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Policy Debates on Public Finance between the Ministry of Finance and the Bank of Japan from 1930 to 1936

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Abstract

In order to appropriate sources of fiscal revenue, the Bank of Japan started direct underwriting of new deficit-financing government bonds (BOJ underwriting) on November 25, 1932. This paper examines the BOJ's underwriting policy making process through the use of newly available archived documents from the BOJ and the Ministry of Finance (MOF).

Evidence from these documents contradicts conventional arguments that the BOJ was forced to underwrite government bonds due to Finance Minister Takahashi's strong request and that it regarded the policy measure as temporary. Instead, the BOJ was confident it could exert monetary control through the market operation of selling underwritten government bonds (selling operation). In addition, the BOJ willingly accepted the underwriting, expecting it to reinforce its influence over financial institutions.

BOJ policy makers partly forecasted the course of events. First, the BOJ started underwriting during the Takahashi finance period (1931-1936). Once it started, it was difficult for the BOJ to stop underwriting bonds. The BOJ was forced to continue underwriting deficit-financing bonds because of expanding financial demand. Second, the MOF used very complex and irregular budgeting methods beginning with the budget process of fiscal year (FY) 1936. They created large deferred fiscal burdens that concealed the realities of fiscal deficits.

Key words: the direct underwriting of deficit-financing bonds by the BOJ (BOJ underwriting); The Joint Research Committee; currency system; market operation by selling government bonds; continuing expenditure; deferred fiscal burden

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Contents

Introduction

Finance Minister Junnosuke Inoue's lifting of the gold embargo and shifting to a tight fiscal policy (so-called "Inoue finance," 1929-1931) caused an outflow of specie and severe deflation. The exhausted economy and spread of military action in China (the Manchurian incident) required an expansion of public finance. During this critical period, an experienced Finance Minister, Korekiyo Takahashi, reappeared. The shift to an active fiscal and monetary policy and the introduction of a virtual fiat money system (so-called "Takahashi finance," 1931-1936) enabled the government to meet its new fiscal demands, such as those steming from sending troops to Manchuria, and public works expenditures.

In order to appropriate sources of fiscal revenue, the Bank of Japan started direct underwriting of new deficit-financing bonds (BOJ underwriting) on November 25, 1932. As shown by self-criticism by the BOJ and the Ministry of Finance (MOF), this was a very important decision in the financial history of Japan.[1] Therefore, innumerable attempts have been made to clarify the economic effects of BOJ underwriting.[2] On the other hand, few effort has gone towards evaluating the "political economy" aspects, such as the policy formation process, the decision making process and the implementation process of BOJ underwriting. This paper examines the issue of BOJ underwriting from a political economy viewpoint and indicates that Inoue's subordinates (in the MOF and the BOJ) argued for more expansive monetary and fiscal systems even under tight budget conditions.

First, this study examines the policy formation process. On this point, previous works point out that Takahashi's ideas and efforts were based on advice from Eigo Fukai, BOJ Vice-Governor, who emphasized the need to stimulate business by supplying money through the financial market operation of buying government bonds (buying operation). The impact on the Japanese economy of Fukai's proposal and Takahashi's decision is well known.[3] However, it is unclear why Takahashi chose a BOJ underwriting over a buying operation, although a BOJ underwriting was a more direct way of granting credit to the government than a buying operation. Shima [1983] who emphasized the personal relationship between Takahashi and Fukai, has written the only study on this issue. Due to the lack of records, the roles of political actors other than Takahashi and Fukai, and the thoughts of other members of the MOF and the

[1] The BOJ later asserted that it regretted agreeing to the underwriting of deficit-financing bonds in the autumn of 1932. The BOJ also pointed out this was the first step toward losing its central banking function, and was the greatest failure in its 100 year history (Bank of Japan [1984], pp.55-56). The MOF also noted that many intellectuals asserted that the BOJ's underwriting which extended credit to the government created the foundation for inflation (Ministry of Finance [1969], p.33).

[2] For a discussion on the changes in economic structure after BOJ underwriting, see Nakamura [1994], lecture 2.

[3] See BOJ [1970], Miwa [1979].

BOJ concerning policy and system design, are not clear. [4]

Second, this study investigates the decision-making process. Most research examining political interaction between the MOF and the BOJ assumed a "financial subordination hypothesis,"[5] which asserts monetary policy was subordinate to fiscal policy. In previous literature, the BOJ has been regarded as a reactionary actor with no capacity for making rational or independent decisions. Also, the BOJ's ideological confrontations and compromises with the MOF have rarely been discussed. However we should pay attention to the BOJ's advantages in monetary control. This study shows that BOJ officials did not consistently oppose the underwriting although they were basically on guard against it, and that discretionary selling operations were systemized in exchange for accepting the underwriting because Bank officials wanted to reinforce their influence over financial institutions.

Third, this study tries to clarify the implementation process during the Takahashi finance period. Many commentators cite the BOJ's monetary control and the MOF's fiscal management in this period as a successful example of business stimulation. However, such a view ignores the relationship between monetary policy and fiscal management, especially budget policy, in this period. As a result of emphasizing the success of monetary control, this view serves as the historical basis for the revival of the argument of adjustment inflation. Therefore, it is necessary to clarify the problems of policy management in the Takahashi finance period relative to fiscal management.

