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Bank of Japan's Monetary Policy in the 1980s:
a View Perceived from Archived and Other Materials

Masanao Itoh, Ryoji Koike, and Masato Shizume

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Bank of Japan's Monetary Policy in the 1980s: a View Perceived from Archived and Other Materials

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Abstract

This monographic paper summarizes views held by the Bank of Japan (hereafter BOJ or the Bank) in the 1980s regarding economic conditions and monetary policy formulation, perceived from the BOJ archives and other materials from the period. From a historical viewpoint, the authors see the 1980s as a watershed time for the Bank's policy formulation, because the Bank acquired lessons for monetary policy formulation under a large fluctuation in economic and financial conditions and innovated new approaches for monetary policy formulation and money market management as stated below.

First, during the 1980s the BOJ had to largely consider the external imbalance in formulating policy, and attention began to shift towards price stability in the medium or long term by the end of the decade. Second, the large fluctuations in asset prices, money supply, and commercial bank lending were closely monitored during this period, but the Bank's assessment about their impacts on macroeconomic consequences in the medium to long term was insufficient. A reflection of these lessons appears to evolve into a perspective on the Bank's monetary policy formulation that financial imbalances should be examined as a risk for achieving price stability in the medium to long term. Third, in light of ongoing financial deregulation during this period, the Bank started to change monetary policy measures from those based on a regulated interest rate framework to those based on market operation with good use of money markets and flexible interest rates.

Keywords: Monetary policy management; Price stability in the medium and long term; Financial imbalance; External imbalance; Financial deregulation

JEL Classification: E52, N15

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Summary

This monographic paper summarizes contemporary views held by the Bank of Japan (hereafter BOJ or the Bank) mainly in the 1980s regarding economic conditions and monetary policy formulation, perceived from archived materials (formally, the materials stored in the Archive,[1] Institute for Monetary and Economic Studies, Bank of Japan) and other contemporary materials.[2]

The BOJ Archive stores a large number of materials produced inside the Bank during the 1980s. The authors digested many documents from that period in the Bank's archive as well as in the public. Among the archived materials, governor's speeches at general managers' meeting, speeches at meetings with top executives of commercial banks,[3] letters from the head of the Policy Planning Department (formerly the Coordination and Planning Department), and letters from the head of Market Operations Department,[4] were drafted at the departments in relation to monetary policy formulation. These documents appear to contain information about the Bank's assessment of economic conditions and policy stance. In addition to these archived documents, the views expressed in *Chosa Geppo* (BOJ's Monthly Bulletin, partly translated into English as BOJ special papers) are also available,

1 The Bank of Japan established the Archives at IMES in 1999. The Archives acquire and preserve historical documents (principally in Japanese) to make them accessible for social needs. As of the end of March 2014, the catalog listed approximately 81,000 document titles.

2 As for references discussing monetary policy in the 1980s, see Okina, Shirakawa and Shiratsuka (2001) written by BOJ officials, Ministry of Finance (2003a) edited by Japan's Ministry of Finance, and Komine ed. (2011) written as a part of a research project organized by Japan's Cabinet Office.

3 So far as the authors read the archived materials, the BOJ general managers' meeting was held four times per year (January, April, July and October) during the 1980s, and the head of the Policy Planning Department sent the text of the speeches to heads of the departments at the head office, general managers of the BOJ branches, and general managers overseas. Also, the meeting with top executives of the regional banks was held nine times per year, and the text of the speeches was sent to the general manager of branches and the heads of the local offices. The Bank released an excerpt of the governor's speech at each general managers' meeting, and the text of speech appears to include closer perspective about contemporary recognitions of the economic conditions, policy stance in the near term and policy issues in the mid-term.

4 Letters from the head of the Policy Planning Department (formerly the Coordination and Planning Department) were personally signed by the head and sent to general managers of branches with personal name of the department's head. Letters from the head of the Market Operations Department (formerly the Banking Department and subsequently the Credit and Market Management Department) were also sent as personal letters to general managers of branches and heads of local offices as necessary. These letters were sent in the form of a personal letter of the department's head, implying possible inclusion of personal views, rather than an institutional document. The information in the letters was still shared institutionally within the Bank. It appears that the letter from the head of the Policy Planning department documented the background and perspective of policy actions thoroughly relative to contemporaneous releases. Among letters from the head of the Market Operations department, those sent every quarter contained the policy orientation for window guidance and background information such as lending attitudes of commercial banks and demand for loans from borrowers.

along with other public materials containing views of BOJ-related personnel. We utilized all the information above in summarizing contemporary views of the Bank in that period.

In digesting documents and surveying a vast amount of information, we consider three viewpoints in mind: (1) the Bank's conceptual framework in formulating policy, (2) the Bank's assessment against factors such as economic conditions which may possibly affect the Bank's policy formulation and (3) the Bank's recognition about consistency between the actual policy action and the alternative action with domestic price stability as the top priority. This paper mainly focuses on the 1980s, but we also try to recognize the position of monetary policy in the 1980s in relation to the policy before the 1970s and the policy from the 1990s onward.

From a historical viewpoint, the authors position the monetary policy in the 1980s as a watershed period, because the Bank learnt lessons about monetary policy formulation amid large fluctuations in economic and financial conditions and innovated new approaches for monetary policy formulation and money market management as stated below. From various experiences, the lessons about financial imbalance or the relationship between the financial bubble and monetary policy relatively have gathered attention. Aside from these lessons, the 1980s can still be positioned as an important watershed period, in terms of a shift in policy priority from external imbalance to price stability for the medium and long term, and a further use of market functions under ongoing financial liberalization.

(1) Under the circumstances in the 1980s, the rectification of the external imbalance had been imperative for Japan, and the Bank had to consider such circumstances in formulating and implementing monetary policy. In the late 1980s, however, the orientation of monetary policy began to shift toward price stability in the medium and long term.

Specifically, the Bank always considered the importance of price stability as a policy goal in formulation and implementation of monetary policy, partly on the basis of experience with the first oil crisis. At the same time, the Bank also considered other important factors such as domestic economic conditions, foreign exchange rates and external balance. As mentioned below, during most of the 1980s the rectification of external imbalance between United States and Japan had been Japan's top priority for Japan's policy goal. It appears that the Bank's did not intentionally prioritize a consideration for price stability as the top priority in monetary policy formulation during some time in the 1980s. Then, by the end of the 1980s, external imbalance tended to be small. The changing circumstances allowed the Bank to shift policy priority from external imbalance to domestic economic conditions, and it started to crystallize the principle in monetary policy formulation toward price stability in the medium to long term.

- During the period between 1982 and 1983, the yen exchange rate frequently weakened against the U.S. dollar mainly due to a high level of the U.S. interest rates. Monetary policy tended to be relatively tightened during this period, for fear that a lower interest rate might induce a weaker yen, an increase in exports and growth in the external imbalance.
- From the latter half of 1986 to the beginning of 1988, monetary policy tended to be relatively eased, from the perspective that domestic demand shall be enlarged to increase imports in line with international policy coordination for coping with a slow adjustment in external imbalance in spite of a sharp appreciation of yen after the Plaza accord.
- By the end of the 1980s, external imbalance began to be smaller and then focuses of economic friction between the U.S. and Japan shifted toward structural issues such as trade barriers of particular industries, land policies and closed aspects of distribution networks. The Bank gradually changed its recognition that the changes in circumstances allow the Bank to place a greater focus on domestic economic conditions rather than external imbalances in conducting monetary policy. Furthermore, the Bank began to state the idea more clearly that the goal for monetary policy is to contribute to the sound development of Japan’s economy with the help of price stability in the middle to long term.

(2) Although the large fluctuations in asset prices, money supply and commercial bank lending were closely monitored, the Bank’s assessment about their impacts on macroeconomic development in the medium to long term was insufficient. A reflection of these lessons appears to evolve into a perspective on the Bank’s monetary policy formulation that financial imbalances should be examined as a risk for achieving price stability in the medium to long term.

Regarding the relationship between monetary policy and fluctuations of asset prices or money stock, the Bank in the latter half of the 1980s had consideration and concern for a potential risk of excessive easing of monetary policy. However, the risk was considered mainly in relation to price stability in the near term as stated below, and the Bank was not able to adequately assess the impact of financial imbalances on macroeconomic development in the medium to long term. The resulting readjustment of balance sheets had continued for more than ten years during the 1990s and early 2000s, and as a result, this had probably amplified fluctuations in economic conditions. Regarding the monetary policy formulation today from two perspectives, the origin of the second perspective examining risks in a longer term such as financial imbalance can be attributed to the lessons learnt in monetary policy implementation from the latter half of the 1980s onward.[5]

- In 1988, when the enlargement of the bubble economy was considered to remain intact in retrospect, the Bank did not tighten monetary policy completely. Regarding this background, the Bank considered that there was a pause in speculative behavior possibly igniting inflation and that an enhanced supply capacity by larger investments would contribute to price stability. The Bank appears to have assessed partly that the desirability of monetary tightening slightly diminished.

- After the end of 1990, when the effect of tightened policy gradually spilled over, the Bank appears to have kept its assessments that economy maintained steady growth, that potential detrimental impact from a readjustment of balance sheets accompanied with a collapse of the bubble economy would not be very severe, and that normalization of bubble economy rather contributed to sound development of Japan's economy. The Bank maintained the tightening during the first half of 1991.

- After the latter half of the 1970s, the Bank considered money supply of much greater importance as the key indicator for monetary policy. At the same time, the Bank has never positioned money supply as the formal intermediate target for monetary policy. The Bank rather regarded money supply as one indicator to pay careful attention to together with other various indicators. Furthermore, in the 1980s, it was pointed out that the relationship between money and prices had become less stable partly as a result of financial deregulation. The Bank had maintained its perspective that money supply should be considered as one indicator to pay careful attention to together with other indicators in monetary policy formulation. Despite a high growth rate in money supply observed in the latter half of the 1980s,

[5] The Bank today conducts monetary policy based on its assessment of economic activity and prices from two perspectives. The first perspective is examining whether the outlook follows a path of sustainable growth under price stability, and the second perspective is examining risks in a longer term, such as financial imbalances in particular. Please see BOJ (2013).

easy monetary conditions were maintained mainly due to very stable prices in that period.

(3) In light of ongoing financial deregulation during this period, the Bank started to change monetary policy measures from those based on a regulated interest rate framework to those based on market operation with good use of money markets and flexible interest rates.

Financial deregulations in the 1980s, particularly an increase in the proportion of free interest rate instruments, affected the conduct of monetary policy both directly and indirectly as stated below. During the period in the 1980s and before that, monetary policy implementation was based on the regulated interest rate framework, and the changes in official discount rate as well as "window guidance" controlling lending directly were primary policy tools. However, among the development of financial deregulation during the 1980s, the Bank increasingly recognized that further use of interest rate adjustment through money market operations should be necessary in order to secure the effectiveness and flexibility of monetary policy implementation. By the end of the 1980s, the Bank started to reform instruments and other methods of monetary policy implementation.

- During the period in the 1980s and before that, monetary policy was basically implemented with changes in the official discount rate accompanied by other interest rates under the regulated interest rate framework, and with window guidance in line with monetary policy stance under the official discount rate. The guidance was ex-ante restrictive guidance for adjustment of commercial bank lending, conducted by the credit and market management department.

- Financial deregulations accelerated after the U.S.-Japan Yen-Dollar Committee's report was released in 1984, and both a decrease in the proportion of bank lending in firms' funding and an increase in the proportion of free interest rate instruments in financial institutions' funding occurred. The Bank became increasingly aware of the necessity that the further use of interest rate adjustment through money market operations should be necessary in order to secure the effectiveness and flexibility of monetary policy implementation.

- After November 1988, the practices in the money market were reviewed on the Bank's initiative, and circumstances conductive for monetary adjustments mainly by guiding market interest rates with open market operations were developed. In a tightening phase between 1989 and 1991, the Bank successively raised the official discount rate, partly because money market rates increased reflecting changes in domestic economic conditions. The Bank also tended to make more emphasis on the role of communication with market participants in monetary policy implementation, such as policy change in larger consideration of its impact on market interest rates.

- Regarding window guidance, which started in 1947, the Bank respected commercial banks' discretion of loan plans from the early 1980s in conducting the guidance. Then, the Bank exploited the guidance again to enhance the effect of monetary policy during the tightening period from 1989 to 1991, and the Bank officially abolished the guidance from July 1991 onward.

I. Response to the Second Oil Crisis (from Late 1978 to Summer 1980)

- Against the second oil crisis, which occurred in late 1978, the Bank gave it top priority to prevent import-price inflation from spreading over inflation in domestic prices, reflecting the lessons learnt from the first oil crisis with high domestic inflation. Specifically, the Bank swiftly tightened monetary conditions, by pre-emptive and large raises of the official discount rate five times from April 1979 to March 1980, as well as by the tightened window guidance.

- The impact of oil price increases on reducing domestic income during the second oil crisis was similar to that during the first oil crisis, but both the inflation in domestic prices and a deceleration in economic activity were relatively mild, as a result of a restrained inflationary mind with calm reactions by firms and households as well as the flexible conduct of monetary policy.

A. Advent of the Second Oil Crisis and the Bank's Reaction (from Late 1978 to Mid-1980)

1. Economic conditions before the second oil crisis (1978)

In Japan's economy during 1978, the domestic prices weakened due to a productivity increase as a result of firms' restructuring and enhanced efficiency, as well as the yen appreciation. The year-on-year rate of change in wholesale price decreased from around 7 percent at end-1976 to minus 1 percent in fall 1978, and the year-on-year rate in consumer prices decreased from the 10 percent level at end-1976 to the 3 percent level in fall 1978 (Charts 2 (1) and (2)). Against a backdrop of restored price stability, under the effects of fiscal expansion for coping with an appreciation of the yen and a larger current account surplus along with a cease of the prolonged adjustments in employment and business investment, personal consumption recovered from spring 1978, so did fixed investment after mid-1978. As a result, Japan's economy maintained a growth rate at about the 6 percent level year on year for 1978, which was recognized as organic growth mainly led by domestic demand (Chart 1 (1)). Money supply (M2) gradually increased its growth rate to 12 percent year on year at end-1978 from the 10 percent level at top 1978, and a future increase in inflationary pressure was a concern (Chart 5 (2)).[6,7]

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[6] BOJ (1979), pp.1–10 and BOJ (1986a), pp.463–467. In this paper, words in double quotations (“ ”) in body text, with footnotes at the end of either segment, sentence or paragraph, indicate either a citation from an English reference if available, or the authors' translation of a Japanese reference (such as the archived documents). The cited parts without double quotations and with footnote indicates indirect citations.

[7] Mr. Yukitsugu Nakagawa was the head of the Coordination and Planning Department from April

On the external front, Japan's current account surplus[8] grew in 1978, accompanied by yen appreciation, mainly reflecting an expansion of the U.S. economy and increase in import demand for Japanese products, such as competitive fuel-efficient cars (Chart 3 (2)). The "locomotive theory," according to which the world economy should be led by the U.S., Japan and West Germany as the locomotives, started to be prevalent overseas around early 1977. Against this backdrop, a rise in Japan's current account surplus was worsening the trade friction between Japan and the U.S., which experienced a rise in current account deficit.[9]

2. The role of money supply in the latter half of the 1970s

After the second half of the 1970s, the Bank came to consider money supply of much greater importance in monetary policy implementation, reflecting the lesson that the first oil crisis, together with increasingly excess liquidity, had resulted in subsequent higher inflation (See Column 5 for Role of the Money Supply).[10] Specifically, the Bank released a paper, "Role of the Money Supply in the Japanese Economy," in 1975[11] and then started to publish in the first month of every quarter a projection (or forecast) of the increase in the money supply for the July–September quarter of 1978 and afterwards.[12]

At that time, the major central banks in the West regarded money supply as the intermediate target for monetary policy. Meanwhile, the Bank of Japan did not position money supply as the official target for monetary policy, and rather regarded money supply as one indicator to pay careful attention to together with other various indicators.

As a backdrop of this perspective by the Bank, two factors are pointed out in the *Centennial History of the Bank of Japan*. First, the relationship between money supply and prices, as well as economic activity, varied depending on time and economic conditions, and the Bank considered it difficult to publish a sufficiently stable official target. Second, the official target in the form of a fixed number with normative significance could later be

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1971 to May 1973, and then the head of the Market Operations Department from May 1973 to April 1975, and the executive director for policy planning from December 1976 to March 1980. In his book Nakagawa (1981, p.106), he wrote about the policy formulation around 1977 and 1978, which was to the effect that if the growth rate of money supply would be 50 percent higher than the nominal economic growth rate, where the growth rate of money supply was around the 16 percent level, monetary policy should be tightened without question.

8 Japan's current account registered a 0.7 billion dollar deficit in 1975, but then registered a 3.7 billion dollar surplus in 1976, 10.9 billion dollar surplus in 1977 and 16.5 billion dollar surplus in 1978 on an increasing trend.

9 BOJ (1986a), p.459.

10 Nakagawa (1981), p.63 and p.67.

11 See BOJ (1975b).

12 BOJ (1978), p.39.

interpreted regardless of the Bank’s intention in transient economic conditions, and could be detrimental for flexibility and options in adjustable implementation of monetary policy.[13]

3. Advent of the second oil crisis (late 1978)

Production and export of oil from Iran, then the second largest oil producer of the OPEC (Organization of Petroleum Exporting Countries), sharply dropped due to an unstable political situation. OPEC countries decided to raise the price of crude oil at the OPEC conference in December 1978. After the occurrence of the Iranian Islamic revolution in February 1979, crude oil exports from Iran remained at a low level. The price of crude oil was further raised frequently during the period between 1979 and 1981, resulting in the increase by a factor of 2.8 during this period (Chart 2 (3)-I and II).[14]

4. Economic conditions after the second oil crisis (from 1979 to mid-1980)

As crude oil prices were surging and the “oil-vulnerability” of the Japanese economy with a high dependence on oil imports was highlighted in the exchange market, the depreciation of the yen progressed from the end of 1978 to spring in 1980 (Chart 3 (1)-I). Wholesale prices rose rapidly from early 1979 to the first half of 1980 in response to the rise in crude oil prices and the weakening of the yen, reaching the 18 percent level on a year-on-year basis in April–May 1980. Consumer prices also rose at a faster pace since mid-1979 and the year-on-year change reached around 9 percent in August–September 1980, reflecting the increase in import prices, but the inflationary effect on domestic final demand goods was limited compared to the situation during the first oil crisis, and did not result in the increase in domestic prices in general (Charts 2 (1) and (2)-I).[15] At the same time, the year-on-year growth rate of the money supply (M2+CD[16]) dropped from around 12 percent in early 1979 to the 7 percent level in fall 1980 (Chart 5(2)-I).

Regarding economic activity, the earlier efforts of the corporate sector for streamlining and improving efficiency continued. Domestic demand such as personal consumption and capital spending particularly remained strong during the year 1979 under a limited spillover of higher prices of products in domestic final demand. Exports also recovered from fall 1979 owing to the improvement of price competitiveness and export profitability resulting from the depreciation of the yen as well as the expansion of demand for Japanese products

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[13] BOJ (1986a), pp.479–480.

[14] Hereafter, a Roman numeral following a chart number indicates a phase in accordance with each section in the body text. Specifically, the Roman numerals from phase I to VII at charts correspond to sections I to VII, respectively.

[15] BOJ (1980), p.1 and BOJ (1981c), pp.2–6.

[16] CD (Certificate of Deposits) was commenced in May 1979.

with non-price competitiveness, including fuel-efficient compact cars and high-end electric appliances (Chart 1 (1)-I).[17] In these circumstances, the economy remained on an uptrend of expansion toward mid-1980.

5. BOJ's policy stance and actions

After the second oil crisis, the Bank put the highest priority on preventing the rise in import prices from spreading over the domestic prices to cause homegrown inflation, reflecting that the Bank allowed an occurrence of higher inflation after the first oil crisis and thus had to implement tightening measures thereafter, which caused a prolonged recession. Under such policy, the Bank tried to implement monetary policy flexibly by continuing early and significant rate increases starting April 1979, facing a clear uptrend of the wholesale prices as a probable early indicator for inflation in general prices. The Bank raised the official discount rate by 5.5 percent in total for five times toward March 1980 (Chart 4-I) [18] and called for commercial banks to restrain lending through window guidance (Chart 5 (1)-I). In particular, faced with the accelerated surges in wholesale prices and higher changes in consumer prices in February 1980, the Bank considered that a permeation of excessive inflationary expectation among the public and a resulting "vicious circle of wages and prices" should be prevented.[19] The Bank firmly decided that "both the firms' attitudes for price increases and the employees' spring negotiations for higher wages should strongly be halted," and raised the official discount rate during budget deliberations for the next fiscal year at the Lower House against the parliamentary custom.[20] The Bank again raised the rate significantly by 1.75 percent one month later.

6. Differences in the situation between the first and second oil crises

In terms of the extent of the downward pressure of the oil price inflation on domestic income via revenue transfer to oil producing countries, the second oil crisis had almost the

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[17] BOJ (1980), pp.9–14 and BOJ (1981c), pp.2–6.

[18] The five raises in the official discount rate were effective on April 17, 1979 (from 3.5% to 4.25%), on July 24, 1979 (to 5.25%), on November 2, 1979 (to 6.25%), on February 19, 1980 (to 7.25%), and on March 19, 1980 (to 9.0%). See BOJ Archives (1979a), BOJ Archives (1979c), BOJ Archives (1980b), BOJ Archives (1980c), and BOJ Archives (1979b).

