan's surplus, might well augment it. If liberalisation were a reciprocal process, Japan as a cheap producer stood to gain more than most other countries. Similarly, they argued that to allow the unrestricted import of foreign capital and enterprise would probably increase the demand for yen. Those who contended in this fashion were, in effect, implying that the only way to achieve a balance was by up-valuing the yen. But the monetary authorities, as well as industrialists, were strongly opposed to such action because of its incalculable effects on the country's competitiveness abroad.

## **The Recession and the Leap-Forward in Exports**

The debate was already becoming acrimonious between Japan and the United States when the long internal boom in the Japanese economy came to an end. In the autumn of 1970 Japan entered upon what was for her a recession. The slackening of home demand diverted the attention of exporters to foreign markets with the result that sales to the United States rose faster than ever. From January to May 1971 an export surplus of 408 million dollars was earned on the Japan-United States commodity trade.<sup>1</sup> Meanwhile

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<sup>1</sup> From January to July 1971, up to the eve of the "Nixon Shock", the surplus was 1,032 million dollars.

Japan's foreign exchange reserves rose from \$4,500 million in December 1970 to \$8,000 million in July 1971. The disadvantageous effects of this movement were, of course, suffered by the Americans. Japan continued to resist pressure for modifying her trade and financial policy until her headstrong course was arrested by the "Nixon Shock".

## **The Monetary Crisis**

For a few weeks after President Nixon's "package" of measures, the Japanese monetary authorities strove to maintain the dollar-yen exchange rate. But forward transactions in dollar export earnings led to a huge increase in the reserves and from August 28th the yen was allowed to "float" upwards. By October the combined effect of the depreciation of the dollar and the import surcharge was a de facto revaluation of the yen, in terms of dollars, of 18 or 19 per cent. By the Washington currency agreement reached in December 1971, the upward revaluation of the yen was fixed at 16.9 per cent.

That agreement has by no means resolved the international monetary crisis. The weakness of the dollar has persisted and the future is uncertain. But it is at any rate possible to estimate the immediate effects of the revaluation on Japan's trade and international finances. In the first place, the loss to the reserves as a direct result of revaluation may be estimated at 1,786 million dollars. Those with a taste for irony will not fail to note the absurdity of striving furiously to enlarge an export trade only to have the proceeds of that trade sharply reduced by the crisis which the very success of the export efforts helped to bring about. This is not likely to be the only loss sustained by Japan from the same cause. She has continued to accumulate dollars throughout the autumn of 1971 and the early months of 1972. At the end of February 1972 the reserves had risen to 16,478 million dollars. The continued inward flow has been brought about, partly by the continuance of a large surplus on Japan's

balance of payments, and partly by advance payments made by customers for Japanese exports as a hedge against a further upward valuation of the yen later in the year.

It had been expected in some quarters that the de facto upvaluing of the yen, together with the surcharge, would seriously damage Japan's trade. But the expectation was never well founded. Japan, despite the changes, remains a cheap supplier of many classes of manufactures, and the persistent recession at home continues to provide encouragement to sell abroad. The growth of exports of cars and electronic apparatus to the United States has not been checked and any decline in other exports to that market has been compensated for by a rise in sales to Europe and elsewhere. Of course, comparisons over a period are vitiated to some extent by the change in the value of the various currencies. For instance, while in dollar values the average monthly export trade was larger in the last few months of 1971 than at the beginning of the year, in terms of yen and some other currencies there was a slight fall. However, imports have become cheaper, and Japan's highly favourable balance of payments has not been impaired.

## **Prospects for the Balance of Payments**

The course of the economy during the present year is difficult to predict because it depends on many complex factors, e.g. the success of efforts now being made to lift Japan out of her domestic recession, trends in the American economy, and developments in the world's financial system. But all the forecasters are agreed that Japan is again likely to earn a large surplus on her foreign transactions. They predict that for the fiscal year 1972 (that is, from April 1972 to March 1973) her favourable trade balance will reach 7,600 million dollars and her favourable overall balance 3,300 million dollars. These predictions are an embarrassment to the Japanese monetary authorities who fear that they will excite demands for a further upvaluing of the yen.