This paper is organized as follows. Section 1 examines the views and system design of BOJ and MOF officials about the monetary system and BOJ underwriting. It has been generally assumed that the BOJ underwriting was initiated because the BOJ was persuaded by Takahashi's influential request and accepted it as a temporary measure.[6] This paper reexamines this assertion and clarifies the origins of the new monetary control system and the BOJ underwriting, by analyzing discussions from "*The Joint Research Committee of MOF and BOJ for Improving the BOJ System ("The Joint Research Committee")*," established in February, 1930. In section 2, the relationship between fiscal and monetary policy is discussed. In Takahashi finance period, as business recovery emerged, the issuance of deficit financing bonds was reduced and domestic prices were stabilized (The shift to a tight fiscal policy, 1935-1936).

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[4] Historical materials concerning the formation process of BOJ underwriting are scarce. Memoirs by Fukai are regarded as the only source of information. In this paper, thoughts of policy makers from the BOJ and the MOF about the BOJ underwriting policy are clarified, through internal records.

[5] This term is from Mabuchi [1994]. Though the expression is different, see also Endo [1954] and Ouchi [1976]. For discussion of the relationship between monetary and fiscal policy, see G.Colm [1957] and G.Schmölders [1981].

[6] BOJ [1984], p.54.

However, this process adopted very problematic budgeting methods and the shift to a tight money policy failed. Consequently, the BOJ underwriting continued.

1. BOJ and MOF in "the Joint Research Committee"

a) Discussions of the Currency System and the Limits of BOJ's Purchase of Government Bonds

Discussion of the BOJ's institutional reform started with the establishment of *the Research Committee on Financial Systems* in 1926.[7] Its establishment was an MOF initiative, and it tended to reflect MOF opinions.[8] After "*Research on the Commercial Bank System*" was submitted to this committee, the Banking Law was formulated in 1927. "*Research on the BOJ (Nihon ginko ni kansuru chosa)*"was drawn up in June 1927 and addressed reforms in the central bank system,[9] which could be regarded as a summation of the arguments for BOJ reform in the second half of the Taisho era.[10] However, due to the financial crisis in March 1927, the committee never deliberated on the reforms. After this crisis passed, the MOF and the BOJ agreed to reexamine the central banking system. Thus, in February 1930, "The Joint Research Committee" was established as an unofficial entity.[11] Though the results of this committee's arguments were never enacted either, due to the outbreak of the Manchurian Incident, the contents are both extensive and bold. The members discussed bank note issue systems, organizations, business activities (especially the relationship between the central bank and the market, and matters that needed authorization of the government), payment to the government, and arrangement of statutes, etc. I will now clarify the historical position of the report of the 1930-31 "Joint Research Committee," by comparing it with the final version of "the Research on BOJ" which was drawn up in the 1927 "Research Committee on Financial Systems."

First, members of the MOF and the BOJ were interested in discussing a system of banknote issue. At the time, the Japanese banknote issue system was called the elastic limit system. Under this system, banknotes were issued as a statutory issue dependent on specie reserves, as fiducial issue subject to certain limits by legislation, and as excess issue. The excess issue was regarded as exceptional, and the BOJ had to pay a tax on it. However, the outflow of gold after the lifting of the gold embargo made excess issue constant. The BOJ and

[7] Yoshino [1962], Chapter 2, Section 4.
[8] Yoshino [1962], p.283. "The Preparatory Committee for Financial System" was established by the MOF. The Chief Secretary to the Exchequer was the chairman and the MOF's highest officials were committee members.
[9] BOJ [1973].
[10] Yoshino [1962], p.289.
[11] "The Report for Improving the BOJ's System of 1-1-1," the 1st meeting, BOJ archive.

the MOF both regarded this condition as problematic.[12] They were inclined to make the banknote issue system flexible. They stated "the chief aim of the system of bank note issue is not only to secure convertibility but to maintain the flexibility of the currency."

"Research on the BOJ" opted to revise upward the maximum limit of fiduciary issue. In August 1928, the MOF expressed their intentions to adopt a proportional reserve system as follows: "as a reserve specie for conversion, the BOJ can hold either gold coins, gold bullion, silver coins or silver bullion the equivalent to at least 40 percent of the total amount of bank note issued."[13] This implies that bank note issue maximum is 2.5 times that of specie reserve. Given the amount of BOJ specie holdings was 826 million yen in 1930, BOJ bank note issue of 2,065 million yen was theoretically possible.

This was a substantial extension compared with the maximum limit of fiduciary issue at that time (120 million yen). It is unlikely that the MOF planned such an extreme expansion of currency issue under the tight fiscal rules of the gold standard. Rather, it seems that MOF's real aim was to save specie and make bank note issue flexible by adopting a proportional reserve system.[14] Just after returning to the gold standard in December 1929, the specie reserve was 1,073 million yen. However, it decreased by 309 million yen during 1930, and by 400 million additional yen by the end of 1931, and the amount of BOJ note issue also decreased by about 200 million yen during 1930. Since the BOJ and the MOF maintained a high interest rate policy in order to reduce specie outflow, bank loans decreased and the depression further deepened. Consequently, a sharp decrease in tax revenues resulted, leading to a revenue deficit, which significantly damaged the credibility of the MOF's fiscal and monetary control.[15]

"Research on BOJ" asserted that a proportional reserve system was appropriate for saving specie, and this was a solution to the above problem the MOF confronted. In the proportional reserve system, the BOJ only had to hold species at a fixed rate (for example, 40% in "Research on BOJ") to the BOJ note issue. Therefore, "even if an outflow of gold occurs, it will not restrain a convertible bank note issue until the decrease in gold reserves reaches the amount of the statutory reserve. It will not have a direct influence on the reduction of currency." In the end, a proportional reserve system was not adopted, but by proposing a proportional reserve system, the MOF wanted to save gold as specie reserve and remove the

[12] "Nihon-Ginko-Enkakushi Series 3 General Comment 1."
[13] "The Report for Improving the System of BOJ 1-1-1," the 1st meeting, BOJ archive.
[14] In "A Proposal from the Tokyo Chamber of Commerce & Industry," the members of the Tokyo Chamber of Commerce & Industry proposed a proportional reserve system as follows. "By adopting a proportional reserve system, it will be possible to save specie or increase flexibility of convertible note issue." See BOJ [1973].
[15] MOF [1969], p.24.

obstacle to fiscal and monetary control.