[19] BOJ Archives (1980a), p.3.

[20] BOJ Archives (1980b), pp.2–3. See column 1 for the contemporaneous framework of interest rate determination and related matters. In addition, the draft budget introduced to the diet by the government presumed the level of interest rates at the time the draft was prepared. The government then was extremely reluctant to change (especially raise) the official discount rate during budget deliberations in the diet because changes in the official discount rate would imply alternation of the budget presumption and could impede smooth passage of the budget on schedule. See Nakagawa (1981), p.144 and BOJ (1986a), p.509. In addition, the reserve requirement ratios were raised in February and March 1980.

same direct impact as the first oil crisis. The Bank at that time recognized that "following the substantial increase in the crude oil price that began in late 1978, the increase in the value of crude oil imports was equivalent to a little more than 3 per cent of the nominal GNP, similar to that in the first oil crisis (about 4 per cent)."[21]

However, in Japan, the impact of the second oil crisis on prices including volatile economic conditions was relatively small compared to that of the first oil crisis.[22] The Bank at that time recognized the two major causes as follows:

(1) Difference in the initial economic conditions at the time when the shock occurred

When the first oil crisis occurred (in October 1973), the economy was at a peak and there was not much slack in terms of supply (in addition to a higher ratio of capacity utilization). The year-on-year consumer price growth rate reached the high level of 16 percent. In contrast, when the second oil crisis occurred (in December 1978), consumer prices were stable at a single digit level, the economy was on a recovery path, and low capacity utilization implied additional room for supply. Inflation was more unlikely to occur because a condition of supply and demand was less tightened than that in the first oil crisis.[23]

(2) Differences in the response against the crisis

When the first oil crisis occurred, firms and households responded in anticipation of higher inflation in the future. They created speculative demand based on speculative accumulation of stocks unrelated to economic activity, which brought about tight demand and supply conditions. Also, substantial pay rises put pressure on corporate profits, which resulted in a subsequent reduction in employment and a decline in capital investments. By contrast, at the time of the second oil crisis, flexible implementation of the monetary policy partly served to restrain the inflationary expectation from spreading and the responses by firms, labor unions and households was in a non-emotional manner on the basis of their experience of the first oil crisis. As a result, the creation of speculative demand was suppressed and the pace of wage increases remained modest. Furthermore, large swings in prices, wages, and demand were contained, and the firms' profit bases were stabilized. Accordingly, investments for efficiency improvement as well as those for labor- and energy-saving underpinned the economic expansion and thereby improved productivity.[24,25]

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[21] See BOJ (1981c), pp.10–12, for the Bank's contemporary view for the oil crisis. The Japanese government also considered that the magnitude of the second oil crisis was roughly similar to that of the first. See EPA (1981), p.80.

[22] See BOJ (1986a) p.496 for the second oil crisis and pp.420–430 for the first oil crisis.

[23] BOJ (1981c), p.6.

[24] BOJ (1981c), pp.6, 10–12.

[25] Masaru Yoshitomi, who was the chief researcher at the Economic Research Institute of the Economic Planning Agency at that time, emphasized the role of initial economic conditions

II. Reduction of the Official Discount Rate with Consideration of Exchange Rates (from Summer 1980 to the First Half of 1981)

- In response to the slowing economy as well as regained price stability, the Bank gradually eased monetary conditions by lowering the official discount rate three times from August 1980 to March 1981, as well as by relaxing window guidance gradually and then allowing commercial banks to submit their loan plans at their discretion from spring 1981 onward.

- Factors such as the amendment of the Foreign Exchange Law in 1980 encouraged international capital transactions between domestic and overseas markets, and then the differences between domestic and overseas interest rates began to have a large effect on exchange rates. Meanwhile, the highest priority for the U.S. was to contain high inflation, and monetary tightening was implemented. Against this background, the BOJ gradually lowered interest rates while assessing developments in exchange rates so that the rate reduction would cause neither depreciation of the yen in relation to the high interest rates in the U.S. nor imported inflation.

A. Economic Conditions and Policy Stance of Major Countries

1. The U.S. high interest rate policy and appreciation of the dollar

In the United States, inflation aggravated following the second oil crisis and the year-on-year changes in consumer prices reached a double-digit figure from 1979 to 1981 (Chart 7 (2)-I). In response, the Federal Reserve (the Board of the Governors of the Federal Reserve System [FRB]) placed the highest priority on inflation control and raised the official discount rate five times in total from July 1979 to February 1980, causing it to reach the historic high of 13 percent. The FRB also implemented a new framework of money market operations which placed emphasis on the total reserves and allowed for increases in short-term interest rates in October 1979. As a result, the monthly average of the Federal Funds (FF) rate was 17.6 percent in April 1980. Faced with a rapid economic downturn caused by high interest rates, the FRB turned to monetary easing from May to July 1980 temporarily. From fall 1980, however, the rate of wage increase was higher than expected,

relative to the lessons learnt in 1974. See Yoshitomi (1981), pp.244–263. Meanwhile, Kuroda (2005, p.61) assessed both the role of initial condition and the lessons rather equally by pointing out that inflation expectations during the second oil crisis were moderate partly due to the memory of sharp tightening during the first oil crisis among the public.

inflation expectation was seen as persistent based on the surveys, and the growth of money supply was higher. The FRB raised again the official discount rate to 14 percent four times in total from September 1980 to May 1981, and the monthly average of the FF rate reached 19.1 percent in June 1981 (Chart 8 (1)-I and II).[26]

Starting in January 1981, the Reagan Administration concluded that the expansionary fiscal and monetary policies implemented by the previous Carter Administration (such as higher social security expenditure) had caused high inflation, economic stagnation, and a deteriorating current account balance. On this recognition, the Reagan Administration promoted the economic policies of so-called Reaganomics, which aimed for: (1) an increase in defense spending to become a the stronger nation; (2) a reduction of corporate and personal taxes to strengthen the supply side of the economy; (3) sound implementation of monetary policy to control inflation by gradually decreasing the growth rate of money supply; and (4) utilization of the market mechanism through deregulation. The administration also publicly stated its commitment to reduce the budget deficit through cuts in expenditure. In fact, however, the budget deficit expanded owing to a tax reduction, an increasing outlay in defense, and a delay in reducing non-defense expenditure due to Congress opposition, and the long-term interest rate remained at a high level throughout the first half of the 1980s (Chart 8 (1)-II, III, and IV).[27]

The economy decelerated during the year 1979 as consumption and housing investment slowed down due to price surges and higher interest rates. After a sharp downturn in spring 1980, the economy recovered slowly from summer 1980 to early 1981 affected by temporary monetary relaxation. However, it started to deteriorate again from spring 1981 partly due to sluggish exports with dollar appreciation, slower consumption growth, and a drop in housing investment resulting from high interest rates (Chart 7 (1)-I, II, and III).[28]

The high interest rates in the U.S. exerted pressure on foreign exchange markets for dollar appreciation through the interest rate differentials between the U.S. and European countries or Japan. In particular, the dollar kept strengthening from 1979 to spring 1980 in response to increases in short-term interest rates resulting from the FRB's tightening, and also from mid-1980 to fall 1982 due to the remained high level of long-term interest rates with expansion of budget deficits (Chart 3 (1)-I, II, and III).[29]

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[26] BOJ (1981a), p.15, BOJ (1981e), pp.12–13, BOJ (1982c), p.17, and Meltzer (2009), pp.1062–1064.

[27] BOJ (1981e), pp.12, 15–18 and BOJ (1983c), pp.7–8,11.

[28] BOJ (1981a), p.12 and BOJ (1981e), pp.15–16.

[29] BOJ (1981a), p.6, BOJ (1981e), p.10, and BOJ (1982c), p.6.

2. Stagflation in Europe

In Europe, constraints on corporate activities became greater, such as increased social security burdens and tighter government regulations, from the mid-1960s onward and greater rigidity of wage setting behavior was seen as a result of wider adoption of the sliding scale of wages throughout the 1970s. Corporate fixed investments stagnated due to increases in these burdens on firms. After the second oil crisis, European countries experienced wage increases in parallel to imported inflation, persistent current account deficits due to lower export competitiveness, and depreciation pressures on European currencies due to the higher U.S. interest rates. Under these circumstances, European countries had to implement tighter monetary policies, and stagflation with both high inflation and economic stagnation permeated with worsening employment conditions as shown by a growing unemployment rate (Charts 9 (1), (2), and (3)-II and III).[30]

B. Economic Conditions in Japan

Japan’s economy started to slow down in summer 1980, affected by a deterioration of terms of trade due to previous oil price inflation (decline in real income) and monetary tightening. So-called “gradual slowdown” started mainly in personal consumption and housing investment in particular, and then permeated over the economy gradually. Meanwhile, corporate profits were strong, fixed investment by large companies was solid in areas such as energy saving, streamlining, technological innovation, and development of new products, and then a large-scale adjustment in employment was avoided. Exports continued to increase with some fluctuations reflecting economic cycles in the U.S. and Europe, mainly due to the growth of products (such as computers and seamless pipes for oil fields) with higher non-price competitiveness. Therefore, the Bank considered that sharp downturn in economic activity would be unlikely under the current circumstances (Chart 1 (1)-II).[31]

With regard to prices, inflation in wholesale prices started to slow down around May 1980. The supply and demand conditions for domestic products were eased partly due to the effect of the tightened monetary policy. The yen also appreciated under a pause in rising prices of overseas raw materials such as fuels and the temporal lift in the U.S. high interest rate policy. The uptrend of consumer prices also started to slow down from mid-1980. Consequently, in mid-1981, the year-on-year changes in wholesale and consumer prices declined to near 0 percent and the 4 percent level, respectively (Charts 2 (1) and (2)-II).

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30 BOJ (1981a), p.7 and BOJ (1981e), pp.8,12,19–20.

31 BOJ (1981c), pp.1–2,8–10 and BOJ (1982a), pp.7–8.

C. Lowering the Official Discount Rate Three Times (from Summer 1980 to Spring 1981)

1. The assessment of economic conditions and policy stance at the time

The Bank at that period considered that "for monetary policy implementation the Bank consistently should recognize price stability as the basis for sustainable growth,"[32] and clearly placed priority on price stability in monetary policy implementation. As for Japan's contemporary economic conditions, the Bank recognized that Japan's economy "performed relatively well" compared with the situation in the first oil crisis or with the situations in other countries, with an assessment that "the steep rises in import prices were contained and were not transformed into domestic inflation, the international balance-of-payments equilibrium was restored speedily and serious deterioration in economic activity was avoided."[33] The Bank considered that rational attitudes of firms and households contributed to the situation in addition to the policy response of early and significant interest rate raises. The Bank also believed that "the corporate profit foundation this time has become stronger than during the first oil crisis" because the firms did "attain greater efficiency of operations by means of energy-saving, reducing per unit of output, controlling inventories, and developing new products," with "the strenuous efforts for rationalization by both management and labor" and labor accepting "moderate wage hikes in consonance with labor productivity."[34]

Meanwhile, the Bank recognized that "it was difficult to expect that Japan alone could achieve higher economic growth under a stagnant world economy, where a large amount of income was transferred to oil producing countries through rapidly increasing oil prices and the slower economic growth of the industrial countries as a whole." Also, the Bank viewed that Japan had to accept lower economic growth, and that the Bank "should not consider an easy solution in which stagnation alone was enough reason for monetary stimulus."[35]

2. Policy responses

In response to the slowing down of the economy while prices regained stability, the Bank lowered the official discount rate three times from August 1980 to March 1981 (Chart 4-II).[36] Regarding window guidance, the Bank started to relax the restrictive stance from

[32] BOJ Archives (1981a), p.1.
[33] BOJ (1981c), p.2.
[34] BOJ (1982a), pp.4–5.
[35] BOJ Archives (1981d), p.8. Also, see BOJ (1981b) and BOJ (1982a), pp.4–5.
[36] The official discount rate was lowered three times. The first was from 9 percent to 8.25 percent on August 20, 1980. The second was to 7.25 percent on November 6, 1980. The third was to 6.25 percent on March 18, 1981. See BOJ Archive (1980d), BOJ Archive (1980e), and BOJ Archive (1981c). In November 1980 and March 1981, the reserve requirement ratio was also lowered.

the October–December quarter of 1980. The Bank then allowed commercial banks to submit their loan plans at their discretion, from the January–March quarter of 1981 for regional banks and *sogo* banks (hereafter regional banks), and from the April–June quarter of 1981 for city banks, long-term credit banks, and trust banks (hereafter major banks).[37] (See Column 4 for the development of window guidance.)

3. Interest rate reduction and exchange rates

In the second half of the 1970s and thereafter, exchange control was gradually relaxed, and it was basically liberated through the amendment of the Foreign Exchange and Foreign Trade Control Law in December 1980.[38] International capital transactions became active, and the difference between domestic and overseas interest rates came to be more influential on exchange rates.[39] Under such circumstances, the Bank undertook a series of rate reductions, on the recognition that prices were stable in the near term and that stable capital inflow should be attractive enough to finance the current account deficit remaining under higher oil prices. In lowering the rate, the Bank cautiously assessed the developments in foreign exchange markets, so that the rate reduction would not cause depreciation of the yen or higher import prices, due to larger differences between the domestic and overseas interest rates and international capital flow.[40]

In addition, on lowering the discount rate in March 1981, the Bank introduced a special lending facility to flexibly provide funds at a rate determined separately from the official discount rate. The facility was prepared for cases where fluctuations in short-term capital flow in response to the interest rate differential between domestic and overseas influenced on foreign exchange markets. The special lending facility was supposed to be implemented without changes in the official discount rate, interest rates of deposits, savings, or bank loans. In this regard, the Bank supposed that "the rate could be changed without consideration of deposit rates and other rates, in a resilient and flexible manner" so that the facility would affect the international short-term capital flow without affecting the domestic economy.[41]

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[37] BOJ Archives (1981b), pp.1,4. The Bank maintained a policy stance of allowing acceptance of the loan plans by respective commercial banks at their discretion until spring 1987.

[38] MOF (2004), pp.70–83.

[39] BOJ Archives (1981d), p.9, BOJ Archives (1981e), pp.8–9, and BOJ (1982a), p.20.

[40] BOJ Archives (1980d), pp.3–6.

[41] BOJ Archives (1981c), pp.6–7. The Bank considered using the special lending facility in face of sharp yen depreciation later, but did not use it in the end, abolishing it at the end of February 2001. As for media reports referring to the Bank's consideration of carrying out the facility in summer 1982, summer 1984 and February 1985, see Nihon Keizai Shimbun (1985), p.1 and Kinyu Zaisei Jijo (1985), p.13. No material specifically mentioning use of the facility can be found in the BOJ Archives. As for documents implying a possible activation of the facility, see BOJ Archives

Column 1. A Framework of Determining Deposit and Savings Rates under Interest Rate Control and Postal Savings

As of 1980, under the Temporary Money Rates Adjustment Act enacted in 1949 in the immediate postwar period, the Bank's Policy Board was responsible for determining the ceiling on the deposit rates of private financial institutions subject to consultation with and a report from the Interest Rates Adjustment Council. On the other hand, under the Postal Savings Act, which was enacted in 1947 and amended in 1963, the postal savings interest rate was consulted on and reported with the Postal Service Council as the advisory body for the Minister of Posts and Telecommunications, and then approved by the cabinet, following which it was published and enforced as a government ordinance. Under this framework, the deposit rates of commercial banks were practically changed in case of necessity after a change in the official discount rate (and the deposit rates were not lowered unless the Bank considered it necessary). At the same time, prior discussions between the Ministry of Finance and the Ministry of Posts and Telecommunications were held regarding the date and extent of the interest rate changes in order to prevent a shift of funds between the saving deposits of commercial banks and the postal savings. When a reduction of interest rates was issued for discussion, the Ministry of Posts and Telecommunications often called for smaller reduction or some alternative measures on the grounds of protecting the depositors' benefits in postal savings. The Bank had considered this as a problem in terms of flexible implementation of monetary policy since the 1960s.[42]

During the phase with higher interest rates after the oil crises, the characteristics of fixed-amount postal savings (such as compound of interest semiannually up to 10 years as the maximum term with a withdrawal option with no penalty after the initial 6 months) were very attractive for depositors. A large amount of funds shifted from commercial bank deposits to postal savings, and then criticism mounted that the quasi-government enterprise put a burden on private-sector corporations. For this reason, the Conference on the Character of Government Enterprises in the Financial Field was established as an advisory body for the Prime Minister in January 1981, and then the conference report requesting a unified decision-making process on deposit interest rates for both commercial banks and

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(1982b), p.7, BOJ Archives (1983b), p.5, and BOJ Archives (1985b), p.5.

[42] Deposit rates for postal saving were determined by the Postal Savings Act from 1947 to 1963, and a change in deposit rates required a revision of the Act. In light of the experience in 1961 when the deposit rates were lowered for the first time since the war, the postal savings act was revised in 1963 for enabling flexible changes of deposit rates by the determination of rates through consultation with the postal committee, its reply, and a government decree. However, difficulties in adjustments among related parties often became a problem. See BOJ (1986a), pp.29–32, 359–360, 446–448, 455–458, 468–469, 547–548.

postal savings was submitted to Prime Minister Zenko Suzuki in August 1981. Based on this report, an agreement among three cabinet members of the Minister of Posts and Telecommunications, the Minister of Finance, and the Chief Cabinet Secretary was attained in September 1981. The three ministers agreed to "promote communication between the Ministry of Posts and Telecommunications and the Ministry of Finance sufficiently enough for consistent and flexible determination of the deposits rates."[43]

Based on the developments as described above, the BOJ started to take practical procedures about changes in deposits rates after a reduction of the official discount rate in December 1981 (described later) without prior discussions. When the Bank lowered the official discount rates in October 1983, however, it took about two months to lower deposit interest rates. The Interest Rate Adjustment Council submitted a formal comment to the Policy Board of the Bank of Japan, stating "it is deplorable from the viewpoint of ensuring the flexibility and effectiveness of monetary policy."[44] The problems were not resolved.

After the report of the working group of the Japan-U.S. Yen-Dollar Committee in May 1984, deregulations of deposits interest rates progressed in the second half of the 1980s and early 1990s. The interest rates of fixed-amount postal savings and other similar products were determined in line with market interest rates from 1993 onward.[45]

III. Cautious Monetary Easing with Consideration of Trade Conflicts (from the Second Half of 1981 to Fall 1983)

- In the U.S. and European countries, the higher inflation remained mainly due to a continuation of significant wage increases, and the tight monetary policy for taming inflation brought the slower economic growth and the higher unemployment rates. Under such circumstances, Japan's expanding current account surplus, accompanied with the smaller imports through energy saving and with the enhanced competitiveness through improvement of the productivity, brought about increasingly intense trade conflicts.

- Japan's economy overcame the impact of the second oil crisis. Solid corporate profits through firms' managerial efforts for improving energy efficiency and labor productivity as well as the tamed wage growth by both labor and management helped to avoid an escalation of inflation and a sharp economic downturn.

43 BOJ (1986a), pp.561, 579–584.
44 Kinri chosei shingikai (1983).
45 Yuseisho yusei kenkyujo (1996), pp.97–100.

However, the economic growth remained relatively low compared to the previous periods, partly due to weak overseas demand under the U.S. monetary tightening for containing high inflation.

- A further interest rate cut may have been appropriate for domestic economic conditions such as low inflation and moderate economic growth. However, in the context of worsening trade conflicts, the lower interest rates could have weakened the yen under the pressure of the U.S. high interest rates. In this regard, the Bank gradually and carefully reduced the interest rates and eased monetary conditions, while confirming that the exchange rates were stable and that the risk of an overly weaker yen was small enough.

A. Economic Conditions and Policy Stance of Major Countries

1. Situation in the U.S.

The U.S. economy became stagnant further from spring 1981 partly because of the slackened export growth under the strong dollar and the sluggish European economy, as well as the stagnation of domestic demand such as consumption, housing investment, and corporate fixed investment under the higher interest rates. The unemployment rate rose to a double digit level from September 1982 to June 1983 for the first time since 1940 (Charts 7 (1) and (3)-III). In response, the FRB turned to reduce the interest rates from November 1981, and lowered the official discount rate twice to 12 percent in December 1981. However, the significant wage growth continued and the inflation remained at a high level. The FRB maintained a stance to place the highest priority on containing inflation until the first half of 1982 and lowered short-term interest rates at a measured pace while confirming the weaker inflationary pressure (Chart 8 (1)-III).[46]

The stagnated economy and worsening unemployment bolstered the protectionist movements, and reciprocity bills were submitted in succession to Congress from late 1981 to 1982, requesting trading partners such as Japan to open their markets or imposing import restrictions in the U.S. otherwise.[47]

In summer 1982, milder inflation became gradually obvious. Also considering the instability in international finance caused by a surfacing problem of accumulated debts by developing countries, the FRB continued to loosen policy from July 1982 and reduced the official discount rate five times to reach 8.5 percent in December 1982 (Chart 8 (1)-III). After early 1983, the economy showed a strong recovery led by increased consumption and

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[46] BOJ (1981e), pp.5–17 and BOJ (1982c), pp.15–17.