## **The Essential Facts in the Japanese Problem**

Let us at this point summarise the results of this survey as far as it has gone. The economy of Japan has moved in a few years from a position of weakness to one of exceptional strength. The foundations on which this great edifice was built were not until recently well understood by the outside world, partly because, even after a diversified and efficient industrial system had been created, Japan's export trade lagged behind and she remained subject to recurrent balance of payments crises which were regarded as a symptom of her commercial and financial immaturity. For most of the last two decades she remained dependent on American financial (and political) support, and her trade with the United States was heavily balanced in the latter's favour. Then, quite dramatically, in the late 1960s, after several years of rapid industrial and trade expansion, she not only achieved the rank of the second largest industrial producer in the non-Communist world, but she also began to earn a massive and sustained surplus in her balance of payments. The change was associated with the steep rise in productivity which steadily increased her competitive strength in foreign markets. The balance of trade with the United States tilted strongly in her favour, and the substantial growth in her dollar holdings became an important factor in the United States' own financial problem. The change from economic weakness to great strength was quicker than the response of the government's policy-makers and the business community towards modifying the system of controls or props built up in earlier years. Being dubious about the continuance of her favourable balance, Japan resisted pressures to abandon these controls or to raise the exchange value of the yen, now obviously under-valued. Her stubbornness exasperated the Americans who believed that their own economic problems were being exacerbated by Japan's policies, and in the end they forced the Japanese to modify their policies.

Before condemning the ego-centricity of the Japanese or their failure to take account of their obligations to their trading partners, one should understand that Japan's position

among the advanced countries is relatively isolated. This isolation is now breaking down, but Japan retains a sense of her uniqueness. Her springs of action differ in many ways from those of the Western world. Social, political and industrial relations are, when viewed by a European or American, rather peculiar. The Japanese have certainly made more anxious efforts to understand our ways than we have made to understand theirs. It is partly because they think that their methods are not comprehended by Westerners, or, if comprehended, regarded with impatience or disdain, that they are reluctant to admit Western firms or investors to unrestrained access to enterprise in Japan. The sentiment of fervent nationalism is present, but it is probably not the predominant motive in the refusal to liberalise at a pace acceptable to the rest of the world. The feeling of relative isolation, together with some lack of confidence in the present international monetary system, also explains in part her reluctance to up-value her currency. She has shown some willingness to impose "voluntary" quotas on her exporters in order to take the edge off the criticisms of her policy. As recently as in December 1971, at the time when the Nixon import surcharge was removed, she came to another agreement with the Americans about such a quota. Yet, as already shown, such quotas are unsatisfactory expedients since, even if they achieve an equilibrium, they succeed only by contracting international trade. The liberalisation of trade and investment, if possible by reciprocal agreement, is a preferred policy from the standpoint of general progress. In Japan's case, however, liberalisation alone is unlikely to prevent further surpluses in the balance of payments. Only by an adequate degree of revaluation can this be achieved. It is improbable that the revaluation agreed in December 1971 was adequate.

## Foreign Investment

It is arguable that a continuance of the huge surplus would be justified if Japan were proposing to embark on a

heavy programme of overseas investment or "aid", or if there were grave danger that foreign investment in Japan itself was liable to dry up. Neither of these conditions is likely to be present. Japan's overseas investments have been increasing fast, but they have been limited to a large extent to countries which are the sources of her imports of fuel and raw materials, or to long credits extended to purchasers of capital equipment. So far, the Japanese have not been heavily involved in portfolio investment or direct investment in overseas manufacturing industry. Moreover, they have participated very little in great international companies. It is possible that the 1970s may see a change in this respect. Japan's technological and economic strength may well be displayed in future in her association with concerns of world-wide scope. She may also sometimes find it expedient to establish branches of her own manufacturing companies in foreign countries as an alternative to a further steep rise in her exports, which often provokes criticism. Even so, it is most improbable that her overseas investment will rise so fast as to require a surplus in the balance of payments of the dimensions of recent years, if only because the flow of foreign capital *into* Japan is likely to be much increased as her investment rules are liberalised.

## A New Economic Policy?

No country would benefit more than Japan at the present time from a realignment of exchange rates in accordance with the real strength of the various national economies. For her to persist in building up still more massive reserves would be irrational. As already shown, the dollar proceeds of Japan's huge unrequited exports during recent years have fallen heavily in terms of other currencies. Every addition she makes to her reserves renders her more vulnerable to this type of loss.

It is a matter for satisfaction that both among the general public and in some official circles disquiet is now being felt

about the policy of concentrating so exclusively on growth in production and export. This is not only because the policy has excited resentment in the outside world, but also because the exceptionally high rate of growth after 1967 brought with it social and environmental disabilities which have lately become obvious to all. Some critics even assert that the Government was at fault in permitting, or encouraging, this exceptionally high rate. We have noted already that this was not really the result of deliberate planning, for the official expectation in the middle 1960s was that the rate would slow down. The factor mainly responsible was the remarkable expansion in export demands. One may judge, with the benefit of hindsight, that the Government would have been well advised, in the public interest, to have damped down the boom in order to secure resources for allocation to the neglected infrastructure and amenities in general. But for the Government deliberately to have taken steps to bring this about would have required it to act contrary to the immediate interests of the business community with which its power and fortunes have been closely associated.