The BOJ responded to the MOF's above discussion in "The Joint Research Committee" as follows:[16]

1. The reason to positively support the proportional reserve system is unclear.
2. Although it is argued that an elastic limit system is based on currency principles and a proportional reserve system on banking principles, there is no clear distinction between the two in terms of a bank note issue.
3. In the case of a proportional reserve system, a bank note issue can reach a level not allowed in a fiduciary issue.
4. Possible remedies for when specie reserves increase and thus currency expands are inadequate.
5. There is no clear difference between the two systems under an extreme financial situation.
6. Revising the system of a bank note issue should be considered in the context of the central bank system as a whole.

However, as a BOJ committee member stated, the BOJ was neither directly opposed to the proportional reserve system nor seriously concerned with the choice of bank note issue system. Rather, whichever system were adopted, the central bank executives considered it necessary to impose a maximum limit on a bank note issue, or to limit a fiduciary issue by some method.[17] That is, the BOJ's main concern was systematic control of the amount of the currency issue.

Consequently, agreement was reached on the following two points.[18]

1. Expansion of the maximum limit of a fiduciary issue, under the elastic limit system, to at least 500 million yen.
2. Considering that BOJ's specie reserve holdings were in crisis during this period, the minimum ratio of specie reserve should be less than 40% if the proportional reserve system were adopted.

Then, the BOJ worked out the following compromise on the framework of the currency system. "We should basically maintain the present elastic limit system and then appropriately extend a maximum limit of fiduciary issue. When adding a factor for the proportional reserve system, we should clarify the relationship between the amount of banknote issue and specie holdings. If so, we can construct a system where the amount of the maximum fiduciary issue

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[16] "The Report for Improving the BOJ's System 1-1-1," the 5th meeting, BOJ archive.
[17] "The Report for Improving the BOJ's System 1-1-1," the 14th meeting, BOJ archive.
[18] "The Report for Improving the BOJ's System 1-1-1," the 13th meeting, BOJ archive.

can be settled automatically and which adequately improves the present system without giving the impression that the present system is fundamentally revised."[19] As a result, "The Joint Research Committee" agreed upon a new banknote issue system, which combined a fiduciary issue system with a proportional reserve system. It would have a maximum fiduciary issue limit of 500 million yen, and a minimum ratio of specie reserve exceeding 30% of the amount of the convertible note issue.[20] It was a compromise for the BOJ that they agreed to adopt a proportional reserve system, which had been rejected in "Research on BOJ."[21] However, the currency issue would be restricted as the BOJ desired.

Once the Committee determined the design of the currency issue system, the criteria for eligible collateral for a fiduciary issue came under discussion. Fiduciary issue, whether in excess or not, needed safe and positive collateral besides specie, government securities and commercial bills. For the BOJ, the amount of a currency issue was influenced both by the extent and maximum limit of securities for fiduciary issue. Therefore, in order to avoid easy currency expansion, it was rational for the BOJ to assert the need for a limit on its government bond holdings.

On this point, "Research on BOJ" stated that "the amount a fiduciary issue not including commercial bills should be less than 120 million yen," in order to "avoid excess convertible note issuance." However, at the same time, this document argued "since we have introduced the effective restriction to the amount of fiduciary issue, there is no risk of the BOJ holding excess government bonds and issuing excess convertible notes. So, there is no need to set a legal restriction on the purchase limit for government bonds or the amount of loans secured by government bonds." Thus, there was no purchase limit on government bonds, because there was a natural limit to the purchase amount of government bonds as securities for fiduciary issue and this guaranteed the stability of a currency issue. At that time, the policy makers probably assumed that the gold embargo would eventually be lifted. If so, they felt a policy of increasing a currency issue through purchasing government bonds was unrealistic.

"The Joint Research Committee," also discussed the pros and cons of purchasing government bonds, not commercial bills, as additional securities for a fiduciary issue. However, the BOJ did not take a stand against its underwriting of government bonds during committee discussions.

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[19] "The Report for Improving the BOJ's System 1-1-1," the 14th meeting, BOJ archive.
[20] In the Takahashi period, in June, 1932, Takahashi and the MOF carried out bold reforms in the currency system. The contents of the reform are similar to these agreements, and we can easily see that the discussion in "The Joint Research Committee" was closely connected with Takahashi's reform.
[21] The BOJ criticized a proportional reserve system in "Research on BOJ" because this system would cause too much flexibility in a banknote issue. See BOJ [1983], p.338.