[47] BOJ (1982c), p.13.

housing investment under tamed inflation, lower short-term interest rates, and tax reduction (Chart 7 (1)-III).[48]

Meanwhile, budget deficits expanded from fiscal year (FY) 1982[49] to 1983, partly because of a conflict between the Reagan Administration (in favor of reducing taxes and expanding defense outlays) and the U.S. Congress (against reducing social security outlays). Against the background of an increasing fiscal deficit, the long-term interest rate remained high at a level exceeding 10 percent throughout 1983 (Chart 8 (1)-III) and partly contributed to an appreciation of the dollar. The current account balance turned into deficit from the July–September quarter of 1982 as the competitiveness declined with the dollar appreciation, and the current account deficit tended to increase in 1983, partly reflecting economic recovery (Chart 8 (2)-III).[50]

2. Situation in Europe

In early 1982, the higher inflation became gradually moderate in major European countries (Chart 9 (2)-III). Under persistently high interest rates in the U.S., however, monetary conditions in Europe were rather tightened to address the pressure for home currency depreciation (Charts 10 (1) and (3)-III). Economic activity remained stagnant and thereby the unemployment rate increased (Charts 9 (1) and (3)-III).[51] Under such circumstances, protectionism intensified also in Europe.[52]

3. Comparison between Japan and major European countries

The responses after the second oil crisis in Japan were different from those in the U.S. and Europe. In Japan, firms' managerial efforts such as saving cost, labor and other inputs supported steady corporate profits, in addition to the modest wage growth with harmonious labor relations. The energy efficiency and the labor productivity were also improved through corporate fixed investment. In contrast, in the United States and Europe, the increasing wages were not restrained under worsening terms-of-trade and thereby the high inflation remained. Against this background, deterioration in corporate profits suppressed fixed investment, inhibited an improvement of the labor productivity and caused firms to refrain from hiring, thereby resulting in the increasing or elevated level of unemployment rate.[53]

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48 BOJ (1982c), pp.11–13, 16–17 and BOJ (1983c), pp.1,9.
49 The U.S. fiscal year is from October of the previous year to September of the current year.
50 BOJ (1983c), pp.7–8, 10–11.
51 BOJ (1983c), pp.7–8, 13.
52 BOJ (1982c), p.14.
53 BOJ (1983a), pp.1–2, 11–12.

The BOJ recognized the adjustments in the corporate sector to address these challenges as the difference in the economic performance between Japan and the West. Meanwhile, the Bank acknowledged that Japan’s improvement of the energy efficiency and the labor productivity resulted in the saving of imported raw materials and fuels and in the higher competitiveness of Japanese products, respectively. This consequently created a trade structure allowing a fast and easy growth of exports, while curtailing the growth of imports serving as one of the structural factors of external imbalance. Although the Bank also recognized that a rectification of external imbalance caused by these structural factors would be time consuming, the Bank expressed the view that it would be necessary to “insure the stability of the yen rate at a higher level, thereby encouraging changes in the structure of exports and imports” together with efforts toward import expansion through greater market access.[54]

B. Economic Conditions in Japan and Policy Responses (from the Second Half of 1981 to October 1983)

1. Situation in the second half of 1981 and the interest rate cut in December 1981

Japan’s economy continued to recover slowly toward the second half of 1981, but the growth was lower compared to the previous periods. Fixed investment by large enterprises was solid, but consumption and housing investment were weak as disposable income grew at a sluggish pace due to lesser overtime earnings (Chart 1 (1)-III). As for prices, wholesale prices remained almost unchanged from the previous year and consumer prices only increased by around 4 percent on a year-on-year basis due to falling crude oil prices and the looser market conditions in domestic supply and demand (Charts 2 (1) and (2)-III). In foreign exchange markets, the yen ceased to depreciate owing to a decline of the U.S. interest rates in fall 1981. The dollar traded at around 220 yen in December 1981, declined from around 230 yen in September and October of 1981 (Chart 3 (1)-III).

The current account generally began to remain in surplus from 1981, because exports grew persistently due to solid demand for Japanese products with enhanced competitiveness and imports declined mainly due to energy savings (Chart 3 (2)-III). With this background, the trade conflicts with the U.S. and Europe intensified. The U.S. Secretary of Commerce Malcolm Baldrige visited Japan to call for more product imports in October 1981, and also in October the European Commission made a request for import expansion to the mission sent to Europe, led by Chairman Yoshihiro Inayama of the Japan Federation of Economic Organizations. In November 1981, Western European countries expressed concern to

[54] BOJ (1984b), p.5. Also, see BOJ (1982b), pp.1, 17, BOJ (1983a), pp.1–2, 13–14, BOJ Archives (1984a), pp.6–7, BOJ (1984a), pp.1, 16–17, and BOJ (1985b), pp.1–2.

Saburo Okita, the government delegate for these countries that Japan was trying to maintain the cheaper yen with policy measures for supporting export competitiveness. The Bank recognized that it was difficult to lower the interest rates as it might cause depreciation of the yen through the larger difference between domestic and overseas interest rates under the trade conflicts. On the other hand, some Japanese government officials argued internally that an early rate reduction would be a policy option for stimulating domestic demand and reducing trade surplus in a circumstance with limited policy options acceptable internationally for the modest surplus.[55]

The Bank recognized that a reduction in interest rates would be desirable on the domestic front in light of stagnant economic growth with stable prices and lower inflation. At the same time, the Bank believed that a higher and stable yen was important as a precondition for interest rate reduction, and in particular that a careful consideration of the timing to avoid causing yen depreciation would be very important to prevent a further deterioration in the relationships with the U.S. and European countries. When the FRB lowered the official discount rate from 14 percent to 13 percent on November 2 and then to 12 percent on December 4, the yen was higher and stable, and the Bank reduced the official discount rate by 0.75 percent to 5.5 percent on December 11 (Chart 4-III).[56] Window guidance was further relaxed, and the Bank decided to allow commercial banks to formulate their loan plans totally at discretion from the January–March quarter of 1982, instead of merely allowing them to formulate their plans at discretion as much as possible.[57]

2. Economic conditions in 1982 and the monetary operation to increase short-term interest rates

Japan’s economy slowed down toward the end of 1982 and the business sentiment worsened, because the slower growth in exports amid stagnation in the U.S. and Europe induced a greater adjustment in production after early 1982 and this circumstance resulted in stagnation in domestic demand such as fixed investment (Charts 1 (1), (2), and (3)-III).[58] Prices further slowed down as a result of looser conditions in supply and demand (Charts 2 (1) and (2)-III). On the other hand, the yen exchange rate was at around 220 yen in early 1982, and it continued to weaken to hit a bottom of 278 yen in November 1982 owing to a situation of a stronger dollar against other currencies under the higher interest rates in the United States (Chart 3 (1)-III).

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55 BOJ Archives (1981g), p.2.
56 BOJ (1981d).
57 BOJ Archives (1981h), pp.1, 4–6.
58 BOJ (1983b), p.1.

The Bank considered that accommodative monetary policy was more appropriate for domestic conditions such as economic activity and prices. Meanwhile, the Bank faced a dilemma that a yen with higher value would be favorable under the deterioration of economic conflicts with the U.S. and European countries, but in reality the difference between domestic and overseas interest rates tended to pressure the yen toward depreciation.[59] In this regard, the Bank implemented tighter money market operations for “raising short-term money market interest rates” without a change in the official discount rate from mid-March to the early fall of 1982, with the intention of avoiding influences as much as possible on the commercial banks’ lending rates and the other domestic interest rates, and of inhibiting the weakness of the yen with the widening gap between domestic and overseas interest rates (Chart 4-III).[60]

3. Situation from early 1983 to fall 1983 and the rate reduction in October 1983

During 1983, Japan’s economy started to recover gradually owing to increases in exports to the U.S. in particular. However, the pace of recovery in domestic demand remained moderate, owing to the end of a series of large-scale plant investments for energy saving and other purposes, moderate consumption under slow increases in employment and wages, and the lower growth of government fiscal disbursement reflecting the on-going fiscal reform measures (Chart 1 (1)-III). Meanwhile, stable prices were maintained (Charts 2 (1) and (2)-III).

In the foreign exchange markets, the yen tended to depreciate toward fall 1983, starting at the level of 230 yen per dollar in early 1983 to 247 yen per dollar in early September of 1983, partly due to a strong view in the market for a persistent gap between domestic and overseas interest rates. However, from fall 1983, the slower inflation in prices and lower growth in money supply calmed down anticipation for a high U.S. interest rate. In addition, an expansion of Japan’s current account surplus gathered attention. The yen became stable at around the 230 yen-level from October 1983 (Chart 3 (1)-III).[61]

The Bank in 1983 consistently assessed as it did in 1982 that an interest rate reduction would be desirable from a domestic perspective with the domestic circumstance where inflation remained stably low and the domestic demand stayed sluggish.[62]

From an international perspective, economic recovery relying on exports might have faced intense criticism from abroad and added fuel to economic frictions. The Bank

[59] BOJ Archives (1982a), pp.3–6.
[60] BOJ (1983b), pp.4–5.
[61] BOJ (1984b), pp.1–3 and BOJ Archives (1983a), p.3.
[62] BOJ Archives (1983a), p.2.

considered that an interest rate reduction with a view to "ensuring an economic recovery balanced for both domestic and external demand" could be accountable overseas. However, the Bank also considered that the rate reduction could possibly bring a weaker yen and rather aggravate the economic friction with other countries. The Bank maintained a stance that "the stability of the yen rate at a higher level" was the necessary condition for an interest rate reduction and the careful examination of timing for the reduction was mandatory.[63]

On October 21, 1983, based on the judgment that "the lowering of the discount rate would not affect the yen's strength," the Bank decided to reduce the official discount rate for the first time in 22 months since December 1981 (from 5.5 percent to 5.0 percent) and effective from October 22 (Chart 4-III).[64] Meanwhile, in preparation for U.S. President Ronald Reagan's official visit to Japan in November 1983, the Japanese government adopted the "comprehensive economic measures for economic promotion" at the economic ministers' meeting on October 22, including measures for domestic demand expansion such as greater market access and import promotion. The Bank carefully considered that "it would be acceptable if the monetary policy was asked to be in coordination with the overall economic policy by the Japanese government" on the grounds of "the basic premise of stability in both prices and exchange rates for supporting solid economic recovery as much as possible." The Bank appeared to accept the recognition of the lowering of the official discount rate as part of the government's policy actions for enlarging domestic demand and rectifying external imbalance.[65]

C. Issues Behind the Policy Stance During This Time

1. Escalation of trade conflicts with the U.S. and European countries

The U.S. and European countries in that time suffered more or less with the economic stagnation and higher unemployment rates, and the higher level of frustrations for external circumstances also brought greater protectionist movements. Under such circumstances, these countries intensified economic conflicts with Japan that showed relatively better economic conditions and had a greater current account surplus.[66]

In the U.S., the FRB eased monetary conditions from summer 1982, but the pace of progress in reducing fiscal deficit was very slow and the long-term interest rate (10-year

[63] BOJ Archives (1983b), p.2.

[64] BOJ Archives (1983a), p.3.

[65] BOJ Archives (1983a), p.5.

[66] See Kondo (2011, pp.46–70) for the survey with details about the history and developments of economic friction between the U.S. and Japan mainly in terms of international trade through the post World War II period.

U.S. Treasury) remained at a high level of double digit (Chart 8 (1)-III). Such persistent high interest rates in the U.S. served as downward pressure on other currencies, and from the perspective of preventing depreciation of the yen amid expansion of Japan's current account surplus, the contemporary situation was not favorable for reducing interest rates.

In this regard, the Bank recognized that "difficulties have developed in maintaining the regime of free trade," which was the foundation for the world economy in the postwar era and which was particularly "the most beneficial for Japan to achieve growth." Therefore, the Bank considered that monetary policy should be implemented with "due attention to economic and political circumstances in the U.S. and European countries" so that the "free trade principle" would be esteemed and Japan "would not be isolated in the global community."[67] In other words, after overcoming the impact of the second oil crisis on prices, the Bank considered Japan's national interests in a broader sense, and also acknowledged that monetary policy should be conducted with consideration given not only to the domestic conditions such as economic activity and prices, but also to the external relations and particularly developments of economic friction.[68]

2. Long-term interest rates remained at a high level with large-scale government bond issuance

In the first half of the 1980s, the long-term interest rates remained at a high level in Japan partly due to the impact of the high interest rates in the U.S. as well as the increases in the outstanding balance of the Japanese government bonds.

After 1975, the issuance of special deficit-financing bonds to cover budget deficit became a customary practice and the outstanding balance of the national government bonds increased progressively (Chart 3 (3)). At first, a large proportion of the bonds in the amount issued were underwritten by a syndicate, where issuance conditions were determined through negotiations between the government and financial institutions, and the amount of government bonds held by financial institutions continued to increase. Throughout the period from the second half of the 1970s to the 1980s, the government continued to pursue the reconstruction of public finance in order to cease an issuance of special deficit-financing bonds. In fiscal years 1981 and 1982, however, the government experienced a large shortfall in tax revenue and the consequent failure of "the government's long-term fiscal target of eliminating the current account deficit by the fiscal 1984" as the goal defined by the

[67] BOJ Archives (1982a), p.3.

[68] Regarding the monetary policy during this period, Kuroda (2005, p.165) stated that "it was uncertain whether the Bank fought against inflation as a battle in the previous period or feared for a weaker yen with a stronger dollar, but in either perspective the policy chosen during this period was inadequate." The materials referred to in this paper imply the latter aspect was stronger.

government became obvious.[69] The percentage of outstanding government bonds against GDP continued to increase until fiscal year 1986. Meanwhile, the secondary bond market expanded, as the selling restrictions were relaxed in response to requests from financial institutions.

The Bank considered that the increasing reliance of public finance on government bonds kept the long-term interest rates at a high level. Therefore, the Bank supported the government's fiscal reconstruction policy shown in the final report of the Second Ad Hoc Commission on Administrative Reform in March 1983 and thereby opposed an easy fiscal policy. At the same time, seeking a monetary policy more centered on the interest rate mechanism and a more smooth formation of interest rates through market conditions, the Bank worked for the further development of deregulation of interest rates in the primary and secondary markets.[70] The Bank consistently maintained a stance of encouraging financial deregulations to increase use of the market mechanism further.

D. Debate over Monetary Policy with a Greater Consideration of the Exchange Rates

The Bank started market operations to "bring the short-term interest rates to a higher level" in spring 1982. Around this time, other countries criticized Japan's combination of tighter fiscal policy and easier monetary policy as causing depreciation of the yen.

At the OECD Working Party Three (WP3) where monetary and fiscal authorities in major countries discussed their policies, the officials from the U.S. and European authorities and international organizations made a criticism. They insisted that "the lower interest rates would cause depreciation of the yen and should be avoided as much as possible" and that "Japan's policy mixture of monetary easing and fiscal tightening for fiscal reconstruction would exacerbate trade conflicts." They asserted that "Japan should implement a different policy mixture with monetary tightening and the slower pace of fiscal reconstruction, instead of the current policy mixture."[71]

Meanwhile, after market operations to "bring the short-term interest rates to a higher level" were implemented, different criticisms arose in the academic community. Some scholars argued that "the market operations for higher interest rates were a tightening policy in the economic stagnation, and that the assignment of monetary policy for a weaker yen as a countermeasure rather than stabler domestic prices or solid economic growth was

[69] BOJ (1983b), p.5.
[70] BOJ Archives (1981e), pp.8–9, BOJ Archives (1981f), pp.7–9, BOJ Archives (1982c), pp.7–9, and BOJ (1983b), p.5.
[71] BOJ (1986a), pp.562–563.

inappropriate"[72] and that "the monetary policy would never be able to control the stabler foreign exchange rates at will."[73]

With regard to the criticism from the academics, the Bank considered that their recognition for assigning monetary policy toward stabler exchange rates as unjustifiable would include oversimplification, under conditions such as the spillover effects by a weaker yen on domestic prices, on Japanese firms and on overseas frustration, as well as the more volatile exchange rate under wider gaps between domestic and overseas interest rates.[74] On the other hand, with regard to the criticisms from abroad, the Bank recognized that they were not entirely irrelevant. Meanwhile, the Bank considered that some counter policy measures against a weaker yen should be desirable, based on the assessment of the effect of a weaker yen on (1) bringing higher prices and larger overseas payment, (2) possibly reducing corporate profits in the material industry, and (3) little possibility for a larger export volume in the stagnating world economy.[75]

IV. Greater Trade Conflicts, Monetary Policy, and the Japan-U.S. Yen-Dollar Committee (from Fall 1983 to Summer 1985)

- The U.S. economy strongly expanded, led by domestic demand, mainly supported by the subdued inflation with the effect of previous monetary tightening and by the effect of tax reduction. At the same time, the progress in reduction of fiscal deficits was not enough. The U.S. interest rates remained at a high level and the dollar continued strengthening.
- Japan's economy recovered gradually and then the expansion became increasingly solid, supported by the remaining price stability due to the improved productivity and the mild rise in wages, and by the spillover effect of export growth to the U.S., in particular on the domestic demand such as fixed investment and consumption.
- The Bank kept the official discount rate unchanged throughout the period from 1984 to 1985. In the first half of 1984, when domestic demand was recovering slowly and prices were stable, the Bank's policy stance was slightly inclined for

[72] Komiya and Suda (1983), p.431. Similar criticism can be found in Kosai (1983) and Shinkai (1983).

[73] Remarks by Professor Komiya at the symposium of the IMES. See BOJ IMES (1983), p.93.

[74] At the Governor's speech on July 22, 1985 (BOJ Archives [1985d], p.4), it was stated regarding earlier monetary policy implementation that "the Bank continuously pursued the best monetary policy with a balancing of various aspects such as prices, economic activity and foreign exchange rates, by assessing overall circumstances domestic and overseas."

[75] BOJ Archives (1982b), pp.2–3, 5.

loosening. From mid-1984 to early 1985 when the recovery of domestic demand became obvious and the yen depreciated further, the Bank's policy stance was slightly inclined for tightening reflecting concerns about intensification of trade frictions or imported inflation under a further depreciation of the yen.

- The widening external imbalance among industrial countries worsened and the trade friction further intensified. However, the requests against Japan in this period were mainly for greater market access in individual sectors. In response to the requests, the Japan-U.S. Yen-Dollar Committee was established, and it published a report in 1984. Then the financial deregulations were persistently promoted in the second half of the 1980s, thereby affecting monetary policy operations from medium- and long-term perspectives.

A. Economic Conditions and Policy Stance of Major Countries

1. Expansion of the U.S. economy and the strong dollar

From 1983 to the first half of 1984, the U.S. economy strongly expanded led by domestic demand, mainly supported by the subdued inflation with the effect of previous monetary tightening and by the growth in consumption and housing investment in addition to the effect of tax reduction (Chart 7 (1)-III and IV). Against this background, the FRB conducted tighter market operations for concerns about inflation from spring 1983 onward and then raised the official discount rate in April 1984. However, from summer 1984 to early 1985, the economic growth slowed partly because of the slowdown in consumption with a preceding surge. Therefore, the FRB in early fall 1984 eased its stance on monetary policy operations, then reduced the official discount rate twice in the consecutive months of November and December 1984, and again lowered the official discount rate again in May 1985 (Chart 8 (1)-III and IV). Meanwhile, the unemployment rate improved during the first half of 1984, but remained at a high level of around 7 percent after mid-1984. Prices in 1984 remained relatively stable despite buoyant economic activity under the moderate wage growth, stable oil prices and growing imports in low-price goods under a stronger dollar (Charts 7 (2) and (3)-IV).[76]

With regard to fiscal policy, the confrontation between the ruling Republican Party against the reduction of defense spending and the Democratic Party against the decrease in social-welfare outlays remained and no effective measures were developed for reducing fiscal deficits. Against this background, with tightened monetary conditions by the FRB,

[76] BOJ (1983c), pp.2–5, 9–12 and BOJ (1984d), pp.2–3, 9–11.

both the short- and long-term interest rates remained high and supported a stronger dollar.[77] With the sluggish export growth and greater import growth under the strong dollar and active domestic economy, the U.S. current account deficit was on an uptrend and reached an exceptionally high level of over 100 billion dollars in 1984 (Chart 8 (2)-IV).[78] The concern about the U.S. becoming a net external debtor was growing rapidly around this period, as Paul Volcker, Chairman of the FRB, testified to Congress that “the world’s largest and richest economy might soon become the world’s largest debtor” in February 1985.[79]

The external imbalances among the industrial countries, particularly the imbalance between the U.S. and Japan, aggravated. The political frustration against Japan increasingly grew at U.S. Congress, under criticism concerning Japan’s persistent current account surplus and Japan’s massive trade surplus against the U.S. in particular. Under these circumstances, the first Reagan Administration (1981–1984) pursued external policies with no direct intervention in principle in the foreign exchange markets and with the requests of greater market access in surplus countries mainly on specific industries (Charts 12 and 13). In line with this policy direction and after President Reagan’s visit to Japan in November 1983, the Japan-U.S. Yen-Dollar Committee (to be described later) was established, and discussions were held there including on liberalization of the Japanese money and capital markets as the main issue. Under the worsening economic conflict, however, the second Reagan Administration starting in January 1985 changed the policy of non-intervention in foreign exchange markets and turned to pursue an exchange rate adjustment to rectify external imbalance.[80]

2. Modest economic recovery and remaining high unemployment in Europe

In Europe, economic activity started to recover from 1983, mainly in West Germany and the United Kingdom, led by domestic demand under price stability with moderate wage growth. In 1984, external demand began to recover, mainly led by exports to the U.S., and the overall economic activity in Europe including France started to recover moderately (Chart 9 (1)-III and IV). Meanwhile, among a tendency of weaker European currencies under a high level of the U.S. interest rates, European countries had little choice but to maintain tighter money policies for concerns of inflationary pressure by weaker home currencies (Charts 10

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[77] BOJ (1983c), pp.11–12 and BOJ (1984d), pp.11–12.