However this may be, there is now a wide acceptance of the proposition that with a rate of growth lower than that of the last decade Japan would find it easier to assimilate the social changes that have accompanied expansion. It is recognised that, in the pursuit of industrial growth, many forms of social overhead capital have been seriously neglected. Housing, communications, sewerage, public works and amenities in general call for a vast investment if Japan is to match the standards of the West in these respects, as she has done in manufacturing industry. Urban congestion and pollution have become urgent problems that require governmental action on a large scale. Social morale, which has been well maintained so far, might well decline if the strains of urban living were not alleviated. Affluence has enabled most households to equip themselves with modern "consumer durables", refrigerators, T.V. sets, washing machines, modern furnishings and even, most lately, motor vehicles. But these abundant possessions have thrown into relief the country's unsatisfactory housing, the lack of facilities for recreation, the paucity of public open spaces and parks.

## The Recession and the Change of Course

The onset of the recession in the autumn of 1970 presented the government with both an opportunity and a stimulus for correcting the imbalance in the country's economy and society. In order to sustain, or rather to restore, a high level of effective demand, the authorities now propose to spend heavily on much needed public works for which resources were lacking during the period of the industrial boom. Industrialists are now likely to welcome this expenditure since other sources of demand are now gushing less copiously. The diversion of investment in these new directions, which is so desirable for the promotion of social welfare, would be assisted if pressure to export were reduced by the introduction of an appropriate exchange rate. To replace unrequited exports and depreciating reserves by investment in social amenities would be a rational policy to follow at this stage in Japan's development. The strong inflationary pressures exerted by the export surplus would be relieved if the trade were more evenly balanced, especially if the revaluation were accompanied by further liberalisation.

Yet Japan cannot be expected to set out on this new course with enthusiasm unless reforms in the international financial system offer a sufficient promise of future stability to persuade her that she can, with safety, become a fully committed member of the world economy. Although, as has been shown, the ratio of her imports to her national income is quite low, and will fall further as her tertiary industries expand relatively to the others, yet her prosperity depends on her having easy access to steadily increasing supplies of raw materials and fuel. It is for this reason that she must pay cautious regard to her foreign trade. Thus, her own choices of policies are likely to be affected by whether or not she can feel confidence in the international monetary and trading system. In developing such a system she herself can play, if she chooses, a role of ever growing importance. There is, in consequence, a reciprocal relationship between her own policy and that of the Western Powers whose influence at present is dominant in the community of international trade.



## Japan and the United States

The intimate economic and political relationship between Japan and the United States in the Pacific area has been one of the most enduring features of the last quarter of a century. *Japan, under the shelter of the American shield, was able to concentrate on economic growth without anxiety or responsibility for her defence.* For the United States Japan constituted a secure base and the Japanese could be counted on as faithful allies in the troubled Far East. The two countries have throughout the post-war period remained close trading partners, and many regions producing primary products in America have owed much of their prosperity to Japan's demands. The financial, technical and commercial links have been very strong. Both the Government and the majority of the Japanese have remained firmly committed to the American alliance.

During the last few years the mutual good feeling has been disturbed by differences of opinion both in the political and the economic spheres. The political differences do not concern us here except in so far as the change in American policy towards China may induce the Japanese to make determined efforts to enlarge their commercial dealings with China. The problem is awkward for her, since she does not want to disturb her excellent (and profitable) commercial relations with Taiwan. However, when all has been said, it seems probable that before long the frost in Japan-America relations will thaw. The two countries have great interests in common, and both would suffer, politically and commercially, if the harmonious relations that have existed between them for the last quarter of a century were permanently disturbed.

## Conclusion

The episode in international economic relations which has been described brings out certain fundamental weaknesses in the world's monetary system. The existence of

large chronic deficits or surpluses in the balance of payments of various countries represents a serious misallocation of resources and a hindrance to economic progress. To accumulate, as Japan has done, huge reserves by means of her export surpluses is difficult to defend at a time when the resources used in creating those surpluses are urgently needed for the construction of social overhead capital at home. Yet, unless governments are prepared readily to adjust their commercial policies and the exchange rates of their currencies to alterations in the relative economic strength of the different countries, the waste and the recurrent crises cannot be avoided. It was the remarkably rapid rise in Japan's competitive power, brought about by the increase in her industrial productivity, that was a major factor in producing the chain of events that led to the crisis of last summer. When there are sudden changes of this kind, the problem of adjustment can never be easy, for no-one can tell in advance whether the new trend is likely to endure. But the readiness of governments to take the risks of adjustments in their commercial policies and exchange rates would be far greater if they felt more confidence than they do now in the international arrangements for regulating the world's currencies.

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