The BOJ raised three reasons for holding government bonds: as instruments for market operations, as reserves for payment of cost and amortization, and as a result of underwriting at the government's request.[22] Concerning the first reason, it is remarkable that they raised the issue of selling operations since this was not yet considered a conventional policy tool (this will be discussed in detail later). The second reason addressed needs in the BOJ's day-to-day business. The third reason is problematic. One BOJ participant indicated the risk of an excessive currency issue. However, he also stated that the government bond holding by the BOJ was originally designed for the application for, underwriting of, and purchase of government bonds, and he assumed underwriting would be used in this way. It was also decided that the BOJ could purchase and hold government bonds as securities for a fiduciary issue.[23] The BOJ's thinking paid much credence to Japan's history.[24] At the early stage of the BOJ's history, specie was given to the BOJ by the government, and the function of a bank note issue was given with the condition that the BOJ hold government bonds. Consequently the BOJ did not oppose the underwriting of government bonds. Instead, BOJ members presumed BOJ underwriting when they discussed the purchase limit of government bonds.[25]

On the other hand, in addressing a purchase limit on government bonds,[26] one BOJ participant asserted that since the expansion of currency might be caused by a BOJ underwriting, government bond purchases should be limited or there should be an effective restriction on the use of securities for fiduciary issue.[27] In other words, the BOJ wanted to set a limit on its government bond holdings, but was ready to accept limiting the holdings of government bonds as securities for a fiduciary issue as an alternative, as outlined in "Research on BOJ."[28]

In "The Joint Research Committee," the MOF opposed this proposal as follows: first, if government bonds held by the BOJ are sold off in market operations and additional government bonds are underwritten, this is a de facto increase in underwriting. In this case, a purchase limit is meaningless. Second, if a purchase limit on government bonds is set, currency cannot be

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[22] "The Report for Improving the BOJ's System 1-1-1," the 33rd meeting, BOJ archive.
[23] "The Report for improving the BOJ's System 1-1-1," the 34th meeting, BOJ archive.
[24] Suzuki [1966], footnote 82.
[25] "The Report for Improving the BOJ's System," the 29th meeting, BOJ archive.
[26] Besides this plan, there is also an August 1928 plan concerning a purchase limit on government bonds. The MOF agreed to the BOJ's offer, setting a purchase limit, on the condition of its adopting the proportional reserve system. This plan indicated that government bills and government bonds should not exceed the maximum 40 percent limit of a fiduciary issue. However, "The Joint Research Committee" determined it would discuss the criteria of eligible securities for fiduciary issue after examining actual figures, and the agreement in 1928 was withdrawn.
[27] "The Report for Improving the BOJ's System 1-1-1," the 33rd meeting, BOJ archive.
[28] "The Report for Improving the BOJ's System 1-1-1," the 6th meeting, BOJ archive.

flexibly supplied.[29] However, one BOJ participant asserted, “it is very difficult to directly restrict the amount of government bond holdings. So if we try to maintain a purchase limit on government bonds to prevent the danger of an expanding currency issue by BOJ underwriting, we should limit the holding of government bonds appropriated for a fiduciary issue.”[30] The dominant opinion was that BOJ appropriation of government bonds should be allowed only within the limit of a fiduciary issue and not as a excess issue. Though it was the second best solution, the BOJ assertion was temporarily accepted. However, a final decision was postponed, as further discussion on the organization and management of BOJ was necessary.[31]

After that, however, the MOF’s Banking Bureau argued that the above conclusion was improper, giving the following explanation about the introduction of a purchase limit. “There is an opinion that the supply of funds, defined as application, underwriting, and purchase of government bonds, should be limited. Such an opinion is appropriate only if a suitable standard can be established. However, such a standard does not exist. If we attempt to set a limit, it will be based on an arbitrary standard. In a meeting on July 4 1930, although we agreed to prepare a certain standard, we could not establish a suitable standard. Thus, we decided not to apply any restriction.”[32] This shows that although the MOF basically consented to prepare a purchase limit on government bonds, they did not accept the BOJ’s arbitrariness. In *“The Issue on the Revision of the BOJ Banknote Issue System”* which was based on the argument at “The Joint Research Committee,” [33] it was decided that the securities suitable for fiduciary issue be listed. However, the MOF did not accept the BOJ’s request for limiting the purchase of government bonds. In the end, the BOJ’s request was completely rejected. In this way, the purchase limit on government bonds as securities for a fiduciary issue, which was accepted in “Research on BOJ,” was not accepted by “The Research Committee.”

To summarize, the BOJ approved the underwriting of government bonds, and virtually ignored a purchase limit on government bonds. Later policy developments and their eventual results, such as wartime fiscal and monetary policy and post-war hyperinflation, show there were serious defects in such a system design. Therefore, we must explain why the BOJ chose such a compromising attitude. To do so, I will examine arguments supporting new monetary control measures for BOJ underwriting.

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[29] “The Report for Improving the BOJ’s System 1-1-1,” the 33rd meeting, BOJ archive.
[30] “The Report for Improving the BOJ’s System 1-1-1,” the 29th meeting, BOJ archive.
[31] “The Report for Improving the BOJ’s System 1-1-1,” the 33rd meeting, BOJ archive.
[32] “April, 1931, Explanation of the Revised Clause in BOJ Regulations,” in “Documents concerning a Meeting about Revising BOJ Regulations, vol.2,” BOJ archive.
[33] “Nihon-Ginko-Enkakushi, vol. 3, General Discussion 1.”

b) The Absence of Regulation of Government Financing and Selling Operations

In 1930, “The Joint Research Committee” discussed new regulations concerning monetary control of the BOJ in “*The Issue of Improving BOJ Operations.*”[34] The following five subjects were identified as proper business for the BOJ.

1. Discounting of bills issued by the government such as financing bills (FB), and discounting of bills such as commercial bills and banker's acceptance bills,
2. Loans on securities such as government bonds, and on silver or gold bullion, foreign currency or commodities, and foreign exchange bills,
3. Dealings of commercial bills or banker's acceptance bills,
4. Application, underwriting, sale and purchase of government bonds and bills issued by the government such as FB,
5. Temporary and unsecured loans to the government, other than those referred to in 2.