[78] BOJ (1983c), pp.10–11 and BOJ (1984d), p.11.

[79] Volcker and Gyohten (1992), p.356. At the end 1985, the U.S. became a net foreign debtor for the first time since relevant statistics became available. Also from BOJ (1986i), p.13.

[80] Both the overall U.S. trade deficit in 1984 (US$ 123.3 billion) and the U.S. trade deficit against Japan (US$ 36.8 billion) released on January 30, 1985, were the highest ever. Then, on February 3, James Baker, who later took initiatives for the Plaza accord, became secretary of the Treasury from the chief of staff to President. BOJ (1985c), pp.7–8 and MOF (2004), pp.350–351.

(1) and (2)-IV). The pace of economic recovery in Europe remained moderate. Furthermore, structural challenges, such as the lower absorption for workers under a prolonged stagnation in corporate fixed investment and the delay of corporate restructuring across industries also brought little improvement for employment conditions. The unemployment rates remained at a high level (Chart 9 (3)-IV). [81]

B. Economic Conditions in Japan from Fall 1983 to Summer 1985

1. Economic conditions from fall 1983 to mid-1984

Japan's exports grew rapidly mainly to the U.S. from 1983 to the first half of 1984. Consequently, corporate fixed investment increased in the export-related manufacturing industry with the elevated capacity utilization ratio and larger profit, and the trend of economic recovery became more solid. However, the economic recovery was mainly driven by exports rather than by domestic demand, with a modest pace of recovery under modest expansion in household outlays due to slower growth in employment and wages, and the modest fiscal expenditure under the fiscal reforms dragged down (Chart 1 (1)-IV). Meanwhile, prices remained generally stable as a result of factors such as the stronger business conditions of firms, the improvement of productivity, and a moderate wage increase (Charts 2 (1) and (2)-IV).[82]

The foreign exchange rates were generally stable in favor of the yen and remained around the 220-yen level, higher than 230-yen level at the time of the interest rate cut in October 1983. On the other hand, current account surplus remained on the uptrend (Charts 3 (1) and (2)-IV).

2. Economic conditions from mid-1984 to summer 1985

From mid-1984 to summer 1985, Japan's export growth moderated due to the slowdown of the U.S. economy. However, the effect of increased production in manufacturing industries and a recovery of their profits permeated into other sectors. Corporate fixed investment showed a strong expansion, and gradual improvements in both employment and personal income helped to recover both consumption and housing investment. Japan's economy expanded smoothly on the whole with stable prices in general (Chart 1 (1)-IV, Charts 2 (1) and (2)-IV).[83]

As for the exchange rates, the yen kept weakening and traded at the 260-yen level in February 1985 (with a bottom of 263.05 yen per dollar on February 25), weaker than the

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[81] BOJ (1983c), pp.12–14 and BOJ (1984d), pp.13–15.
[82] BOJ Archives (1984b), p.4 and BOJ (1985a), pp.1–2.
[83] BOJ (1985a), pp.1–2.

230-yen level per dollar in June 1984. Then, the trend of yen depreciation gradually changed under the declining U.S. interest rates, and the yen was traded at around 240 yen per dollar from summer to fall 1985. Current account surplus continued to expand (Charts 3 (1) and (2)-IV).[84]

C. Monetary Policy from Fall 1983 to Summer 1985

After the official discount rate reduction in October 1983, the Bank kept the official discount rate unchanged from 1984 to 1985 (Chart 4-IV). From fall 1983 to mid-1984, the pace of recovery in domestic demand was solid but slow under very stable prices. The Bank considered that a desirable “direction should be an economic recovery with the balance of domestic demand and foreign demand”[85] instead of an economic recovery driven by exports. In this regard, the Bank considered in monetary policy implementation that “a growth of domestic demand should be supported as much as possible so far as no significant concerns would be found on the price stability”[86] and the Bank’s policy stance tended to be relatively accommodative with the unchanged official discount rate. Meanwhile, from mid-1984 to early 1985, Japan’s economy experienced a slowdown in exports, a clear recovery in domestic demand, a solid penetration of the effect of monetary easing, and a weaker yen in the foreign exchange markets. Under these circumstances, regarding preventing possible inflation, the Bank considered the perspective that “a sharp appreciation of the yen could possibly have a more remarkable detrimental effect as a sharp rise in domestic prices” as well as another perspective of rectifying current account imbalances.[87] From these perspectives, the Bank’s policy stance tended to be relatively tight. Then, in spring 1985 the trend of the weaker yen was overturned in the foreign exchange markets. Under these circumstances, the Bank considered that “further efforts would be desirable for stabilizing the trend of the stronger yen”[88] from the perspective of monetary policy implementation, in addition to a consideration of rectifying the current account imbalance.

D. Establishment of the Japan-U.S. Yen-Dollar Committee and Its Achievements

1. Establishment of the Japan-U.S. Yen-Dollar Committee and its report

Trade frictions escalated as the problem of external imbalances exacerbated among the major industrial countries, but the requests for Japan around that time focused on market access in individual sectors. In this regard, slightly before President Reagan’s planned visit

[84] BOJ (1985a), pp.2–3 and BOJ (1986f), pp.3–4.
[85] BOJ Archives (1983b), p.2.
[86] BOJ Archives (1984a), p.5.
[87] BOJ Archives (1984d), p.5.
[88] BOJ Archives (1985d), p.4.

in November 1983, the U.S. requested Japan to liberalize its financial markets and promote internationalization of the yen, with the recognition that exclusive characteristics of Japan's financial markets caused both the weaker yen and stronger dollar and thereby derived a trade imbalance between the U.S. and Japan. Jointly chaired by Japan's Finance Minister Noboru Takeshita and the U.S. Secretary of Treasury Donald Regan, the Japan-U.S. Yen-Dollar Committee was established. Substantial discussions were held at meetings of the working group, jointly chaired by Vice Minister of Finance for International Affairs Tomomitsu Oba and the U.S. Under Secretary of Treasury Beryl Sprinkel.[89]

The working group submitted a report to Finance Minister Takeshita and Secretary of Treasury Regan in May 1984. The report encouraged Japan to further (1) liberalize the money and capital markets; (2) allow greater access to foreign financial institutions; and (3) develop the Euro-yen markets. Regarding the liberalization of the money and capital markets among these issues, the report indicated that a policy should be directed toward a step-by-step deregulation of deposit interest rates, starting from the large time deposits toward the small deposits, including postal savings as an ultimate goal. In addition, the report offered other policy directions such as an enhancement of the treasury bill market, a relaxation of issuance restrictions on the domestic CD (certificates of deposit), creation of a yen-denominated Banker's Acceptance market, and elimination of the yen conversion regulations (from June 1, 1984).

2. The Bank's recognition

Basically, the Bank embraced developments for financial deregulation as an unavoidable destiny at times. At the same time, the Bank considered that "proper attention should be paid so as neither to damage the stability and soundness of financial institutions in a transitory period of financial circumstances nor to cause large confusion in the financial system." Also the Bank acknowledged that "a further utilization of the interest rate function in line with the liberalization of financial markets" should be necessary.[90] In this regard, the Bank recognized that Japan "at this stage would never be able to avoid the issues of liberalization and internationalization"[91] indicated in the report by the Japan-U.S. Yen-Dollar Committee. In particular, the Bank positively considered that deregulations of deposit interest rates "should be steadily implemented hereafter, as a core of Japan's financial liberalizations."[92] On the other hand, the Bank considered that the very rapid pace

[89] MOF (2004), pp.330–331 and BOJ Archives (1984c).
[90] BOJ Archives (1982a), pp.8–9.
[91] BOJ Archives (1984d), p.6.
[92] BOJ Archives (1984b), p.7.

of liberalization in euroyen markets relative to the pace in domestic financial markets could possibly shrink transactions in domestic markets. The Bank also considered that the rapid liberalization of euroyen markets would cause difficulties in the Bank's domestic market operations. In this regard, the Bank concerned that a very rapid liberalization would intensify international capital flow and "might induce a destabilization of the international currency system as a whole."[93] In this regard, the Bank recognized that "a disproportional expansion of euroyen markets would not be appropriate" and that "a proactive stance for liberalization in domestic financial markets would be necessary steadfastly for avoiding adverse impacts."[94]

3. Progress of liberalization after the U.S.-Japan Yen-Dollar Committee's report

The report by the Japan-U.S. Yen-Dollar Committee did not have an immediate impact in nature on the monetary policy at that time. However, in the medium- and long-term, the policy directions for extensive financial liberalization significantly affected Japan's financial intermediation and then the monetary policy framework. For example, in the second half of the 1980s, liberalization progressed steadily in such fields as the deregulation of interest rates on deposits by financial institutions, broader fields in businesses and lower separation in activities by financial institutions, deregulations in domestic and overseas financial transactions, and the liberalization of domestic financial markets.[95] Under these circumstances, the ratios of both firms' raising and investing funds via financial markets instead of commercial banks increased (Charts 11 (2) and (3)). Under the gradual deregulation of deposit interest rates, the proportion of the free interest rate instruments to the total deposits increased (Chart 11 (1)). Regarding the commercial banks, they were compelled to take different directions in their business, in face of both the progress of interest rate deregulation on the fund-raising side and the decline in conventional bank loans on the investment side. The commercial banks increased the loans with variable lending rates in parallel to market interest rates, such as lending with spread methods[96] or with the new prime rate methods.[97]

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93 BOJ Archives (1984c), p.9.

94 BOJ Archives (1984d), p.6.

95 BOJ (1985a), pp.3–4.

96 With the so-called spread method, commercial banks determine their lending rates by adding a certain margin to funding the cost of the short-term market interest rates. See Kure and Shima (1987), pp.105–106.

97 Previously, in the so-called prime rate method, commercial banks determined the lending rate for prime borrowers in correspondence with the official discount rate. However, on January 23, 1989, Mitsubishi bank started to introduce a framework in which the lending rate was determined on the basis of funding cost from short-term money markets. Other commercial banks followed to adopt the similar determination method. Their lending rate was called "the new prime rate." See MOF

Even under the ongoing financial liberalization, monetary policy implementation was still based on the policy measures under the regulated interest rates framework. Under these circumstances, the Bank considered that monetary policy measures should be reformed for "better use of money market and free interest rates" to ensure the effectiveness and flexibility of monetary policy. The Bank also recognized that "further elaboration by ourselves should be necessary" for operational frameworks "such as the role of financial markets and monetary operations with conveying policy intentions smoothly."[98]

The Bank acknowledged the progress of financial liberalization itself as inevitable, and assessed it positively from a viewpoint of more proper distribution of funds across economy and greater efficiency in the financial system. At the same time, the Bank considered that an attempt to radically reform the nation's financial system would "cause difficulties such as unexpected shifts of funds and instability in the management of financial institutions." For preventing difficulties connected with the transitional phase, the Bank also recognized that "the varied measures for liberalization and internationalization should be implemented in a gradual manner, while sustaining a balance between them," and that an orderly and gradual liberalization would be desirable.[99] The Bank further acknowledged that under a circumstance in future with a greater progress of liberalization, the interest rates for small deposits including postal savings should be "managed with greater consideration of financial market conditions" to enhance the functioning of markets for smoothing interest rates and thereby ensuring greater effectiveness and flexibility of the monetary policy.[100]

V. Development of International Policy Coordination and Monetary Policy (from the Plaza Accord to the Louvre Accord)

- In September 1985, the Plaza Accord was achieved primarily for exchange rate realignment through concerted intervention in the foreign exchange markets and thereby rectifying the external imbalance, and the U.S. dollar depreciated sharply. However, the external imbalance continued to expand partly due to the J-curve effect. Therefore, from fall 1986 onward, major countries strengthened their pursuit for international policy coordination with fiscal and monetary policies in addition to exchange rate realignment. In February 1987 the Louvre Accord was achieved, aiming for the stabilization of exchange rates, the expansion of domestic demand

(2003a), p.19.

98 BOJ Archives (1984d), pp.6–7.

99 BOJ (1985a), pp.4–5.

100 BOJ Archives (1984d), p.7.

and subsequent reduction of current account surplus in surplus countries, and the reduction of both domestic imbalance and current account deficit in deficit countries.

- Against a backdrop of the yen's sharp appreciation from fall 1985 onward, prices became calmer and calmer, affected by lower import prices with a stabilization effect on domestic prices. Regarding economic activity, domestic demand continued to grow, but the decline in exports and subsequent deterioration of corporate profits in export-oriented industries steadily worsened conditions of corporate fixed investment and employment.
- In the first half of 1986, the Bank reduced the official discount rate three times and thereby eased monetary conditions, considering that expansion of domestic demand should be necessary in terms of both solid economic growth and rectification of external imbalance. In fall 1986 and afterwards, although both a turnaround in economic activity and a sign of financial imbalance were emerging, the Bank gave higher priority to a better circumstance for achieving the international agreement on stabilization of exchange rates. The official discount rate was lowered twice in November 1986 and February 1987 for further monetary easing.

A. The Plaza Accord and Market Operations to Leave the Short-Term Interest Rates at a Higher Level (from Fall 1985 to the End of 1985)

1. Situation of major countries prior to the Plaza Accord

The U.S. continued to experience a significant "drain of demand to overseas" under a stronger dollar, and the U.S. current account deficit increased further (Chart 8 (2)-IV). The economic activity slowed down with stable prices, and the unemployment rate remained high at the 7 percent level (Charts 7 (1), (2) and (3)-IV). Against this backdrop, the FRB maintained the relatively accommodative policy stance with an unchanged discount rate (Chart 8 (1)-IV). Meanwhile, actions for rectifying the U.S. trade imbalance with Japan became increasingly stronger mainly in Congress.[101] In summer 1985, the U.S. government intended an exchange rate adjustment for rectifying the external imbalance (as aforementioned in IV. A.1.).

In European countries such as West Germany, the economy on the whole was expanding moderately under stable prices, but the unemployment rate remained high (Charts 9 (1), (2)

[101] BOJ (1985c), pp.2,11–16 and Ishii (2011), pp.142–145.

and (3)-IV). With a concern about higher inflation led by weaker home currencies, central banks in Europe implemented monetary policies with accommodation to a limited extent (Chart 10 (1)-IV).[102] Under these circumstances, the realignment of foreign exchange rates for stronger home currencies and a weaker dollar was desirable to broaden room for additional monetary easing.

In Japan, the economy was expanding moderately under the slower growth of exports to the U.S. and the steady growth of domestic demand mainly in consumption and corporate fixed investment together with the still high level of corporate profits (Chart 1 (1)-IV). Concurrently, prices were stable, where the year-on-year changes were around 2 percent in consumer prices and slightly negative in domestic wholesale prices.

The Bank assessed that "further simulative policies would not be necessary for current conditions of domestic demand," and also considered that "a stabilization of the yen exchange rate at a higher value" would be "the most important for correcting the external imbalance as a very serious problem."[103] An exchange rate adjustment for the stronger yen against the weaker dollar was also desirable for Japan.

2. The Plaza Accord

On September 22, 1985, a G-5 meeting was held at the Plaza Hotel in New York, with the participants of the finance ministers and the central bank governors from the five countries of Japan, the United States, the United Kingdom, West Germany, and France. The meeting achieved the so-called Plaza Accord, implicitly including conduct of concerted intervention (with selling the dollar) as a main measure for an orderly appreciation of the main non-dollar currencies.

According to the content of the joint announcement published, Ministers and Central Bank Governors of the five countries agreed that "it was essential that protectionist pressures be resisted." Furthermore, they "agreed that exchange rates should play a role in adjusting external imbalances" and also believed that "some further orderly appreciation of the main non-dollar currencies against the dollar is desirable." In this regard, the Accord indicated the possibility of concerted intervention in the foreign exchange markets for rectifying an overly strong dollar, by stating that "they stand ready to cooperate more closely to encourage this when to do so would be helpful." Also, according to the part of the Accord describing desirable policy packages for each of the governments, Japan was supposed to conduct "flexible management of monetary policy with due attention to the

[102] BOJ (1985c), pp.16–22.
[103] BOJ Archives (1985e), pp.2–4. Also, see BOJ (1985b), pp.1–2, 16, 19.

exchange rate"[104] in addition to further opening up of its domestic market, utilization of private sector vitality through the implementation of vigorous deregulation measures, and a reduction of government deficit.[105]

The Bank allegedly did not know the contents of informal talks for the accord until just before the meeting. However, the Bank supported the Plaza Accord because the fundamental policy direction of the Accord itself for a reduction of the external imbalances mainly through a rectification of the overly stronger dollar and weaker yen was fairly consistent with the Bank's policy direction up to now.[106]

3. Appreciation of the yen after the Plaza Accord and the BOJ's policy stance (money market operations to leave the short-term interest rates at a high level)

Under the Plaza Accord, G-5 countries conducted the concerted intervention in the foreign exchange markets from September 23, 1985. The dollar exchange rate dropped sharply against the major currencies including the yen, falling from 242 yen per dollar (September 20) just before the Plaza Accord to 211 yen per dollar against the yen on October 4. However, the dollar sometimes rebounded toward late October, partly because of speculations that the Plaza Accord "might be losing its effect" and that "market intervention was not sufficient for a rectification of an overly strong dollar" (Chart 3 (1)-V and Chart 10 (2)-V). [107] Meanwhile, the long-term interest rates dropped sharply in domestic financial markets partly due to growing anticipation for the lower interest rates (as in Chart 4-V where the over-the-counter quotation of the 10-year government bond yield dropped from 6.58 percent at the end of August to 5.77 percent at the end of September 1985). The difference between domestic and overseas interest rates was broadening.[108]

Under these circumstances, the Bank acknowledged regarding foreign exchange rates that a future development of the U.S. fiscal deficit as a foundation for a strong dollar would be "unpredictable" and that the stabilization of the yen at a higher value would be still uncertain. At the same time, the Bank's assessment of Japan's economy was that "although the pace of economic growth would somewhat be slower, the solid economic expansion led by domestic demand would remain with little change in the near term." Under these

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[104] Regarding the term of "flexible management" of monetary policy, the Vice Minister for International Affairs of Ministry of Finance, Mr. Tomomitsu Oba, later noted that the term was adopted in consideration of the independence of monetary authority although the term of "reduction of policy rates" was close to the real intention. Oba (1995), pp.176–177.

[105] "Press release by G-5 finance ministers and central bank governors on September 22, 1985", from MOF (2003b), pp.117–119. Also, see Funabashi (1988, pp.261–266) for the reprinted release.

[106] MOF (2004), p.358 and BOJ Archives (1985f), pp.2–3.

[107] BOJ Archives (1985h), pp.14–15.

[108] BOJ (1986b), p.21 and BOJ (1986f), p.35.

circumstances, the Bank believed that "for a rectification of the external imbalance as Japan's biggest problem, the stabilization of the yen at a higher value was the most important policy task in the near future."[109]

For the purpose of dispelling anticipation for lower interest rates and thereby laying ground for a persistent appreciation of the yen, from late October to mid-December 1985, the Bank implemented money market operations "to leave short-term interest rates at a higher level" by allowing the autonomous tightening of supply and demand conditions in the short-term money market to permeate overall market interest rates (Chart 4-V).[110] As a result, the bill rate (monthly average rate on three-month instruments) increased from 6.37 percent in September to 6.73 percent in October and then to 7.86 percent in November. The long-term interest rate also rose from 5.77 percent at the end of September to 6.60 percent at the end of October. The yen appreciated to 202 yen per dollar by November 7 and then remained at the level of 200–205 yen.[111] The Bank assessed that the circumstance for a stronger yen would be stable enough, and the Bank's stance at money market operation was gradually restored from a stance with "short-term interest rates at a higher level" to a neutral stance in the second half of December 1985.[112]

The "market operations to leave the interest rate at a high level" brought overseas concerns such that "a move toward monetary restraint for the foreign exchange realignments would be inadequate in terms of Japan's concurrent economic conditions with a steady but moderate pace of growth."[113]

B. Monetary Policy amid a Sharp Rise in the Yen (from the End of 1985 to Spring 1986)

1. Further progress of appreciation of the yen against the dollar and the economic situation in major overseas countries

In the U.S., the Balanced Budget and Emergency Deficit Control Act, also known as Gramm-Rudman-Hollings Act, was signed into law in December 1985, with the goal of a the balanced budget by fiscal 1991. Against a backdrop of developments for fiscal deficit reduction like this enactment, the U.S. long-term interest rates dropped sharply from late 1985 to spring 1986 (the monthly average of the 10-year government bond yield declining from 9.8 percent in November 1985 to 7.3 percent in April 1986, as in Chart 8 (1)-V). The decline in the long-term interest rates supported solid personal consumption and also

109 BOJ Archives (1985f), pp.3–4.
110 BOJ (1986f), pp.3–4.
111 BOJ Archives (1985h), p.15.
112 BOJ (1986f), pp.3–4.
113 Ogata (1996), p.23. Also, see Volcker and Gyohten (1992), pp.246–247.

encouraged a further depreciation of the dollar. However, the pace of the U.S. import decline against a weaker dollar became slower under a J-curve effect and a structural change in U.S. international trade, where the stronger dollar in the past phase increased imports of capital goods and parts from other countries including Japan. With this background, the leakage of demand abroad remained and the economic growth became slower under an uptrend of current account deficits (Chart 7 (1) and Chart 8 (2)-V).[114] Under these circumstances, Saudi Arabia decided to increase oil production in December 1985 and then crude oil prices started to drop sharply after early 1986 (Chart 2 (3)-V). The developments for reducing production in the oil-related industry along with lower oil prices slowed the U.S. economic growth in spring 1986 to some extent, and the unemployment rate remained high, at around 7 percent (Charts 7 (1) and (3)-V). Meanwhile, the decline in oil prices and the loosening conditions of supply and demand stabilized prices, with a level of less than 2 percent of the year-on-year change in consumer prices (Chart 7(2)-V) and with a level lower than the previous year's level in producer prices.