As is often pointed out, these regulations basically provided legal confirmation of what had already been implemented.[35] However, given the policy structure after the implementation of Takahashi finance, there were a number of problems.

First, “The Joint Research Committee” decided the BOJ could provide funds to the government without collateral (clause 5). Second, the application, underwriting and dealing of government bonds and government securities were stipulated as BOJ business (clause 4). Thus, a system for supporting fiscal expansion was introduced. This revision followed MOF intentions, which set out to allow unrestricted BOJ holding of government bonds. The flexible currency issue system was closely connected with discretionary fiscal management by the MOF.

At that time, financing of the government was “to be in the form of government securities such as FB in principle.”[36] That is, unsecured finance to the government was restricted unconditionally. However, as FB issue had reached its limit,[37] reflecting the deepening depression and the sharp decrease in tax revenues, it became difficult for the government to be financed only through the underwriting of FB. Therefore, for the time being, the MOF and the

[34] “Nihon-Ginko-Enkakushi Series 3 General Comment 1.” We can regard this document as a compilation of discussions about the reform of the central banking system in the Inoue period.
[35] Yoshino [1962], p.315.
[36] “April, 1931 Explanation of the Revised Clause in BOJ Regulations,” BOJ archive.
[37] The maximum limit of an FB issue was to be 100 million yen by regulation of Article 6 in the Public Account Law. However, the limit was immediately expanded to 150 million yen in fiscal year 1930 and to 250 million yen in FY1931, and the frequency of its issue increased rapidly (6 times in FY1929, 19 times in FY1930 and 19 times in FY 1931).

BOJ determined that the BOJ could also lend without discounting securities. In these circumstances, unsecured finance to the government was stipulated.

In addition to easing BOJ financing of the government, the BOJ's monetary control function was also enhanced (clause 4). FB Sales, which had not been permitted before, were allowed. The MOF's permission in government bond dealing, which had been needed, was no longer necessary. The BOJ's political intentions behind the institutional changes which enabled fiscal expansion and enhancement of its monetary control can be summarized in the following two points.

First, strengthening intervention in the market had become an urgent priority for the BOJ. This contrasts with a decrease in the BOJ's ordinary loans and in its influence over financial institutions.[38] At the time, the BOJ recognized that it was difficult to impose monetary control through large banks because the five major banks had increased power and could disregard BOJ commands.[39] Under such conditions, the BOJ could have extended business relations with only minor banks and individual customers. However, "The Joint Research Committee" stressed, "the BOJ should not be satisfied with being the bank of commercial banks. Rather, it should be the central organization of all financial institutions." Therefore, "it is not appropriate to conduct individual dealings and to compete with other commercial banks in our country's present condition."[40] Consequently, policies were proposed not to increase individual dealings but to promote the development of financial markets and to strengthen relations between the BOJ and markets by Open Market Operations.[41]

However, the "Open Market Operations" here, were assumed to be selling operations. In 1930, maintaining the gold embargo required high interest rates, and business conditions became very serious, so the demand for funds decreased. On the other hand, the BOJ held a large amount of long-term fixed relief loans and there was a surplus of bank funds. Therefore, the financial markets were relaxed, the dependence on BOJ ordinary loans decreased and monetary control by the BOJ became more difficult.[42] So, it was indispensable for the BOJ to seek policy instruments to absorb liquidity from financial markets and to increase its influence

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[38] The BOJ's loans and discounts outstanding decreased sharply from 265.14 million yen (December, 1925) to 52.03 million yen (December, 1929).

[39] "April, 1931, Explanation of the Revised Clause in BOJ Regulations," BOJ archive.

[40] "The Report for Improving the BOJ's System 1-1-1," the 30th meeting, BOJ archive.

[41] "The Report for Improving the BOJ's System 1-1-1," the 31st meeting, BOJ archive.

[42] "The Report for Improving the BOJ's System 1-1-1," the 30th meeting, BOJ archive. Finance Minister Junnosuke Inoue inquired, "In order to effectively control financial markets, shouldn't we allow for the market conditions where financial institutions require BOJ financing?" A BOJ committee member responded, "There are already enough loans outstanding. However, these loans become fixed. So this is virtually the same as when we have no loans outstanding. As a result, there are large funds in the financial market."

over financial institutions. This policy, which started at the beginning of Takahashi finance, made the BOJ compromise on issues of BOJ underwriting and unsecured finance to the government. However, at the same time, an environment emerged where the BOJ could exert its influence over financial institutions.[43]

Second, in accepting the underwriting of government bonds, the BOJ believed it could prevent the currency expansion through selling operations.[44] In October, 1932, Governor Hijikata expressed confidence in monetary control, addressing BOJ underwriting, "as we may expect investors to purchase government bonds, BOJ underwriting of government bonds need not lead directly to the expansion of a currency issue."[45]

To summarize, a basic reason for the BOJ's compromise with the MOF was the BOJ's desire to strengthen its power of intervention in financial markets and its influence over financial institutions. The BOJ was also confident it could maintain monetary control even with BOJ underwriting. The BOJ and the MOF agreed to relax regulations on government financing, but concerning the revision of the bank note issue system, the BOJ failed to set a purchase limit on government bonds. Nevertheless, we cannot overlook the fact that the BOJ willingly introduced selling operations to strengthen its financial market function and to maintain its influence over financial institutions and its power of market control.

2. The Transition of Monetary Policy and the Budget Process during the Takahashi Finance Period

This section will examine policy developments after "The Joint Research Committee" disbanded, and investigate the relationship between fiscal management and monetary control through selling operations during the Takahashi finance period. After 1932, when BOJ underwriting of government bonds started, ease in selling operations was recognized as one of the policy variables for measuring fiscal soundness.[46] This was similar to arguments presented

[43] Along with increasing intervention in financial markets, the selling operation was recognized as a means of adjusting money market rates. Although there were problems with BOJ underwriting, the BOJ intended to strengthen monetary control in accordance with market function.
[44] One BOJ participant asserted, however, that since the term of government bond redemption was quite long, if they did not sell the bonds off, they could not absorb liquidity. "Reports for Improving the BOJ's System 1-1-1," the 34th meeting, BOJ archive.
[45] "The Reference for Home Branch Managers' Meetings," "BOJ's Documents on Home Branch Managers' Meetings, 1932, Spring-Autumn," BOJ Archive. It can be argued that as the background of the above two points, especially the latter, policy developments in foreign central banks were influential. The BOJ was investigating changes in instruments for monetary control of central banks in various countries, such as the Bank of England, The Federal Reserve, and the Reichs bank. "The business of central banks in England, US, Germany and France" in "Reports for Improving the BOJ's System 1-1-2," BOJ archive.
[46] Ide [1998]. As stated later, the BOJ carefully observed market trends, and as stagnation of government bond sales became apparent, the BOJ advised the MOF to reduce government bond issuance.

in “The Joint Research Committee.” So, in order to properly evaluate the system design in this committee, it helps look at the relationship between market intervention by selling operations and fiscal management after 1932.

Table 1 shows the developments in the financing of the private sector from fiscal year[47] 1932 to 1936, or roughly the Takahashi finance period. Government[48] payments in 1933 were extremely large. This was due to a rapid increase in the refunds of food financing bills,[49] as well as general payments[50] by the government reaching its highest level during these five years. However, the massive flow of funds into the private sector in the same period was offset by the sale of government bonds and FB, especially food financing bills. Consequently, the overall flow into the private sector was only 51.3 million yen in 1933, as compared to 395.1 million yen in 1932. During these years, monetary policy was dedicated to absorbing excess liquidity in the financial market.

In 1934, BOJ government bond sales peaked, and general payments by the government were restrained. Consequently, the inflow of funds to the private sector turned into an outflow of 10.6 million yen. However, in looking at the figures closely, the second half of 1934 and all of 1935 provided the turning point in terms of monetary control. Government bond sales in the second half of 1934 were lower than the same period in the previous year. In the first half of 1935, government bond sales decreased by about 250 million yen, while general spending increased slightly. These changes reflected a surge in demand for funds in the private sector. Consequently, the inflow to the private sector jumped to 89.8 million yen, the highest since FY1933 when selling operations first hit its stride.

[47] April to March for respective years.
[48] This section defines “government” as the national government hereafter unless otherwise indicated. Local government falls under “the private sector.”
[49] The food financing bill is a financing bill issued by the government to adjust seasonal discrepancy of funds in terms of buying and selling crops such as rice.
[50] Payments by the government other than debt service.

Table 1 Flow of Funds into/out of Private Sector (in thousands of yen)

Fiscal Year	General Payments by Government	Debt Payments: Government Bonds	Debt Payments: Financing Bills	Government Payment Total	GB Sale by BOJ	FB Sale by BOJ	BOJ Sales Total	Change in Fund Private Sector
1932								
1st half	49,800	87,900	451,900	258,900	0	243,000	208,800	50,100
		(-95,600)	(-235,100)		(-10,900)	(-23,300)		
2nd half	450,200	89,900	233,800	653,000	16,300	291,700	308,000	345,000
		(-91,100)	(-29,800)					
Total	500,000	177,800	685,700	911,900	16,300	534,700	516,800	395,100
		(-186,700)	(-264,900)		(-10,900)	(-23,300)		
1933								
1st half	345,500	–	840,000	1,185,500	462,200	880,500	1,342,700	-157,200
2nd half	345,500	–	480,600	826,100	326,400	290,800	617,200	208,900
Total	691,000	–	1,320,600	2,011,600	788,600	1,171,300	1,959,900	51,700
1934								
1st half	292,300	87,500	471,000	850,800	602,600	374,600	977,200	-126,400
2nd half	197,100	10,000	353,000	560,100	297,800	146,500	444,300	115,800
Total	489,400	97,500	824,000	1,410,900	900,400	521,100	1,421,500	-10,600
1935								
1st half	314,400	–	335,800	650,200	351,700	366,700	718,400	-68,200
2nd half	156,600	189,400	419,800	765,800	303,100	304,700	607,800	158,000
Total	471,000	189,400	755,600	1,416,000	654,800	671,400	1,326,200	89,800
1936								
1st half	150,100	844,400	394,000	693,900	505,000	411,400	899,200	-205,300
		(-694,600)				(-17,200)		
2nd half	301,600	1,217,000	400,600	774,100	180,700	340,400	521,100	253,000
		(-1,145,100)						
Total	451,700	2,061,400	794,600	1,468,000	685,700	751,800	1,420,300	47,700
		(-1,839,700)				(-17,200)		

Source: Bank of Japan, Fiscal and Monetary Indicators (ZaiseiKin'yu Siryo Yoroku), various issues.
Note: Figures in parentheses indicate gross inflow of funds, e.g., debt payments and buying operations for Government Bonds and Financial Bills in 1932 and 1936.

As a whole, monetary control based on selling operations succeeded through the Takahashi finance period. When the demand for funds in the private sector stagnated, the market liquidity, which increased rapidly due to BOJ financing of the government, was absorbed through the purchase of government bonds by private financial institutions. Table 2 shows developments in deposit, loan and government bond investment by banks. Table 2 shows decreases in loans and increases in government bond investment. Through this process, the BOJ conducted financial market operations not through genuine open market operations but through negotiated transactions with financial institutions.[51] The BOJ exerted influence over financial institutions through allocating liquidity to each institution. It can be argued that the BOJ's policy objective in "The Joint Research Committee" was eventually attained.