In early 1986, the FRB adjusted the short-term market interest rate to a slightly lower level and thereby maintained a slightly accommodative policy stance (Chart 8 (1)-V), on the grounds of domestic conditions with modest economic growth and a high unemployment rate. At the same time, the FRB considered that overly eased monetary conditions with a subsequent instability of the foreign exchange markets should be avoided from the perspective of preventing a sharp drop of the dollar and a resurgence of inflation concerns.[115] The FRB "appeared to be vexed with the dilemma" for monetary policy formulation.[116]

In West Germany, the economic activity was solid mainly in corporate fixed investment and personal consumption under stable prices. At the same time, the economic growth rate was moderate at a level slightly lower than 3 percent partly due to slower export growth under a higher German mark value (Chart 9 (1)-V). In addition, the unemployment rate remained at a high level partly due to such structural factors as favorable institutional frameworks for employees (Chart 9 (3)-V). Meanwhile, the year-on-year changes around spring 1986 declined, becoming negative for both consumer prices and producer prices, partly due to the effects of a stronger German mark and a drop in oil prices (Chart 9 (2)-V).[117]

The foreign exchange markets were relatively stable from December 1985 to

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[114] For the Bank's analysis of the U.S. trade deficits in those times, see BOJ (1986g), pp.1–2.

[115] BOJ (1985c), pp.15–16.

[116] BOJ Archives (1986a), p.2. Also, see Volcker and Gyohten (1992), p.247.

[117] BIS (1987), pp.17–19, 23–26.

mid-January 1986, at a level of around 200 yen to the dollar. Then, a G-5 meeting in London agreed on January 19 that "the progress which has been made so far should not be reversed," and there was growing speculation that the effect of a sharp drop in oil prices for an improvement of trade balances would be greater for Japan and West Germany than for the U.S. and would further increase the trade surplus of Japan and of West Germany. With this background, the dollar started to depreciate to a level below 200 yen to the dollar after late January 1986. Furthermore, the U.S. long-term interest rate declined continuously and the U.S. current account deficit increased further. Also, speculation arose that lower oil prices would widen an additional slack of monetary easing for the U.S., which should be persistently precautious against renewed inflation. Then, the dollar weakened to a level of 180 yen to the dollar in March and to 160 yen to the dollar at the end of April 1986 (Chart 3 (1)-V).[118]

2. Changing circumstances and the Bank's response to the sharp yen appreciation

In Japan, domestic demand remained firm mainly in corporate fixed investment and personal consumption. Meanwhile, a deceleration of export growth became clearer under the yen's appreciation and the slowdown of U.S. economic growth. After the end of 1985, industrial production gradually turned to a declining trend and the firms' business confidence continued to deteriorate mainly in the manufacturing industries with the passage of time (Charts 1 (1) and (3)-V).[119] The Bank assessed the yen's appreciation positively in the medium- and long-term that a stronger yen would be beneficial to economic activity by increasing household income in real terms under lower product prices and by increasing corporate profits under lower prices of import materials. At the same time, the Bank considered the yen's appreciation negatively in the near term, with the assessment that "the slower economic growth would be inevitable against a background of sluggish export growth" under the yen appreciation.[120]

Meanwhile, prices were further stabilized under the yen's appreciation and lower oil prices affecting lower import prices and stable domestic prices (Charts 2 (1), (2), and (3)-V). The Bank assessed that "a failure of price stability would be unthinkable in the near term." At the same time, the year-on-year growth rate of money supply (M2+CD) increased from the 7 percent level in early 1985 to 9 percent in early 1986 (Chart 5 (2)-V), and the Bank considered that the higher growth in money supply "would partly be attributed to deregulations of interest rates on large-scale time deposits as a special factor." Also, with

[118] BOJ (1986i), p.4.
[119] BOJ Archives (1986c), p.2.
[120] BOJ Archives (1986e), pp.4–5.

the awareness of the rise of land prices in central Tokyo (Chart 6 (2)-V), the Bank considered that the land price increase "was mainly caused by greater demand for office buildings rather than monetary easing."[121]

In December 1985, when the yen was around 200 yen per dollar, the Bank considered that "a fortification of the progress of the higher yen rate at this level" would be adequate and that a further appreciation of the yen would not be desirable for negative effects on the industries.[122] The yen actually continued to appreciate even after the turn of the year, however, and the effect of the yen appreciation appeared to slow down future economic growth. For this reason, the Bank lowered the official discount rate in January (from 5.0 percent to 4.5 percent), March (to 4.0 percent) and April (to 3.5 percent) 1986, considering that "the effect of lower interest rates for improvement in business prospects" would support economic activity, "strengthen the growth of domestic demand," and thereby "contribute to further adjustment of external imbalances" (Chart 4-V).[123] In this regard, it appears that a reduction of interest rates in this period did not basically cause a dilemma between the domestic and international policy goals, that is, the stabilization of economic activity on the domestic front and the rectification of external imbalance on the international front. Meanwhile, when the yen's appreciation reached a level of around 180 yen per dollar on March 18, the Japanese authorities solely started the dollar-buying intervention for the first time after the Plaza Accord,[124] and when the Bank rate was lowered in both March and April 1986, the policy intention to "prevent excessive fluctuations of exchange rates" was explicitly included in the press releases.[125]

3. Coordination of timing in interest rate reductions and the background

The policy developments of the official discount rate reductions in March and April 1986 as well as those in February 1987 (to be described later) differed from those of monetary policy changes in the other timing, with respect to the prior communications closely among Japan, the U.S. and West Germany and the timing of the discount rate reductions almost at the same time by Japan and the U.S. (in addition to West Germany in March 1986).

It appears that the major countries would not necessarily try to change their monetary policies at the same time under the circumstance before the Bank's rate reduction in January 1986. Specifically, the FRB's Chairman Volcker recalled that, "[a]round the fringes of a G-5

121 BOJ Archives (1986g), pp.3–4.
122 BOJ Archives (1986b), p.2.
123 BOJ Archives (1986b), p.2. Also, see BOJ Archives (1986c), p.3, BOJ Archives (1986d), pp.2–3, and BOJ Archives (1986f), p.3.
124 MOF (2004), p.370.
125 BOJ (1986c) and BOJ (1986e).

meeting in London in January 1986, there was some talk about a coordinated move to reduce interest rates to spur the world economy" and that "[t]he time was not ripe" for the FRB in terms of concerns about an inflationary surge from the current sharp depreciation of the dollar.[126]

Regarding the developments for the official discount rate cut in January 1986, the Bank recognized that in spite of the unchanged monetary policy in the U.S. "the official exchange rate was reduced expeditiously" in response to "the further appreciation of the yen as a new development" in the foreign exchange markets. The Bank emphasized that the decision was "solely based on independent judgment" and that "neither prior requests from the U.S. authorities nor preliminary consultations with them existed" in the policy formulation.[127]

In contrast, regarding the development for the official discount rate reductions in March 1986, the Bank implied the existence of preliminary consultations among the central banks of Japan, the U.S. and West Germany in order to reduce the interest rates almost at the same time. Particularly, the BOJ recognized that "according to daily communication and exchange of information with the FRB and the Bundesbank the monetary authorities of both countries would be likely to reduce the official discount rates in the near future," and that "the strong concern of the FRB for a further sharp depreciation of the dollar from the lower interest rates" was gradually informed. Furthermore, the BOJ considered that "a further sharp depreciation of the dollar with a sharp appreciation of the yen would possibly have a seriously negative impact on Japan's economy." The BOJ also considered that "the possibility of a sharp depreciation of the dollar would not be ruled out and the realization of the possibility by chance should be avoided for the stabilization of the international monetary conditions." Against this background, the BOJ formed a policy intention that "it would be appropriate to reduce the official discount rate for the Bank" if both of the U.S. and West Germany would lower the interest rates. Furthermore, the BOJ suspected that the intention of the BOJ "would be shared with the counterparts through the communication and exchange of information."[128]

Regarding the official discount rate reductions in April 1986, Finance Minister Noboru Takeshita and Secretary of Treasury James Baker held a meeting on April 8, and then the Bank's Governor Satoshi Sumita and Chairman of the FRB Paul Volcker held a meeting on April 10 prior to the rate reductions.[129] It is implied that at the meeting between Governor Sumita and Chairman Volcker as well as the officials of both countries, they exchanged

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[126] Volcker and Gyohten (1992), p.247 and MOF (2004), p.369.
[127] BOJ Archives (1986b), pp.4–5.
[128] BOJ Archives (1986d), pp.2–3.
[129] MOF (2004),p.372.

their preliminary opinions about interest rate reductions.

Specifically, Governor Sumita, who attended international conferences associated with the Bank for International Settlements (BIS) and the International Monetary Fund (IMF), had discussions with his colleagues there in these meetings and with Chairman Volcker bilaterally. Governor Sumita appears to have had an impression that "the U.S. would intend to reduce the official discount rate and that they had an aspiration for Japan's additional interest rate reduction at about the same time." The Bank further came to consider that "the FRB's timing for the reduction of the official discount rate could be in the near future through information exchanges with the FRB" after Governor Sumita's return to Japan. Under these circumstances, the Bank considered that "additional assessments would be preferred admittedly." At the same time, the Bank recognized that "under the current fluctuation of the foreign exchange rates toward the stronger yen Japan's interest rate would be appropriate in terms of stabilization of the foreign exchange rates" and that "the calmer prices and the slower economic growth were becoming more obvious on the domestic front." Under these circumstances, the Bank considered that "the Bank's policy decision would be to lower the interest rates if the FRB would reduce the official discount rate."[130]

These developments were also affected by the two perspectives in the U.S. authorities that lower interest rates would be appropriate for domestic economic activity on one hand, but a unilateral reduction of the official discount rate would be harmful for a possible depreciation of the dollar in terms of the stabler prices and the stabler international capital flow. For example, among the officials of the U.S. authorities around February 1986, Chairman Volcker at the FRB was concerned about the weakening of the dollar in terms of the price stability and the avoidance of rapid international capital flow. Trade Representative Clayton Yeutter and Commerce Secretary Malcolm Baldrige, however, wanted a stronger yen for reducing the current account deficit further. Secretary of Treasury Baker also tolerated orderly depreciation of the dollar for ameliorating the U.S. protectionism. Under such circumstances, during the unscheduled meeting of the Board of Governors on February 24 with the participation of two newly-appointed governors, a proposal for a unilateral reduction of the official discount rate carried 4 votes to 3 despite Chairman Volcker's opposition. Then, Chairman Volcker, with a fear of a weaker dollar by a unilateral rate reduction, proposed to defer the implementation of the rate reduction until the achievement of coordination in reducing interest rates simultaneously with Japan and West Germany, and the proposal was approved unanimously. With this background, Chairman Volcker "initiated further discussions with" his "colleagues at the Bundesbank and the Bank of Japan, reaching agreement" that the three countries would lower the interest rates almost

[130] BOJ Archives (1986f), pp.2–3.

at the same time.[131] In July 1986, Chairman Volcker made a congressional statement meaning that "an important consideration in the timing and extent of any rate cut was the risk posed by an excessive reaction in the foreign exchange markets" and that "the discount rate reductions in March and April were timed to coincide with similar changes by one or more other key countries, minimizing any impact on the exchange markets."[132]

C. Monetary Policies under Macroeconomic "Policy Coordination" (from Summer 1986 to Spring 1987)

1. Circumstances in major economies including Japan (from spring 1986 to spring 1987)

In the U.S., the dollar continued to depreciate, but "erosion of domestic demand abroad" remained under the structural tendency of lesser imports particularly in capital goods and parts. The current account deficit expanded to a level exceeding 140 billion dollars in 1986 (Chart 8 (2)-V). In addition, the economic activity "in general lacked strength somewhat" and the unemployment rate remained high at a level of around 7 percent, partly due to the developments for a large production cutback and reduction of corporate fixed investment in the oil-related industry after lower oil prices in early 1986. Meanwhile, prices tended to be more stable mainly due to lower oil prices (Charts 7 (1), (2), and (3)-V). Under these circumstances, the FRB reduced the official discount rate unilaterally in July and again in August (Chart 8 (1)-V).[133] In West Germany, exports became slower under the appreciation of the German Mark, but the growth of personal consumption accelerated under better income conditions with stable prices and tax reductions. Also, corporate fixed investment increased through higher capacity utilization and better corporate profit, and the overall economy continued to grow (Chart 9 (1)-V). Concurrently, prices declined sharply under the appreciation of the German Mark and a drop in oil prices (Chart 9 (2)-V), but under the ongoing economic growth, the Bundesbank adopted a cautious policy stance for further monetary easing and kept the official discount rate unchanged until the end of 1986 (Chart 10 (1)-V).[134]

In Japan, after fall 1985, exports started to decline under a sharp and significant appreciation of the yen, and the economic growth rapidly slowed owing to larger adjustments in both corporate fixed investment and employment due to worsening profitability in the export-related industries. Meanwhile, the growth in domestic demand

[131] Volcker and Gyohten (1992), p.274. Also, see MOF (2004), p.370.
[132] BOJ (1986i), p.14. Also, see FRB (1986), pp.613, 641–642.
[133] BOJ (1986i), pp.8–11. Also, see BOJ Archives (1986i), p.5.
[134] BOJ (1986i), pp.16–17, 20–21, 23.

remained steady mainly in household spending and capital investment by non-manufacturers. The overall economy avoided a deep economic downturn, and the composition in gross demand changed with the larger share in domestic demand and the smaller share of overseas demand (Chart 1 (1)-V).[135] On the external front, Japan's trade surplus in terms of quantity turned to decrease, but under the effects of a raise in export prices in response to strong demand for Japanese products and lower oil prices, Japan's trade surplus in dollar terms grew further from fall 1985 to summer 1986, and then remained at a high level with no signs of decline until spring 1987 (Chart 3 (2)-V).[136]

In the foreign exchange markets, the dollar continued to weaken against other currencies sharply after early 1986, due to the maintained coordination among the authorities of each country toward the rectification of excessive appreciation of the dollar, possible room for an additional interest rate reduction in the U.S. under the sharp decline in oil prices, and few signs of improvement of the U.S. trade imbalance (Chart 3 (1) and Chart 10 (2)-V).[137]

2. Developments in the macroeconomic policy coordination for the Louvre Accord

The U.S. Treasury allegedly sought international policy coordination in the field of both fiscal policy and monetary policy in addition to foreign exchange policy, even before the Plaza Accord. It appears that the development for the international coordination of overall macroeconomic policies would be more concrete after the Tokyo Summit in May 1986 and became full-scale from fall 1986 onward.[138] Under these circumstances, the Bank recognized that the interest rates should be kept unchanged on the domestic front so far as the stability of foreign exchange markets would be maintained as described below. At the same time, the Bank received requests for further monetary easing from overseas authorities. Against this background, the Bank assessed that necessary conditions for the stable domestic economy would possibly be lost without obtaining an international agreement for stabler foreign exchange rates, and lowered the official discount rate in November 1986 and February 1987.[139]

On the Tokyo Economic Summit Conference, Secretary of Treasury Baker proposed a new initiative of "a system of conducting mutual surveillance on economic policy

135 BOJ (1987b), pp.1–2.
136 BOJ (1987b), pp.2–3.
137 BOJ (1986i), pp.4–5.
138 MOF (2004), pp.354, 372–373.
139 In this regard, Okina, Shirakawa and Shiratsuka (2001, p.420) pointed out that considerable emphasis was given to ensuring foreign exchange rate stability, especially preventing the yen's appreciation, in conducting monetary policy.

managements" by applying economic indicators for possible actions.[140] On May 6, a framework for such "multilateral surveillance"[141] was proposed in the Tokyo Economic Declaration.

Prior to the Tokyo Summit, "the Advisory Group on Economic Structural Adjustment for international Harmony" organized by the request of Prime Minister Nakasone in October 1985 (headed by the former Governor of the Bank Haruo Mayekawa as the Chairman) submitted a report (known as the Mayekawa report) to the Prime Minister in April 1986. The Report, with a purpose to "attain the goal of steadily reducing the nation's current account imbalance to one consistent with international harmony" by "setting [it] as a medium-term national policy goal," included recommendations such as "basic transformations in the nation's trade and industrial structure" along with "striving for economic growth led by domestic demand." (See Column 2 for the "Mayekawa Report.")

It appears that the informal talks toward the full-scale international coordination of macro-economic policy including fiscal and monetary policies began around fall 1986. Minister of Finance Kiichi Miyazawa, who assumed the office in July 1986, had the first meeting with Secretary of Treasury Baker on September 6. It was reported that at the meeting Finance Minister Miyazawa called for the stabilization of exchange rates and the reduction of the U.S. fiscal deficit, and that Secretary of Treasury Baker requested Japan to increase domestic demand, lower the official discount rate, reform the tax system and reduce taxes. The specific details of the policy coordination were not achieved at this stage, but the authorities of both Japan and the U.S. began a joint study on strengthening their policy coordination. From late September and early October 1986, such international conferences as the IMF Annual Meetings were held in Washington D.C. The second Miyazawa-Baker meeting was also held in this period, and the Baker-Miyazawa joint communiqué was released on October 31.[142] The communiqué included Japan's policy actions such as a submission of a supplementary budget to the Diet in order to implement the 3.6 trillion yen package announced in September, a tax reform plan including reductions in the tax rate for both personal and corporate income, and the Bank's decision to reduce its

140 BOJ Archives (1986h), p.6.

141 The multilateral surveillance proposed by Secretary of Treasury James Baker mainly consisted of two parts: first, a formulation of G-7 meetings by finance ministers and their deputies and the conduct of mutual surveillance for the coordination of respective policies among peers at regular meetings at least once a year; second, a framework using several macroeconomic indicators for objective and strict surveillance of respective countries and enforcing automatic corrective measures for countries largely deviating in terms of their indicators. MOF (2004), pp.372–373. Also, see BOJ Archives (1986h), p.6. Among the Baker proposal, member countries agreed on a formulation of G-7 meetings, but countries did not agree on the use or role of indicators.

142 Volcker and Gyohten (1992), pp.263–266 and MOF (2004), pp.354, 374–376.

discount rate from 3.5 percent to 3 percent effective November 1. The policy actions by the U.S. included steady reductions in the U.S. budget deficit, a tax reform providing additional incentives to invest and to work for promoting economic growth, and resistance against protectionist pressures. Furthermore, in the communiqué they "shared the view that exchange rate instability can jeopardize stable economic growth" and they "expressed their mutual understanding that … the exchange rate realignment is now broadly consistent with the present underlying fundamentals."[143]

The Bank lowered the official discount rate in November 1986 and February 1987, placing priority on international coordination on stabilization of the exchange rates. Until early fall 1986, the Bank considered that the economy was slowing down but the pace of deceleration would not be increasing," and also recognized "a rising stock market and wider areas with increasing land prices." The Bank assessed that "this timing would not be appropriate for lowering interest rates.[144] Under these circumstances, during Governor Sumita's U.S. visit, he was asked about "a possible reduction of interest rates" by Chairman Volcker, who coincided with Secretary of Treasury Baker on a stance of asking additional measures for Japan's greater domestic demand, at the international meetings in late September and early October.[145] The Bank also acknowledged the necessity to expand domestic demand and Governor Sumita recognized that "given the size of the external surplus and Japan's proportion relative to the global economy, we should prepare well for larger expectations by other countries."[146] Furthermore, on October 31, the Bank decided to lower its discount rate with the recognition that mainly in the export-related industries "larger developments for restraining capital investment and employment made firms' stance for business more cautious on the whole, and thereby economic activity was slowing."[147] The Bank considered that an important point for a decision on a rate reduction was a likely "reaffirmation of the U.S. intention to cooperate on the exchange rate issues in face of Japan's reduction of the official discount rate." The Bank also released a statement by the governor that the Bank "highly evaluates" the announcement that the countries "reaffirmed their willingness to cooperate on exchange market issues" in the Baker-Miyazawa joint communiqué.[148]

After the announcement of the Baker-Miyazawa joint communiqué, the exchange rate remained stable at around 160 yen per dollar until the end of 1986. However, on December

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[143] "Joint announcement" on October 31, 1986, taken from BOJ Archives (1986l), exhibit #1.
[144] BOJ Archives (1986l), pp.1–2.
[145] Ohta (1991), p.109.
[146] BOJ Archives (1986k), p.4.
[147] BOJ (1986h).
[148] BOJ Archives (1986l), pp.2–3 and exhibit #2.

31, 1986, it was released that the U.S. trade deficit amounted to 19.2 billion dollars (preliminary figure) in one month of November 1986. Then on January 8 Secretary of Treasury Baker showed recognition at the U.S. Senate Budget Committee's meeting that the dollar depreciation at the time was appropriate and orderly. Furthermore, the New York Times on January 14 reported that an unidentified official of the U.S. administration wanted the dollar to decline further. Against this background the dollar depreciated further and on January 19 temporarily depreciated to a level of 149 yen per dollar (Chart 3 (1)-V).[149]

Under these circumstances, Finance Minister Miyazawa urgently visited the U.S. to meet with Secretary of Treasury Baker, and after the meeting on January 21 they issued another Baker-Miyazawa joint communiqué.[150] Regarding the stabilization of exchange rates in the communiqué, "Secretary Baker and Minister Miyazawa agreed that developments in exchange markets warrant monitoring. The ministers expressed their view that during most of the period since October 31, 1986, the yen/dollar exchange rate has been broadly consistent with underlying fundamentals, although there were recent instances of temporary instability in exchange rate markets. Accordingly, the ministers reaffirmed their willingness to cooperate on exchange market issue." Regarding policy coordination among industrial countries in the communiqué, "both ministers agreed that in order to promote global growth, reduce imbalances and promote open market, closer coordination of economic policies among all major industrial countries is critical. Towards this end, they agreed to intensify consultations with other major industrial countries." This indicated a start of preparatory works for the Louvre Accord in February.[151] And on January 28, the Federal Reserve Bank of New York intervened to buy the dollar for the first time after the Plaza Accord.[152]

The Bank considered that after the interest rate reduction in November 1986 "the deceleration of economic growth started to cease in the manufacturing industry" and expected that "economic recovery would be clearer after mid-1987 regardless of its pace."[153] At the same time, the Bank obligingly considered on the financial front that "under the longer duration of monetary accommodation than ever before, the excessive monetary easing should not contribute to an increasing risk for excessive inflation in the future." Therefore, in terms of domestic circumstances, the Bank recognized that "a further

149 MOF (2004), p.377.

150 MOF (2004), p.377.

151 All citation in this paragraph were taken from "Press release (in Japanese)" on January 21, 1987 in BOJ Archives (1987c), exhibit #1. Also, see Funabashi (1988, p.276) for the reprinted release.

152 MOF (2004), p.377.

153 BOJ Archives (1987c), p.2.

monetary easing would not be appropriate" in monetary policy implementation.[154] However, the Bank also considered that "a more stable yen exchange rate" should be "a major precondition" for a possible realization of economic recovery. Therefore, regarding the yen's appreciation after early 1987, the Bank assessed that "a continuously unstable exchange rate with a higher yen could possibly suppress business conditions of manufacturing industry" and "concerns for a possible economic recovery would be larger."[155]

The Bank exchanged views with the Ministry of Finance before Finance Minister Miyazawa's visit to the U.S. in January. The Bank recognized that the U.S. would possibly call for a further expansion of domestic demand by a further reduction of interest rates in return for coordination toward the stability of foreign exchange rates. In this regard, at the discussion with the government, the Bank considered that although a further monetary accommodation would not be necessary on domestic fronts "the most important task at this stage should be the exchange rate stability, and a satisfactory accord of the exchange rate stability would be a compelling reason for a further interest rate reduction.

About the agreement between Minister Miyazawa and Secretary of Treasury Baker, the Bank "evaluated it to a certain extent" and would "assess the timing for the interest rate reduction, expecting a greater prospect for reaching a multinational agreement on stabilization of the exchange rates."[156]

After the Miyazawa-Baker meeting in January 1987, the substance of agreement about the stabilization of exchange rates and macroeconomic policy coordination was discussed and adjusted, and the "Louvre Accord" was achieved at the G-7 meeting of Finance Ministers and Central Bank Governors, held at the Louvre Palace in Paris on February 22, 1987.[157]

In the joint statement on the Louvre Accord issued, Financial Ministers and Central Bank Governors agreed that "the reduction of the large unsustainable trade imbalances is a matter of high priority." They also agreed "to intensify their economic policy coordination efforts in order to promote more balanced global growth and to reduce existing imbalances." Then, "surplus countries committed themselves to follow policies designed to strengthen domestic demand and to reduce their external surpluses while maintaining price stability. Deficit countries committed themselves to follow policies designed to encourage steady,

[154] BOJ Archives (1987a), pp.5–6.
[155] BOJ Archives (1987c), p.3.
[156] BOJ Archives (1987c), pp.3–4.
[157] MOF (2004), pp.377–381. At this time Italy were against an informal G-5 meeting without Italy and Canada a day before the formal G-7 meeting, and Italian delegates walked out of the G-7 meeting in protest. Also, see Funabashi (1988, pp.277–281) for the reprinted release.

low-inflation growth while reducing their domestic imbalances and external deficits." Regarding the exchange rates, the Ministers and Governors agreed that they brought "their currencies within ranges broadly consistent with underlying economic fundamentals, given the policy commitments summarized in this statement," and they "agreed to cooperate closely to foster stability of exchange rates around current levels." Regarding their respective policy management, Japan committed to conduct "monetary and fiscal policies which will help to expand domestic demand and thereby contribute to reducing the external surplus." The policies included the comprehensive tax reform, the early implementation of the fiscal 1987 budget, the preparation of a comprehensive economic program to stimulate domestic demand, and the Bank's announcement to reduce its discount rate by one half percent on February 23. The United States agreed to pursue policies with a view to reducing the fiscal 1988 deficit to 2.3% of GNP from its estimated level of 3.9% in fiscal 1987.[158]

The Bank decided to reduce its official discount rate on February 20 (from 3.0 percent to 2.5 percent, effective on February 23) before the Louvre Accord (Chart 4-V). Regarding the decision, the Bank considered that "a further continuation of unstable exchange rates with upward pressure on the yen would worsen a further deflationary impact on Japan's economy and thereby hinder a correction of external imbalance through promotion of long-term structural adjustment with an uninterrupted growth of domestic demand as an achievement of the most important task for Japan."[159] The Bank also emphasized "the reduction of interest rates with greater consideration on stabilization of the exchange rates than before."[160] Also, based on the recognition of "coordination among the major countries as indispensable in ensuring stability of exchange rates,"[161] the Bank reflected that its interest rate reduction was "highly evaluated by the other countries as the specific measure conducted simultaneously with the meeting as well as the leading move among participants" during the G-7 meeting toward an achievement of the Louvre Accord.[162,163]

In early 1987, against a backdrop of sharp deceleration of economic activity under a harsh winter and an appreciation of the German mark (to be described later in VI. 1. (1)), the Bundesbank of West Germany unilaterally lowered the official discount rate on January

158 MOF (2003b), pp.184–186.
159 BOJ (1987a).
160 BOJ Archives (1987c), p.6.
161 BOJ (1987a).
162 BOJ Archives (1987d), p.2.
163 Regarding this phase, Kuroda (2005, p.95) suspected that "external economic policy would be formulated independently of the other policies." Okina, Shirakawa and Shiratsuka (2001, p.419) also considered that monetary policy was strongly influenced by the framework of international policy coordination and under this framework countries with a current account surplus such as Japan and Germany were request to boost domestic demand.

22 (Chart 10 (1)-V).[164]

3. Developments on the financial fronts and the Bank's recognition

The Bank in the 1980s paid attention to developments on the monetary and financial fronts as an indication of inflationary pressures in a longer term, such as developments of money supply, asset prices including land prices and stock prices, and a stance of bank lending by commercial banks. Under a persistent double-digit growth of bank loans (Chart 5 (1)-V), an uptrend of stock prices became stronger in spring 1986 and land price rises in the center of Tokyo commercial district sprawled to the other neighboring areas (Charts 6 (1) and (2)-V).[165] The Bank gradually became cautious against these signs of financial imbalances.

On the reduction of interest rates in April 1986, the Bank called for the representatives of financial institutions to "maintain a prudent lending attitude," considering the level of its official discount rate as "a postwar record low except for a temporal level in immediate postwar days."[166] (Similar requests were made when discount rate reductions were made in November 1986 and February 1987.) In a Nikkei Newspaper article on May 20, 1986, "an unidentified high official of the Bank" expressed "concern about an increase of money supply" as "a lot of dry tinder under the chair." In the article "the Bank was also concerned that once an inflationary mind was ignited, speculative money held for asset-related purposes as well as money for transactions could rush into commercial products." The growth of money supply became slightly higher around summer 1986 (Chart 5 (2)-V), and concurrently during the summer the land price increases in commercial areas in central Tokyo sprawled to residential areas in the city and to the commercial areas of other cities. Regarding the background to these developments, the Bank increasingly regarded "monetary accommodation as one factor,"[167] and simultaneously recognized speculative fund investment or the "so-called *zaitech*"[168] as progressively active mainly among

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[164] Three days after the rate reduction (on January 25, 1987), the ruling party in West Germany won the general election. Nihon Keizai Shimbun (1987a).

[165] In 1985, National Land Agency published a report. National Land Agency (1985, pp.103–104) included a projection that new demand for office space in the area of Tokyo's 23 wards could reach about 5 thousand hectares (equivalent to 250 skyscrapers). This estimated number was interpreted carelessly, and then "criticized as fueling bubbles in land prices" during the second half of the 1980s. See Ishii (2011), pp.283–284.

[166] BOJ Archives (1986f), exhibit #2. However, the Bank of Japan's stance of respecting autonomous formulation of the loan plans by respective banks remained effective until spring 1987.

[167] See Nihon Keizai Shimbun (1986). Also, see BOJ Archives (1986k), p.7.

[168] "Zaitech" referred to the activity that, in the face of lower funding costs in the prolonged monetary easing, funds obtained by firms were more directed for speculative transactions in assets such as shares, bond and land for seeking capital gains, than for real investments. See BOJ (1987b), p.6 and BOJ (1988a), p.16.

firms.[169] Furthermore, the Bank acknowledged around fall 1986 that competition among some large city banks to obtain deposits “appeared to strengthen the volume-oriented tendency of these banks” and that the merger between Sumitomo Bank and Heiwa Sogo Bank (in October 1986) brought more stiff competition to lending. The BOJ recognized commercial banks’ lending attitude as becoming gradually aggressive.[170] Furthermore, after the elimination of the yen conversion regulations in 1984, arbitrages between yen-denominated loans of domestic branches and impact loans (the so-called *inpa* in Japanese) [171] became active. From fall 1986 onward, the level of the interest rates declined, and impact loans without a reporting requirement under window guidance grew notably.[172]

The Bank recognized that “there should be no essential differences between yen-denominated loans provided by domestic branches and impact loans” to the extent of an “effect on money supply” and that high growth of impact loans “could be problematic in terms of controlling liquidity in the future.” In this regard, from the April–June quarter of 1987 onward, the Bank called for major banks (specifically city banks, long-term credit banks and trust banks) as a part of the Bank’s claim for a prudent lending attitude to ensure a consistent growth rate of impact loans relative to that of yen-denominated loans.[173,174] (See Column 4 for the development of window guidance.)

However, wholesale prices showed a year-on-year decline and the year-on-year change in consumer prices remained almost unchanged at zero percent mainly due to the appreciation of the yen and the decline in oil prices. The Bank also recognized that “the circumstances surrounding price stability would not change significantly”[175] for prices in the near term. Against this background, the Bank assessed that the current developments on monetary and financial fronts would “be no threat against price stability”[176] and the developments would not become a hindrance to the reduction of interest rates.

Column 2. “Mayekawa Report”

With the recognition that the economic conflict between Japan and the U.S. caused by

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[169] BOJ Archives (1986j), p.6.

[170] BOJ Archives (1986j), pp.6–9

[171] The so-called impact loans here refer to foreign currency denominated loans without restrictions on use and euroyen denominated loans provided by overseas branches. Ginkokeiri mondai kenkyukai (2008), pp.355–357. Deregulations for impact loans started in 1980 by enforcement of the new foreign exchange control law.

[172] BOJ Archives (1987f), pp.1–3.

[173] BOJ Archives (1987f), pp.1–2.

[174] In this regard, Okina, Shirakawa and Shiratsuka (2001) (pp.422–425) noted that the Bank was seeking to shift to tightening from around spring 1987.

[175] BOJ Archives (1987b), p.5.

[176] BOJ Archives (1986l), p.3.

external imbalance could completely jeopardize Japan's external economic relations, Prime Minister Nakasone's government seriously acknowledged the necessity to implement policy measures for fundamental adjustments of economic structure in order to maintain the free trade system. Under this recognition, "the Advisory Group on Economic Structural Adjustment for international Harmony" organized by the request of Prime Minister Nakasone in October 1985 (chaired by former BOJ Governor Haruo Mayekawa) submitted the report (the so-called Mayekawa report) to the Prime Minister in April 1986 immediately before the Tokyo Summit.

With a purpose to "attain the goal of steadily reducing the nation's current account imbalance to one consistent with international harmony" by "setting [it] as a medium-term national policy goal," the Report stated that "an urgent need for Japan" was "to seek to transform the Japanese economic structure into one oriented toward international coordination." Specifically, the Report proposed five imperative goals as follows: (1) economic growth led by domestic demand; (2) basic transformations in the nation's trade and industrial structure; (3) the realization and stabilization of the exchange rate at an appropriate level; (4) the liberalization and internationalization of the nation's capital markets, and (5) review of the preferential tax treatment for saving.[177]

In the conclusion, the Report emphasized that "each and every Japanese should also be fully aware that Japan cannot develop unless it also contributes actively to the international community" and that "it is imperative that every effort be made for attainment of this national goal." Regarding these points, Governor Sumita "completely agreed with the conclusion and we should further strengthen our recognition."[178] In practice, the Bank supported the Report's policy direction for reducing the nation's current account imbalance by expanding domestic demand and continuing long-term efforts to reform the economic structure. In monetary policy implementation, the Bank's policy stance tended to promote domestic demand expansion and a structural adjustment process consistent with international harmonization so far as price stability was maintained.

VI. Economic Growth Led by Domestic Demand and Monetary Policy (from Spring 1987 to Spring 1989)

- After the second half of 1987, reflecting price stability as a result of the past appreciation of the yen and the effect of monetary easing and fiscal expansion

[177] The whole report can be seen at Advisory Group on Economic Structural Adjustment for International Harmony (1986).

[178] BOJ Archives (1986g), p.6.

under the Louvre Accord, Japan's economy entered a phase of strong expansion, led by increases in personal consumption and corporate fixed investment. The expansion continued with a faster pace than the Bank's preliminary anticipation.

- During the summer and fall of 1987, the Bank increasingly became cautious about excessive monetary easing, while confronting the greater upward pressure on prices with the tighter domestic conditions of supply and demand, as well as the indication of larger financial imbalances such as faster growth in money supply, more aggressive lending attitude by commercial banks, and steep rises in stock prices and land prices. Against this background, the Bank called for a "prudent lending attitude" toward commercial banks in window guidance while respecting the autonomous formulation of commercial banks' loan plans as a basic principle.

- In the aftermath of Black Monday in October 1987, the Bank strenuously tried to stabilize financial markets mainly by providing plentiful liquidity. After the markets calmed down, the Bank assessed by contrast that a sharp drop of stock prices reduced speculative bank loans and that the financial imbalances somewhat shrank. It appears that the Bank in those days considered ongoing structural changes for the economy driven by domestic demand to be elevating the potential economic growth rate, and that the Bank's recognition of an expansion of the bubble in those days was not sufficient. Regarding a concurrent prospect in the near term, the Bank considered that the further appreciation of the yen after the Black Monday would support both a calmer inflationary mind and more active fixed investment, and that both price stability and higher economic growth would thereby continue. Accordingly, the Bank continued monetary accommodation by maintaining low interest rates.

- Throughout the period from spring 1987 to early 1989, the Bank recognized that the prolonged monetary accommodation served as a contributing factor to increases in asset prices. At the same time, it appears that the Bank did not strongly recognize the necessity of monetary tightening so far as prices were stable.

- Meanwhile, in light of the progress of financial liberalization, the Bank played a leading role in the market reforms in November 1988 for smoother market operations, including a shift to an offer-bid system at interbank money markets.

A. Macroeconomic Policy Coordination and the Black Monday (from Spring 1987 to Spring 1988)

1. Overseas circumstances under macroeconomic policy coordination after the Louvre Accord (from spring to fall 1987)

In the U.S., from spring to fall 1987, the economy expanded at a faster pace and the unemployment rate declined gradually, led by a significant export increase under the past depreciation of the dollar, and recovering corporate fixed investments under an increase in production and improvement in corporate profits (Charts 7 (1) and (3)-VI). However, the nominal trade deficits of the U.S. were higher than the previous year’s level owing to the past depreciation of the dollar (Chart 8 (2)-VI). Under these circumstances, protectionist movements continued in the U.S., such as the Omnibus Trade Reform Act of 1987 with protectionist clauses, which was submitted to Congress in early 1987 and discriminative measures became effective in May 1987 regarding the semiconductor issue between the U.S. and Japan.[179]

On the price fronts, the year-on-year change in producer prices increased from negative to positive (specifically from -2.6 percent in January 1987 to +4.5 percent in August 1987 on a year-on-year basis), owing to a rebound in oil prices in early 1987 after an agreement for coordinated reduction of production at the OPEC meeting in December 1986, an effect of the past depreciation of the dollar, and a tighter balance of supply and demand under economic expansion (Chart 2 (3)-VI). The change in consumer prices also increased from +1.5 percent in January 1987 to +4.3 percent in August on a year-on-year basis (Chart 7 (2)-VI). Against this background, in late March 1987, the FRB turned to tighten market operations to prevent a higher domestic inflation in advance and to ensure exchange rate stability. In September 1987, the FRB raised its official discount rate for the first time in three years and five months (Chart 8 (1)-VI), under the initiative of new Chairman Alan Greenspan, who assumed office in August 1987.[180]

In West Germany, economic activity slowed down in the first half of 1987 due to the past appreciation of the German mark and the effect of the harsh winter in early 1987, but in summer and fall 1987 a pause in the German mark appreciation recovered exports and thereby turned to improve economic expansion. Consumer prices (the cost-of-living index) remained below the previous year level from April 1986 to March 1987, but turned to be positive on a year-on-year basis from April 1987 onward (Charts 9 (1) and (2)-VI). Under these circumstances, from February to around June 1987, the Bundesbank maintained an accommodative policy stance in market operation for lower interest rates. Then, the

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[179] BOJ (1987g), pp.6, 8, 13.

[180] BOJ (1987g), pp.8, 12.

year-on-year changes in prices turned to be positive, the economy was recovering although modestly, and the appreciation of the German mark ceased in the foreign exchange markets. In this changing circumstance, the Bundesbank changed its stance from July 1987 onward to rather tightening by raising the repo interest rate and thereby allowing increases of market interest rates, in order to prevent a greater inflationary sentiment (Chart 10 (1)-VI).[181]

2. Japan's circumstances and policy stance under macroeconomic policy coordination (from spring to fall 1987)

Japan's economy sharply recovered, led by domestic demand mainly attributable to active household consumption and fixed investments in nonmanufacturing sectors, under the effect of the eased monetary conditions and price stability with the past appreciation of the yen. In the first half of 1987, Japan's policy authorities considered that "the economy remained sluggish in an adjustment process,"[182] and promoted further expansion of domestic demand for the goal of reducing current account surplus, by means of monetary easing and fiscal expansion (larger fiscal outlay and tax reduction) consistently with the intention of the Louvre Accord. In summer 1987 and afterwards, the aggressive fiscal policy such as the Emergency Economic Measures with a fiscal measure of more than 6 trillion yen announced at the end of May 1987 become effective, and the adjustments in inventory and fixed capital stock mainly in the export-oriented manufacturing industry were becoming complete. Then, the manufacturing industry began to show an increase in production and a sharp surge in fixed investments, mainly for rationalizing production processes, developing new goods and entering new business fields. After summer 1987, the economy "entered a phase of vigorous economic expansion" and the employment conditions also tended to improve (Chart 1 (1)-VI and Chart 2 (4)-VI). Although prices were stable on the whole, in summer and fall 1987 commodity prices increased sharply, mainly in construction-related items, due to the tighter conditions of supply and demand, the higher month-on-month changes in wholesale prices, and a larger number of firms expecting higher future prices was indicated in the Tankan business survey in August 1987. In addition, land prices continued to rise mainly in the large cities, and stock markets were active (Charts 6 (1) and (2)-VI). The changes in money supply continued to grow progressively after early 1987 (as the year-on-year change of M2+CD increased from +8.2 percent in December 1986 to +11.1 percent in September 1987). Behind the scenes, a stance of bank lending by financial institutions became aggressive, and the double-digit growth of bank loans on a year-on-year

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[181] BOJ (1987g), pp.6–7, 10, 12–13, BOJ (1987c), p.53, BOJ (1987d), p.53, and BOJ (1987e), p.36.
[182] BOJ Archives (1987g), p.6.

basis accelerated further mainly due to increasing demands for so-called *zaitech* (speculative investments), for constructing buildings of offices and apartments, and for impact loans without a reporting requirement under window guidance (Charts 5 (1) and (2)-VI). Meanwhile, on the external fronts, the trade surplus on a volume basis was solidly decreasing, but the pace of decline in surpluses on a nominal dollar basis was small for both trade and current accounts. In the foreign exchange markets, the yen remained generally at a range of 150–140 to the dollar, but sometimes appreciated excessively due to a delay in rectifying trade imbalances between the U.S. and Japan (Charts 3 (1) and (2)-VI).[183]

Under these circumstances, the Bank's first priority until around May 1987 was "to strengthen coordination among major countries and thereby ensure the stability of exchange rates,"[184] and in May 1987 the Bank conducted market operations to lower short-term market interest rates for a permeating effect of monetary easing (Chart 4-VI). In face of the greater protectionist movements at Congress in the U.S., the Joint Statement on Japan-United Stats Relations after the meeting on April 30 and May 1 referred to the step "taken by the Bank of Japan to begin operations to lower short-term interest rates" as part of the statement of actions by two countries regarding policy coordination after the Louvre Accord.[185]

At the same time, the Bank became increasingly concerned about developments on the financial front, such as higher growth in money supply, aggressive lending stance by financial institutions, and rises in both stock and land prices. The Bank acknowledged that "the effects of the prolonged monetary relaxation and lower interest rates would be undeniable" for supporting these developments and also considered that the effects of financial developments upon firms' behaviors including financial institutions and future circumstances for prices "must be carefully monitored with full attention."[186] Against this backdrop as stated above, the Bank called for a "prudent lending attitude" for financial institutions (or the so-called moral suasion to suppress excessive lending) from April–June quarter of 1987 in the conduct of window guidance. Furthermore, the Bank also asked the institutions to additionally work for the consistent growth of impact loans relative to the growth of the yen-denominated loans, despite no reporting obligation for impact loans under the window guidance.[187] Furthermore, in face of the higher growth rate of money supply and rises in commodity and wholesale prices in summer 1987, the Bank came to recognize that "price movements and circumstances in the future should require

[183] BOJ (1988d), pp.1–7 and BOJ Archives (1987j), attachment pp.1–9.
[184] BOJ Archives (1987i), p.3.
[185] BOJ Archives (1987i), p.6.
[186] BOJ Archives (1987h), p.7.
[187] BOJ Archives (1987f), p.2.

increasingly close attention" and that "a more cautious policy stance with greater attention to prices is necessary."[188] In this regard, the Bank took a stance of market operations allowing seasonal increases of interest rates toward the end of September.[189] Also in the window guidance for the October–December quarter of 1987, the Bank asked for the major banks (city banks, long-term credit banks, and trust banks) to formulating their loan planning such that "the year-on-year change of the increment of bank lending should be reduced further than a previous quarter and to be a level around zero" and thereby indicated "a stance of more tightening."[190] (See Column 4 for development of window guidance.)