[51] BOJ [1984], p.44. The BOJ determined whether to meet the offer from financial institutions for purchasing government bonds after asking their finance condition. It was considerably different from open market operations in today's sense.

Table 2 Deposit, Loan and Government Bond Investment (in thousands of yen)

	1931	1932	1933	1934	1935	1936
Deposits						
Fixed and Saving	4,884,929	4,766,430	5,049,272	5,514,156	6,027,987	6,686,277
Special and Checking Account	3,446,957	3,619,793	3,843,853	4,013,894	4,027,786	4,433,166
Totals A	8,331,886	8,386,223	8,893,125	9,528,050	10,055,773	11,119,443
Loans						
Loans on Bills and Deeds	5,238,002	4,878,360	4,659,785	4,523,337	4,665,852	5,008,023
Discount Bills and Overdrafts	1,599,546	1,813,700	1,945,041	1,897,823	2,049,293	2,248,565
Totals B	6,837,548	6,692,060	6,604,826	6,421,160	6,715,145	7,256,588
A-B	1,494,338	1,694,163	2,288,299	3,106,890	3,340,628	3,862,855
Bank's GB Holdings	1,328,280	1,080,950	1,491,465	1,998,148	2,220,387	2,558,296
Loans/Deposits	82.10%	79.80%	74.30%	67.40%	66.80%	65.30%
GB/Fixed and Saving	27.20%	22.70%	29.50%	36.20%	36.80%	38.30%

Source: Ministry of Finance [1939]

At that time, some argued that consistency between the absorption of funds through selling operations and fiscal expenditures by the government could not be maintained in such a policy framework.[52] However, the BOJ regarded market operations as far more practical than changes in official discount rates because they could not expect to change official discount rates as a form of monetary control.[53]

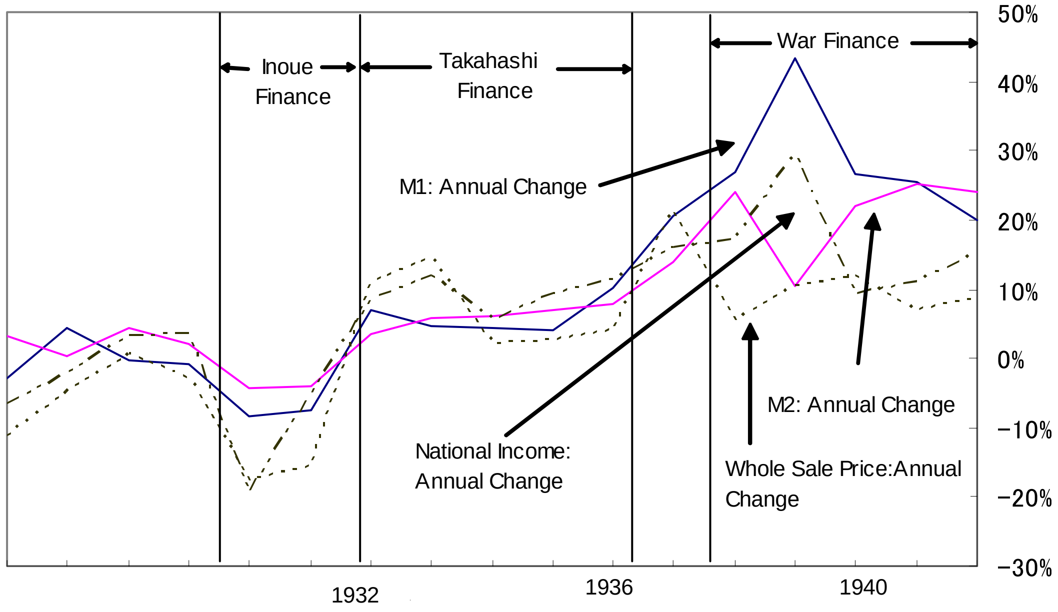
It is well known that economic recovery with low inflation was achieved. Chart shows developments in the money supply, prices and national income during this period. Although prices and money supply were very stable, national income gradually increased.

However, this temporary success in monetary control and economic recovery does not justify a policy framework based on BOJ credit. As confirmation, monetary control through selling operations functioned well, as "The Joint Research Committee" had assumed. Also, when government bond sales stagnated after the second half of 1934, BOJ deficit financing of the government was reduced through consultation between the BOJ and the MOF.[54] In response to increased demand for funds in the private sector and stagnation of government bond sales, the MOF opted for a gradual reduction of government bond issues in the budgetary process of FY1936, and tried to reduce the budget deficit. This led the MOF to attempt to balance the

[52] Kinyu Kenkyu Kai (Financial study group) [1936], p.58. Kinyu Kenkyu Kai asserted that it expected fiscal expenditures to promote the business sector's recovery from depression, but that monetary control by selling operations blocked it.
[53] "BOJ Market Operations, January, 1933" in "Documents on the Capacity for Government Bond Issue, January, 1933 - August, 1935," BOJ archive.
[54] "Document Submitted by Vice-Governor Fukai to Financial Bureau Chief Aoki, August, 1934" and "The Reference on Government Bonds, May, 1935" in "Documents on the Capacity for Government Bond Issue, January, 1933 - August, 1935," BOJ archive. After the second half of 1934, Vice-Governor Fukai worried about the feasibility of additional government bond sales and consulted the MOF Financial Bureau Chief. However, it seems that Fukai did not reach a clear conclusion.