3. Occurrence of and escape from Black Monday (from around October 1987 to spring 1988)

On October 19, 1987, stock prices crashed in the New York market and the closing price of the S&P500 fell by 20 percent from the previous day's level. The crash affected the markets in other countries, including Tokyo, London, Paris, and Frankfurt on the following day (Chart 6 (1)-VI). Meanwhile, in the foreign exchange markets, the dollar weakened against all major currencies (Chart 3 (1)-VI and Chart 10 (2)-VI). Behind the scenes of the stock market crash, it was mainly considered that concerns about the outlook of the U.S. economy grew among the market participants amid the persistent twin deficits of the U.S. public finance and international trade. Other considerations are that the framework of policy coordination among the major countries after the Louvre Accord was sometimes undermined by press reports, such as Secretary of Treasury Baker's criticism of the rate increases in West Germany, and that the so-called program trading[191] with the purpose of mitigating the risk of price declines amplified by falling prices in the stock market.[192]

In response to the occurrence of the stock market crash known as Black Monday, the central banks in major countries supplied liquidity to markets as crisis management measures, and also expressed their intention to maintain the framework of international policy coordination. The FRB affirmed "its readiness to serve as a source of liquidity to support the economic and financial system" by issuing a short statement. Practically, the

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188 BOJ Archives (1987k), p.6.

189 Nihon Keizai Shimbun (1987b), p.18.

190 BOJ Archives (1987l), pp.1–4.

191 "Program trading" refers to the strategy calling for purchases and sales according to stock prices automatically under a prearranged program. During the crash on October 1987, transactions of selling in futures markets of stock indexes in response to falling spot equity prices were automatically executed under a prearranged program for reducing the risk of price declines. These transactions were considered to amplify falling prices, by causing an extra decline in futures prices and then bringing a further decline in spot prices in the stock market.

192 BOJ Archives (1987m), p.2. Also, see BOJ (1988d), p.7 and BIS (1988), p.91.

FRB provided liquidity through market operations and also liberalized the rules for lending government securities from its own portfolio to financial institution for mitigating a counterparty risk within transactions of good collateral felt by financial institutions. Consequently, the decline of the federal funds rate was 1 percent in two weeks (Chart 8 (1)-VI).[193] In West Germany, the Bundesbank lowered the interest rates for Lombard lending and for securities purchase and resale operations, and then reduced the official discount rate in early December (Chart 10 (1)-VI).[194] On October 20, 1987, the BOJ also released a statement by the governor that the Bank would "steadily maintain the framework for coordination under the Louvre Accord."[195] While "maintaining a cautious policy stance with careful attention to prices," the Bank provided liquidity smoothly with a stance that "full attention should be paid to unstable developments in both domestic and overseas financial markets, and that the management of operations in money markets should be flexible as necessary."[196]

The finance ministers of the U.S. and West Germany had a meeting immediately after Black Monday and they expressed the intention to maintain the framework of international coordination. Also after the monthly meeting at the BIS on November 9, 1987, Group of 10 governors released a statement bearing the signature of the chairman. The statement emphasized the importance of adopting fiscal policies for correcting external imbalances, stabilizing the foreign exchange rates and maintaining noninflationary growth. The statement also demonstrated the readiness of the central banks to support these objectives with appropriate monetary policies. On November 20, the U.S. government agreed with congressional leaders on a package to reduce the deficit, and on December 23, G-7 Finance Ministers and Central Bank Governors issued a statement reemphasizing their common interest in more stable exchange rates.[197]

In the foreign exchange markets, the dollar weakened from a level of 140 yen per dollar at the time before Black Monday to a level of 120 yen per dollar by the end of 1987, but after early 1988 the tendency of a weaker dollar turned to flattening partly due to an observed rectification of the U.S. trade account (Charts 3 (1) and (2)-VI). Then, the stock market of each country bottomed out and rebounded (Chart 6 (1)-VI). Therefore, the Bank in January 1988 assessed that the worldwide "evolution of plunging stock prices into financial panics was prevented so far and their impact on real economic activity was very

193 BOJ Archives (1987m), p.3. Also, see BIS (1988), pp.144–146.
194 BOJ (1987h), pp.85–86.
195 BOJ (1987f), p.47.
196 BOJ Archives (1987n), p.6. Also, see BOJ Archives (1988b) ,p.4.
197 MOF (2004), pp.386–387 and BOJ (1987f), p.47.

small and limited."[198]

Concurrently, Japan's economy "experienced autonomous and strong expansion led by domestic demand" on economic activity, in spite of the global plunge in stock prices and the further appreciation of the yen. Active consumption by households and investments by the non-manufacturing industry continued, and fixed investments of the manufacturing industry expanded mainly due to an increase in production and expansion of corporate profits (Chart 1 (1)-VI). On the price front, the Bank assessed that "the upward impetus of wholesale prices weakened more significantly than before"[199] and that "the price stability would remain"[200] for a while, mainly due to the past appreciation of the yen, increase in less expensive imports of products and decline in oil prices (Charts 2 (1) and (2)-VI). On the financial front, the Bank maintained its cautious attitude toward a higher growth rate of money.[201] At the same time, regarding the contents of bank loans behind the money growth the Bank's assessment was that the lower stock prices reduced speculative bank loans, such as speculative lending for financial investments and real estate-related loans, and that loan demand for real economic activity was increasing such as fixed investments and working capital for small and medium-sized firms, under the permeation of economic expansion, including that in regional areas. In this regard, the Bank acknowledged that the stock price declines worked toward a mitigation of financial imbalances (Charts 5 (1) and (2)-VI). [202]

B. The Robust Economic Growth with Stable Prices and the Consequent Maintenance of Low Interest Rates (from Spring 1988 to Spring 1989)

1. Economic conditions of major countries (from spring 1988 to spring 1989)

In the aftermath of Black Monday, the turbulence in financial markets and foreign exchange markets worldwide was contained due the prompt policy responses by the policy authorities of major countries to avert a crisis. The deflationary impact of market turbulence on economic activity "was relatively mild in the major countries" and their economies expanded at a solid pace in 1988.[203]

In the U.S., exports remained buoyant under the weakened dollar after Black Monday and the improving competitiveness of U.S. firms, and then full-fledged materialization of fixed investments followed. The employment conditions also improved, as evidenced by a decline of the unemployment rate in mid-1988 to the lower part of the 5 percent range, the

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198 BOJ Archives (1988b), pp.4, 7.
199 BOJ Archives (1987n), p.5.
200 BOJ Archives (1988b), p.6.
201 BOJ Archives (1987n), p.5.
202 BOJ Archives (1987o), attachment p.1 and BOJ Archives (1988a), p.2.
203 BOJ Archives (1988c), p.1. Also, see BOJ (1988h), p.5.

lowest since 1974. With an increase in household income, personal consumption also strengthened and the U.S. economy achieved strong growth of around 4 percent in 1988.[204]

On the price front, inflationary expectations intensified between spring and summer partly due to the dollar depreciation after Black Monday, rapid tightening in goods and labor markets under a robust economy, and a surge in commodity prices under a drought in the Mid-West (Charts 7 (1), (2), and (3)-VI). Furthermore, oil prices rebounded in late 1988 following the OPEC conference in November 1988, where an agreement was reached on production limitation and price targeting with the re-entry of Iraq (Chart 2 (3)-VI).[205] Meanwhile, the U.S. external imbalance improved considerably on a nominal basis as well as on a real basis, although the pace of improvement somewhat slowed after mid-1988 reflecting larger imports parallel with continued economic expansion.[206] In these circumstances, the FRB was concerned about inflation by tighter conditions in goods and labor markets. In spring 1988 the FRB gradually switched its policy stance from accommodative to tightening and then raised the official discount rate in August 1988 and February 1989 (Chart 8 (1)-VI).[207]

As for Europe, corporate fixed investments were stimulated on the whole against a background of increases in foreign direct investment in Europe from countries both inside and outside the region in light of a schedule toward completion of market integration by the end of 1992.[208] In West Germany, personal consumption was significantly affected by a substantial income tax cut at the top of 1988, and exports recovered due to the weaker German mark from spring 1988 onward. Under such circumstance, corporate fixed investment was stimulated and thereby added more buoyancy to the economy after mid-1988 (Chart 9 (1)-VI).[209] The Bundesbank assessed that inflationary expectations were intensified under an economic expansion and the depreciation of the German mark reflecting the rectification of the U.S. current account deficit, and then raised the official discount rate in July 1988, August 1988 and January 1989 (Chart 10 (1)-VI).[210]

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[204] BOJ (1988h), p.5.
[205] BOJ (1988h), pp.10–11.
[206] BOJ (1988h), pp.12–13.
[207] BOJ (1988h), p.11, BOJ Archives (1988g), pp.1–2, BOJ (1989h), p.13, and BOJ Archives (1989c), p.2.
[208] It was pointed out that movements toward market integration in Europe were activated further after effectuation of "Single European Act" in July 1987. See BOJ (1989a), pp.24–25, 35.
[209] BOJ (1988h), p.6.
[210] BOJ Archives (1988g), p.2 and BOJ Archives (1989b), p.4.

2. Coexistence of robust economic growth and stable prices (from spring 1988 to spring 1989)

In Japan, responses to Black Monday subdued by spring 1988, and Japan's economy maintained active consumption outlays and a strong uptrend of corporate fixed investments in both manufacturing and non-manufacturing industries. The Bank assessed that the endogenous expansion of domestic demand drove "the economic activity with a stronger uptrend" (Chart 1 (1) and (3)-VI). The Bank also considered that the pace of economic expansion was "greater than the expectation" in the past.[211]

As for the rectification of external imbalances, a declining trend of trade surplus in dollar terms as well as in volume gradually became obvious, under a robust economic expansion led by domestic demand (Chart 3 (2)-VI). Meanwhile, the year-on-year change in wholesale prices remained negative and the change in consumer prices remained at 1 percent or less on a year-on-year basis (Charts 2 (1) and (2)-VI). Considering the effect for more stable prices by a stronger yen and subdued oil prices (Chart 2 (3)-VI) along with the contribution of past fixed investment for expanding supply capacity and enhancing productivity, the Bank assessed that "price stability would not be jeopardized" in the near future.[212] In this regard, the Bank in 1988 recognized that "Japan's economy achieved a favorable balance of the vigorous increase in domestic demand under price stability and the resulting rectification of external imbalances and also showed favorable economic performance relative to other economies."[213]

On the monetary and financial fronts, the year-on-year change in money supply (M2+CD) once reached the 12 percent level from late 1987 to early 1988, and then gradually declined throughout 1988 to a level of 10 percent at the end of 1988. The year-on-year change in bank loans remained at a double-digit level. However, the growth in bank loans leveled off and declined during 1988, partly owing to the decline of loan demand for speculative financial or real estate-related investments after Black Monday and the shift by large firms' funding through securities issuance instead of bank borrowing under favorable market conditions (Charts 5 (1) and (2)-VI). On the other hand, under a robust economic expansion led by domestic demand, bank lending for small and medium-sized firms was buoyant owing to demand for fixed investment in domestic demand-oriented industries. Their business projects included distribution centers, new branches by retailers, the construction of office buildings and the development of resort areas in the non-manufacturing industry, as well as investment in electrical machinery, precision

[211] BOJ Archives (1988c), p.4.
[212] BOJ Archives (1988c), p.5.
[213] BOJ Archives (1988c), p.7. Also, see BOJ Archives (1988f), p.7 and BOJ (1988g), pp.26–27.

instruments, and automobile subcontractors in the manufacturing industry. Bank lending also increased in personal loans for constructing a rental apartment or loans with no use restrictions.[214] On the geographical front, due to the permeation of robust economic expansion across regional areas, demand for bank loans widened from city to regional areas after late 1987. In summer 1988 the year-on-year change in loans provided by regional banks (regional banks and *sogo* banks) tended to exceed that in loans provided by major banks (city banks, long-term credit banks and trust banks).[215] The Bank cautiously acknowledged the continuous high growth rates of money supply and bank loans as well as the excessive easing of firms' financial conditions. Meanwhile, regarding borrowers' demand, the Bank recognized that demand for speculative real-estate-related or financial investments was declining whereas demand for real economic activity under economic expansion was increasing.[216]

Under these circumstances, the Bank took a tighter policy stance in market operations and window guidance, but did not tighten monetary policy completely. In the short-term money markets during summer 1988, stronger demand for fund-raising under the robust economic activity along with higher overseas interest rates brought about higher interest rates in open markets, such as markets for euroyen deposits, CDs and repurchase bonds (*gensaki*). The interest rate differential between the open markets and the interbank markets, such as bill discount markets, widened considerably (Chart 4-VI). The Bank "assessed that the rising interest rates in bill discount markets due to changes in market conditions were reflecting actual and autonomous market developments," and then "accepted" these developments to some extent. At the same time, the Bank recognized that "a growing excessive expectation for higher interest rates across financial markets was not favorable." In the money market operation, the Bank conducted "flexible operations" in the markets for bill discount, CDs and repurchase bonds, and thereby suppressed a possible sharp rise in market interest rates consequently.[217]

In window guidance, the Bank continued to request commercial banks to carry out "the maintenance of a prudent lending attitude." For the October–December quarter of 1988, the Bank intended to "maintain the request of prudent lending attitude with the nuance of the similar or slightly stronger magnitude relative to the July–September quarter."[218] At the same time, the Bank recognized that there would be "obviously limited room" in calling for "a more restrictive lending stance than ever before under the current basic principle"

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214 BOJ Archives (1988d), attachment pp.3–7 and BOJ Archives (1988h) attachment pp.6–7.
215 BOJ Archives (1989a), p.5.
216 BOJ Archives (1988g), p.6, BOJ Archives (1988h), attachment p.8, and BOJ (1988l), pp.1–2.
217 BOJ Archives (1988g), pp.6–7.
218 BOJ Archives (1988h), p.2.

without a change of policy stance for full-fledged tightening.[219]

Among the aforementioned economic recovery becoming gradually clearer from spring 1987 onward along with the conspicuous signs of high money growth and rising asset prices, the Bank gradually took a cautious stance in monetary policy management. Regarding the stance in 1988 after Black Monday, the Bank acknowledged that it "should continue to call for restrictive loan planning" for commercial banks through window guidance.[220]

However, considering the aforementioned assessment of economic and financial conditions as well as the policy stance reflected on money market operations, the Bank appears to have assessed also that the desirability of monetary tightening slightly diminished after Black Monday as well. It also appears that the Bank intended to "have a direction of maintaining the current stance basically in the near term" without a turnaround to complete tightening.[221,222]

The wider interest rate differential between the open and interbank markets caused a shift of transaction to open markets with higher interest rates, and the outstanding amount of the bill market as a primary market for the Bank's monetary operations declined sharply. Partly triggered by this incident, the Bank implemented the reform of the interbank money market in November 1988 for conducting market operations more smoothly (also see Column 3 for a review of short-term money market operations).[223]

3. The Bank's recognition about changes in the economic structure

Prior to the Plaza Accord, the Bank recognized that the most important and immediate task for Japan was "a correction of external imbalances along with the continuous and stable growth for avoiding a surge of protectionist moves and thereby preventing a collapse of the free trade regime which was the most beneficial for Japan."[224] The Bank also believed that "the nature of the Japanese economy that exports can increase easily while imports hardly increase" was formed because Japan's economy "adjusted itself to the two oil crises, when

[219] BOJ Archives (1988i), p.6.

[220] BOJ Archives (1988d), p.2.

[221] BOJ Archives (1988k), p.9.

[222] In this regard, Okina, Shirakawa and Shiratsuka (2001, p.423) stated developments in window guidance from the April–June quarter of 1987 onward, as follows: "In the situation where the official discount rate was unchanged, the BOJ could not conduct effective moral suasion on financial institutions to suppress lending, and even if it did lending would probably not have declined. On the other hand, if the BOJ did not effect strong moral suasion, there was a risk that the market would think the BOJ had no concern over the aggressive lending attitude of commercial banks. Under such circumstances, although the BOJ gradually strengthened window guidance with respect to the lending of commercial banks, more decisive policy action had to wait until the official discount rate was raised."

[223] Kinyu Zaisei Jijo (1988b), pp.18–19.

[224] BOJ (1985a), p.24 in Japanese original. Also see BOJ (1985b), pp.2, 18.

efforts were made to strengthen export competitiveness and to convert the economic structure to promote resource conservation."[225] Accordingly, the Bank also considered that the "promotion of yen appreciation seemed basically to be the only macroeconomic measure for correcting the external imbalance as well as pursuing a more balanced and stable growth." In this regard, the Bank acknowledged that yen appreciation had the short-term "effect of depressing exports and stimulating imports" as well as the "effect of stimulating personal consumption" through lower import prices (or better terms-of-trade conditions). The Bank also believed in the longer term that a higher yen had "the effect of absorbing resources for investments in domestic demand" by improving the relative profitability of economic activity related to the domestic sector over that relative to the external sector, and therefore a higher yen "would enable a more balanced growth on a medium- and long-term basis."[226]

After the Plaza Accord, the Bank still acknowledged that "rectification of the external imbalance remained the major policy mandate for Japan's economic growth in harmony with the growth of world economy." For this task, the Bank recognized that "the persistent appreciation of the yen as an undertone could be the fulcrum for solid transformation of Japan's industrial structure" and that "the shift of resources toward technology-intensive industries or industries aiming at domestic demand, as well as the promotion of foreign direct investments or horizontal trade through larger product imports" should be materialized in the long term.[227,228]

In 1988, the Bank believed that the above-mentioned long-standing concerns were being resolved. Specifically, the Bank considered that "increasing imports caused by the yen's appreciation [would] continue to play a role in stabilizing prices"[229] through competition between domestic and imported products, as "the safety valve"[230] effect of imports would remain functioning in the near term. Under such circumstances, the Bank recognized that "the terms-of-trade gains and stable prices stimulated domestic demand through increases in the real income of firms and households, which, in turn, contributed to correcting external imbalances." The Bank acknowledged the surfacing "terms-of-trade gains accompanying the yen's appreciation" in short. Furthermore, from the medium- and long-term perspectives, the Bank considered that "in these circumstances, a number of structural changes started to

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225 BOJ (1985a), p.2 in English version.

226 BOJ (1985a), p.25 in Japanese original. Also see BOJ (1985b), pp.18–19.

227 BOJ (1986d), p.17. Also see BOJ (1986f), pp.7–8.

228 In this regard, Okina, Shirakawa and Shiratsuka (2001, p.421) stated that monetary policy was influenced by the economic policy agenda of the time that the current account surplus should be reduced by expanding domestic demand.