FY1936 budget.[55] In the budgetary process, however, irregular and problematic budgeting methods were adopted under military pressure.[56]

Chart Money Supply, Wholesale Prices, and National Income



Sources: Fujino, Shozaburo, *Nihon no Mane Sapurai (The Money Supply of Japan)* , Keisoshobo, 1994 (in Japanese).
Ohkawa, Kazushi, Tsutomu Noda, Nobukiyo Takamatsu, Saburo Yamada, Minoru Kumazaki, Yuichi Shionoya, and Ryoshin Minami, *Choki Keizai Tokei 8: Bukka (Estimates of Long-Term Economic Statistics of Japan since 1868 8:Prices)* , Toyo Keizai Shinposha, 1967.
Ohkawa, Kazushi, Nobukiyo Takamatsu, and Yuzo Yamamoto, *Choki Keizai Tokei 1: Kokumin Shotoku (Estimates of Long-Term Economic Statistics of Japan since 1868 1: National Income)* , Toyo Keizai Shinposha, 1974.

For example, multi-year continuing expenditures created a financial burden to be incurred in the budgets over consecutive years. Both the total amount and the annual spending schedule were to appear in the budget of each year. But, during this period fiscal authorities used this clause to postpone future fiscal burdens, especially those for military spending. In FY1936, continuing expenditures for the Department of the Army increased to 489.92 million yen from 140.87 million yen in the previous year. Continuing expenditures, also increased for the Department of the Navy, to 484.88 million yen from 368.21 million yen. These two

[55] In the budgetary process of FY 1936, the MOF and Takahashi set a policy goal, the so-called "kokusai zengen seisaku (reducing deficit-financing government debt policy)." The MOF set the target amount of bond issue reduction as the equivalent of the natural increase tax revenue. As a result, government bond issuance decreased by 91 million yen and "kokusai zengen seisaku" was achieved.
[56] These included accumulation of deferred fiscal burden through continuing expenditure clause, off-balance fund transfers between general account and special account, reduction of subsidies to local government with increasing local government spending, and promoting repayments of local bonds to draw funds for government bond sales. See Ide [1998, 2001].

departments represent about 70 percent of the all continuing expenditures after FY1936.[57] Moreover, since the expected tax revenues in FY1936 were 924.8million yen, deferred military expenditures reached half the total expected tax revenue in the same year. Thus, total continuing expenditures amounted to 1,427.55 million yen in FY1936, as compared with 2,278.13 million yen of the total FY1936 budget.

Despite a gradual decrease in government bond issues, which Korekiyo Takahashi willfully achieved, long-term government debt increased to an enormous level, even before the outbreak of the 2.26 incident.[58] The rapid increase in military expenditures after the 2.26 incident added to these hidden government debts, which were already heavy. If one emphasizes the soft budget constraint before the 2.26 incident, there is a continuity between Takahashi finance and wartime finance. Given that BOJ underwriting was institutionalized in 1932, we can easily anticipate that BOJ financing of the government would be exploited in order to finance such hidden fiscal burdens afterwards. In fact, during and after World War II, the BOJ continued to provide money for the government.

Concluding Remarks

Policy Formation Process

We can summarize the agreements between the BOJ and the MOF in “The Joint Research Committee” in 1930 as follows.

Unsecured financing of the government and underwriting of government bonds by the BOJ were institutionalized. The maximum purchase limit of government bonds for the BOJ was not stipulated. Selling operations of government securities by the BOJ was permitted. The MOF's permission, which had been needed when dealing government securities, became unnecessary. These agreements refute the conventional argument that the BOJ was persuaded to underwrite government bonds by Finance Minister Takahashi's persuasive request and accepted it as a temporary expedient. Rather, the BOJ had its own reasons for underwriting bonds. Confidence in monetary control through selling operations and expectations of its influence over financial institutions contributed to the BOJ's acceptance of government bond underwriting.

[57] Continuing expenditures in FY1935 were only 4.99 million yen for the Department of the Army, and 80.7 million yen for the Department of the Navy.

[58] The 2.26 incident was an attempted military coup d’etat in 1936 where Finance Minister Korekiyo Takahashi was killed. After this, military expenditures increased rapidly and Japanese fiscal management shifted to wartime finance.

Implementation Process

The above agreements were made in the Inoue period, but carried out during the Takahashi finance period. Considering the tough economic and social situation, which included a severe decrease in tax revenues due to the Showa economic crisis, the outbreak of the Manchurian incident and social unrest caused by the 5.15 incident,[59] we may regard BOJ underwriting and expansionary fiscal expenditures as unavoidable political choices. In addition, BOJ monetary control was strictly conducted and even functioned temporarily as a way to allow changes in fiscal policy. Therefore, it can be argued that the BOJ's system design in "The Joint Research Committee" was well-grounded. However, in spite of the shift in 1935-36 to tight fiscal policy, it was difficult for the BOJ to stop underwriting government bonds. The MOF used irregular and problematic budgeting methods during and after the budgetary process of FY 1936, and this led to a large deferred fiscal burden. The BOJ was forced to continue underwriting deficit-financing bonds to cover this expanding financial demand. This was the flaw in BOJ's system design in "The Joint Research Committee," which allowed for easy financing by the government. The problem in this policy was, despite its apparent consistency with economic recovery, it created an unanticipated policy structure under political pressure, which would later become impossible to abolish.

[59] The 5.15 incident was the attempted military coup d'etat in 1932, in which Prime Minister Tuyoshi Inukai was killed. With his assassination, it is said that party politics in Japan substantially faded away.

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