229 BOJ (1988c), p.2.

230 BOJ (1988c), pp.2, 14 and BOJ (1989b), p.2.

appear, e.g., a rapid increase in the import of manufactures and a shift in corporate marketing strategy from being export- to domestic-market oriented" and that "all this not only tended to reduce external payment imbalances, but also contributed to price stability through promoting competition in the domestic market." In this regard, the Bank considered that "in short, a favorable nexus emerged in the economy in the sense that economic growth, price stability and external adjustment augmented each other."[231]

Under such circumstances, the Bank recognized that "the expansion of overseas direct investment, the substitution of imported semi-finished goods for domestic supplies, and the penetration of imported final goods in domestic markets" started to reduce the level of structurally persistent trade surplus. The Bank also considered that under these circumstances "the reallocation of resources is also under way with capital and labor shifting towards production aimed at domestic sales, which, in turn, increases supply potential as well as corporate and household income, and hence domestic demand," and eventually "a dynamic process involving demand, supply and income" was emerging.[232]

The Bank particularly recognized corporate fixed investments as key to supporting the high growth under stable prices from the aspects of creating new demand, enhancing supply capacity and improving productivity, and then gradually became confident in their sustainability. Specifically, the Bank assessed that investments of manufacturing industries such as for developing new products, rationalizing, increasing new production capacity and expanding the domestic network "are expected to materialize gradually towards the end of the year [1988]." Accordingly, the Bank believed that "the increase in supply capacity was a precondition for realizing sustained growth, and it would also reinforce price stability."[233] The Bank also recognized for non-manufacturing industries that "vigorous corporate demand for office automation and strong consumption induced active investment especially by the leasing and distribution industries" and that "in light of the high return on capital and potential demand related to resort and urban development, fixed investment in the non-manufacturing sector will continue to increase for some time."[234]

Despite the limited availability of documents, it appears to imply that the Bank concurrently assessed the robust economic growth under price stability as an indication of the higher potential growth rate of Japan's economy. Not only the Bank but also the wider public shared this bullish expectation of Japan's economy. For example, *Economic Survey of Japan (1988-1989)* by Japan's Economic Planning Agency in August 1989 reported that

[231] BOJ (1988f), pp.7–8.
[232] BOJ (1988b), p.1.
[233] BOJ (1988f), p.11.
[234] BOJ (1988f), p.12.

the characteristics such as "sophistication of both industry and daily life," greater "globalization," and an "accumulation of assets" (such as financial assets and rising asset prices) led to the "Japanese economy … as having entered a new phase in its history" and thereby discussed the development of the "economy at the new phase." The report also saw "advances toward information intensification, high-technology application and manufacture of higher added value products" and considered that "this new sophistication has set the stage for the powerful expansion of domestic demand." In this regard, it appears that bullish expectations for higher productivity were widely shared.[235]

4. Differences in the situation between major overseas countries and Japan

While other central banks in major countries, including the FRB and the Bundesbank, changed their policy stance and raised the interest rates in 1988, the BOJ maintained the official discount rate at 2.5 percent until May 1989. Regarding such difference in actions, the Bank considered that "the recent policy responses in major overseas countries for raising the interest rates shared common characteristics in growing concerns for higher inflation under economic expansion."[236] At the same time, the Bank assessed that "the relatively large depreciation of home currencies and the concerns on domestic prices toward acceleration occurred in West Germany and the U.K. but did not occur in Japan" by pointing out Japan's differences from West Germany and the U.K. Thus the Bank acknowledged that Japan's current economic condition should differ from these countries in this regard.[237] The Bank also recognized that in the background were the solid aspects of real economic activity such as "strong economic fundamentals" and "higher productivity" as well as the effect of the safety valve of imports under the past appreciation of the yen.[238]

Concurrently, opinions of "Japan as the anchor" were prevalent, such that from the perspective of international policy coordination "for propelling the world economy similarly to the prosperous years of the U.K. and the U.S., Japan should maintain low interest rates and monetary accommodation as long as possible."[239] Regarding such

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[235] EPA (1989), p.2. In this regard, MOF (2003a, p.55) assessed that a critical opinion for containing the surge in asset prices supported under people's excessively optimistic view could have been considered "with a knowledge of hindsight, but the experience and knowledge in that time was not enough to make a decision" for taking such policy. Ishii (2011, p.137) also considered that surges in stock prices and land price in the buoyant economic expansion "were later regarded as bubble but that recognition was not general before 1989."

[236] BOJ Archives (1988g), p.2.

[237] BOJ Archives (1988e), p.6.

[238] BOJ Archives (1988e), p.6.

[239] Nihon Keizai Shimbun (1988a), p.3. Although the article implied that the view was increasingly supported in the Bank, the authors cannot find any primary sources ratifying this from the Bank's archived documents. For arguments about "Japan as an anchor for low interest rates in the global

opinions, the Bank considered that, in order to sustain stable prices for the long term, an assurance of flexible monetary policy was necessary. The Bank also considered that "in Japan's monetary policy implementation, if circumstances such as a situation in foreign exchange markets or conditions surrounding prices were to have changed significantly and the fundamental policy stance were to have altered, proper measures would be taken without hesitation."[240] The Bank also considered that "preemptive effort for containing inflation would be necessary for avoiding sharp tightening of interest rates across every country and such effort must be truly consistent with a spirit of international coordination."[241] In this regard, the Bank negatively acknowledged that "an opinion of the so-called Japan as the anchor by taking the unchanged low interest rates as the best policy would be obviously myopic in that sense," and dismissed the opinion.[242]

Column 3. Financial Deregulation and Money Market Reform

Japan's financial deregulation gradually progressed after the late 1970s, in terms of both the interest rate deregulations and the scope of business and international financial transactions, such as commencement of Certificates of Deposits as free interest instruments (in 1979), deregulation of foreign currency deposits for residents and impact loans due to an introduction of the new Foreign Exchange Control Law (in 1980), and over-the-counter sales of public bonds by banks (in 1983). The pace of deregulation accelerated in the second half of the 1980s after the announcement of the "Japan-U.S. Yen-Dollar Committee Report" in May 1984, containing a drastic schedule for further financial deregulation. Specifically, the yen-swap limit was removed in June 1984, interest rates on large time deposits were gradually liberalized, and the use of the "spread method" where loan rates were determined by adding a spread to short-term market rates increased. These raised the proportion of market interest rates in both assets and liabilities of financial institutions. For firms' funding, due to financial deregulation and higher stock prices under low interest rates, both equity financing and funding by issuance of other securities such as Commercial Paper permitted in November increased, mainly by large firms (Charts 11 (1), (2) and (3)).[243]

During the first half of the 1980s, the Bank acknowledged the necessity of reform in monetary policy implementation due to the progress in financial deregulation. For example, during 1984 the Bank recognized that the most important issue concerning financial

market," see Tanaka (1989), pp.207–208 and Shukan Toyo Keizai (1989), pp.26–34.

240 BOJ Archives (1988g), p.8.

241 BOJ Archives (1988g), p.7.

242 BOJ Archives (1988k), p.10.

243 Morita and Hara (1988), pp.381–383, BOJ (1988e), pp.1–2, 14–17, and BOJ (1989f), pp.1–2, 15–24, 49–53.

liberalization was “how to secure the effectiveness of monetary policy,” and that the Bank had to “make use of the functions of interest rate during ongoing liberalization.” The Bank also recognized that “the role of interest rates should be increasingly important in monetary policy implementation, considering further deregulation for interest rates including deposit rates, integration of both domestic financial markets and euroyen financial market and increased international financial transactions.”[244]

Meanwhile, the Bank also acknowledged that “there existed the various practices and tacit understanding as the long-lasting common knowledge among market participants in Japan’s financial markets and they were sometimes employed as a precondition for monetary policy implementation.” The Bank was concerned about the possibility of causing difficulties by radical deregulation, considering that “the existing practices being obsolete would not necessarily mean to quickly initiate a new alternative framework or practice that enhances effects of monetary policy implementation.” The Bank tried to seek a gradual and orderly progress of financial deregulation consistent with effective implementation of monetary policy.[245]

In the middle of the 1980s, the Bank recognized that “with the progress of financial liberalization and internationalization as well as greater linkage among various market interest rates, there has been active interest arbitrage among different financial markets both within Japan and between Japanese and overseas financial markets.” In addition, the Bank assessed that “the effective use of freely-determined market interest rates has become an increasingly important tool of monetary policy management,” and that “liberalization and internationalization have imposed new constraints on Japanese monetary policy, thereby calling for new devices and techniques in the conduct of monetary policy.”[246]

As Japan’s economic activity strengthened during the second half in 1987, the interest rates in open markets such as euroyen and CD rose more rapidly (the rate of euroyen 3M monthly average rising from 3.96% in June 1987 to 4.87% in October), relative to a moderate increase in the bill rate (monthly average rising from 3.64% in June 1987 to 3.91% in October). The interest rates in open markets declined once after the occurrence of Black Monday, but after buoyancy in economic activity was more acknowledged, the rates tended to rise again and widen the interest rate differential between the open markets and the bill markets (Chart 4-VI). This difference induced a shift of funds from the bill markets to the open markets and thereby the sharp decline in the outstanding amount of the bill

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[244] BOJ Archives (1984d), p.6.
[245] BOJ Archives (1984e), p.7.
[246] BOJ (1986f), p.5.

market where monetary adjustment was mainly conducted by the Bank.[247]

These circumstances made the Bank recognize the necessity of reforming management in interbank money markets including bill markets. In November 1988, the practices in the money market were reviewed on the Bank's initiative, for the purpose of "a further induction of active and smooth arbitrage between interest rates among markets and a smoother conduct of money market adjustment." Specifically, (1) the Bank started short-term operations (less than one month) using bills as instruments to reinforce the flexibility of monetary adjustment tools; (2) the Bank asked market participants to discuss measures to increase both transactions with a short term (less than one month) in bill discount markets and transactions in uncollateralized call money markets with terms of more than one month.[248] In addition, (3) the quotation system where the *kehaichi* rates were quoted every morning by the call loan dealers conjecturing the Bank's intention was abolished for transactions with terms of more than one week, and a competitive offer-bid system was then adopted, where rates were formed through a market mechanism between bids by fundraisers and offers by fund investors for these transactions.[249] After the review of these market practices, restrictions of short term money markets were largely reduced, and interest rates were formed through market conditions smoothly both in name and in reality.

Meanwhile, in January 1989, the new short-term prime lending rates linking to market rates instead of the official discount rate were introduced by major banks, and then the new prime rates were adopted steadily for existing loans. Then regional banks also started to adopt the new prime lending rates.[250]

VII. Monetary Tightening and a Tight Monetary Policy Retained (from Spring 1989 to Summer 1991)

- Under eased monetary conditions maintained during the second half of the 1980s, Japan's economy continued to expand mainly led by private domestic demand, and adjustment in current account imbalance steadily progressed. Among a gradual rectification of macroeconomic external imbalance, issues of economic friction

247 Kinyu Zaisei Jijo (1988a) and Kinyu Zaisei Jijo (1988b), p.19.

248 BOJ Archives (1988j), pp.1–2 and the press release attached to the document.

249 See Kinyu Zaisei Jijo (1988b), p.21 and Nihon Keizai Shimbun (1988b), p.1. Regarding (3) the change from a quoted system to an offer-bid system, the money market participants such as dealers and banks were in charge of implementation. Although we do not find official documents by the Bank promoting the change, we suspect that the change should be consistent with the Bank's intention considering market practices at that time.

250 BOJ Archives (1989d), p.7 and BOJ Archives (1989h), pp.6–7.

between Japan and the U.S. shifted toward structural factors such as structural impediments in certain sectors and accessibility to markets. At the same time, mainly due to the progress in current account adjustment and the monetary tightening in the U.S. ahead of that in Japan, the yen ceased to appreciate and started to depreciate from late 1989 to mid-1990.

- Although inflation in the near term did not rapidly accelerate, the Bank considered that inflationary pressure started to be elevated, reflecting an increase in labor cost due to a tightened labor market on the domestic front and yen appreciation on the international front. The Bank also considered that an increase in asset prices might raise inflationary sentiment. The Bank turned its policy stance and raised the official discount rate five times between May 1989 and August 1990 in order to prevent inflationary sentiments from arising.

- Japan's economic conditions remained strong amid the sequence of tightening, and land prices continued to rise. Therefore, the Bank assessed that a cautious consideration for rising asset prices remained necessary.

- In November 1990 and afterwards, the growth of money supply slowed down rapidly due to the effect of interest rate increases to date and a more cautious attitude in extending credit by financial institutions, and then in summer 1991 the deceleration in economic expansion was gradually becoming clear. Meanwhile, the Bank maintained its tightening of monetary policy until June 1991, emphasizing the risk of recurrent inflation and assessing that that upward pressure on prices remained strong against a background of tightness in product and labor markets. Then, in July 1991 the Bank turned its policy stance and lowered the official discount rate, on the assessment that the upsurge of inflationary pressure weakened.

- The Bank gradually strengthened recognition that the framework for window guidance, where the Bank ex-ante adjusted loan plans submitted from each commercial bank in consideration of the rivalry and equality among the banks, was getting out of date as financial deregulation progressed. However, from 1989 to mid-1991, the Bank tightened the guidance for commercial banks. Specifically, the Bank induced commercial banks to provide smaller loans than those in the same period in the previous year. Then from July 1991 onward the Bank abolished the framework, considering that the growth of bank lending was expected to be moderate even if the loan plan of each bank was fully left to its discretion.

A. Shift to Monetary Tightening (from Spring 1989 to Summer 1990)

1. Economic conditions in major overseas economies (from spring 1989 to summer 1990)

In the U.S., exports continued to increase reflecting economic expansion in Japan and Europe as major trading partners, but in 1989 and afterwards domestic demand such as household consumption started to slow down due to penetration of tightening by the FRB. The overall pace of the U.S. economic expansion decelerated.[251] At the same time, inflationary pressure remained strong mainly due to higher growth reflecting tight labor markets, such as a low unemployment rate in the lower part of the 5 percent range from fall 1988 to mid-1990 in addition to rising oil prices around early 1990 after bottoming out in fall 1988 with stronger world demand (Charts 7 (1), (2) and (3)-VII).[252] The FRB raised the official discount rate in August 1988 and February 1989 to 7 percent. From spring 1989 the FRB lowered the target for the FF rate gradually, but the level of the official discount rate was maintained until December 1990 (Chart 8 (1)-VII).

Meanwhile, economic friction between Japan and the U.S. were persistent among micro-level sectors. The 1988 Omnibus Trade and Competitiveness Act, enacted in August 1988, contained the Super 301 provision articulating both an identification of an unfair trading partner by the Office of the United States Trade Representative (USTR) and a sanction for that trading partner in case of trade impediments left unchanged by a deadline.[253] In May 1989, Japan was identified as an unfair trading partner under the Super 301 provision of the Omnibus Trade Act.[254] At the same time, the U.S. trade deficit and current account deficit was oscillating but on a downtrend from fall 1987 (Chart 8 (2)-VI and VII). As a rectification of the macroeconomic external imbalance gradually progressed around 1989, issues of economic friction between Japan and the U.S. shifted toward structural factors such as structural impediments in certain sectors and accessibility to markets, such as those related to semiconductors, land policy and distribution networks in retail sales.[255]

In West Germany, the pace of economic growth remained high due to intra-European exports, fixed investment and consumption, with a background of continued developments

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[251] BOJ (1989h), pp.4–5.
[252] BIS (1990), pp.23–33.
[253] Miyazato (1989), pp.110–125.
[254] Mitsuhashi and Uchida (1994), pp.234–235.
[255] MOF (2004), p.392.

for market integration of the European Community by 1992, democratic transformation in Eastern Europe from spring 1989, progress in reunification of East and West Germany, and an income tax cut in early 1990.[256] The unemployment rate, already on a downtrend after mid-1988, continued to decline in 1989 and 1990. Due to these tight conditions in product and labor markets, inflationary pressure remained high and the year-on-year change in consumer prices remained around 3 percent (Charts 9 (1), (2) and (3)-VII). In addition, the adoption of a conversion rate which over-evaluated the currency of former East Germany upon the monetary unification of Germany in July 1990 was conjectured to strengthen inflationary pressure further.[257] Under these circumstances, the Bundesbank, which tightened monetary policy twice in summer 1988, again raised the official discount rate in January, April, June and October 1989 to 6 percent, and then kept the rate unchanged in 1990 (Chart 10 (1) -VI and VII).[258]

In the foreign exchange markets, the dollar appreciated against the yen from late 1988 to spring 1990, due to an oscillating downtrend in the U.S. trade deficit and current account deficit, tightening in the U.S. ahead of that in Japan, and the Tiananmen Square incident in June 1989, which was recognized as a geopolitical risk factor for Japan (Charts 3 (1)-VII). Meanwhile, the German mark tended to appreciate against the dollar until early 1991 due to economic growth and greater tightening in West Germany relative to that in the U.S. (Chart 10 (2) -VII).[259]

2. Economic conditions in Japan (from spring 1989 to late 1990)

Japan's economy continued to expand led by robust domestic demand. Although a deceleration in the U.S. economy and a steady increase of overseas production by Japanese manufacturers contributed negatively, corporate fixed investment expanded strongly and personal consumption remained robust under sustained price stability as well as favorable conditions in employment and income (Chart 1 (1)-VII). Regarding factors behind the robustness of corporate fixed investments, the Bank pointed out high capacity utilization, high corporate profits and firms' vigorous efforts to adjust medium- to long-term strategy thereby increasing R&D investment and promoting industrial restructuring with new businesses. Furthermore, the adjustment in current account imbalance progressed steadily, due to structural changes such as a shift in demand from domestic products to imported products and an export-substitution effect of increased overseas production by Japanese

[256] BOJ (1989h), pp.5–6 and BOJ (1990f), pp.4–6.
[257] BOJ (1989h), p.10 and BOJ (1990f), pp.19–20.
[258] BOJ (1989h), p.14.
[259] BIS (1990), pp.183–190.

manufacturers, along with the cyclical aspect of economic conditions with strong domestic demand in Japan and slowing economic expansion overseas (Chart 3 (2)-VI and VII).[260]

On the price front, although both wholesale prices and consumer prices remained generally stable in the near term, the Bank assessed that upward pressure on prices was mounting gradually around spring 1989 (Charts 2 (1), (2), (4)-VII), considering the yen's depreciation and oil price rises after late 1988 (Charts 3 (1) and 2 (3)-VI and VII) as well as the gradual increase in service prices with a gradual upturn in labor cost under tighter conditions in the labor market.[261]

On the monetary and financial front, stock prices rose sharply in late 1989. Also, under the economic expansion and higher land prices permeating across Japan (Chart 6 (1), (2)-VII), bank lending continued double digit growth on a year-on-year basis around summer 1990 mainly due to the development of the resort industry, redevelopment of cities, and development of industrial estates. Money supply also maintained a growth rate of around 10 percent over the previous year (Chart 5 (1), (2)-VII).[262] Bank lending by the regional banks in particular grew sharply in summer 1989 and afterwards due to their use of impact loans.[263] The BOJ displayed more serious concern about the asset price increases by using strong words of "asset price inflation," with a recognition that "the excessive increase in asset prices would create larger social inequality in distribution of income or assets, and cause other large detrimental impacts such as pressure on general prices, growing instability in economic and financial conditions and temptation of banks for reckless lending behavior.[264]

3. Monetary policy response (from spring 1989 to late 1989)

In late March 1989, the Bank recognized that "it becomes increasingly desirable to request commercial banks for further restraint in their lending plan given tighter economic conditions for upward pressures on prices" in the window guidance for the April–June quarter of 1989. However, the Bank also assessed that "it would not be appropriate for the Bank to actively and quantitatively tighten commercial bank lending at this time prior to any change in the stance of interest rate policy" such as a change in the official discount rate,

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260 BOJ (1990d), pp.1–3.

261 BOJ Archives (1989f), pp.6–9 and BOJ (1989c) pp.8–9. It also should be noted that the Bank started to compose the Corporate Service Price Index (CSPI) with a recognition of necessity in grasping developments of prices including service prices more comprehensively, and started to release the index in 1991 and afterwards. See Nihon Keizai Shimbun (1989a) and Nihon Keizai Shimbun (1991a).

262 BOJ Archives (1989e), p.4.

263 BOJ Archives (1989l), p.3.

264 BOJ Archives (1989m), pp.1,5–6.

in light of “consistency with the stance of overall monetary policy implementation” including the official discount rate.[265]

Meanwhile, further progress in financial deregulation and the money market reform helped market interest rates to reflect changes in economic conditions more rapidly and directly. From spring 1989 onward, sustained economic expansion and rising pressure on prices heightened further anticipation for higher interest rates, and caused an uptrend in both short- and long-term market interest rates (Chart 4-VII).[266]

The Bank considered that as the monetary condition eased over the years, the uptrend in market interest rates reflected tighter conditions in product and labor markets, the increase in wages, and inflationary pressure on prices from the yen’s depreciation and rise in oil prices. Accordingly, the Bank decided to raise the official discount rate by 0.75 percentage points to 3.25 in May 1989.[267] After this action, the Bank successively raised the official discount rate by 0.5 points to 3.75 percent in October 1989 and by 0.5 points to 4.25 percent in December 1989, with a recognition of strong and enhanced upward pressure on prices due to tighter market conditions in general and higher import costs.[268]

Meanwhile, the year-on-year changes of both consumer prices and wholesale prices around this time still moderately remained at around the 3 percent level including the effect of 3 percent of the consumption tax introduced in April 1989. The Bank regarded these policy actions as “precautionary measures” in a sense that “inflationary expectation should be contained in advance for assuring price stability in the future” and that actions should be necessary at an early stage.[269]

On the decisions of rate raises, the Bank acknowledged the increase in market interest rates reflecting changes in economic conditions more rapidly and directly by financial deregulation and the money market reform, and emphasized that “greater consideration for developments in market interest rates” enabled the Bank to act in a timely manner.[270]

Regarding window guidance, the Bank assessed that “further decline in lending growth by commercial banks was necessary” in light of the rate rise in May 1989, and aimed to request the major banks to contain their loans with respect to the increased lending amount on a year-to-year basis from the level of “growth at a lower half of single digit” to the level of “change basically at a negative single digit” in providing guidance for the

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[265] BOJ Archives (1989d), p.2.
[266] BOJ Archives (1989g), pp.2–3.
[267] BOJ (1989d).
[268] BOJ (1989g), BOJ Archive (1989k), pp.1–3, BOJ (1989j), and BOJ Archive (1989o), pp.2–3.
[269] BOJ Archive (1989k) Q&A#1 at exhibit. Also, see BOJ Archive (1989o), p.5.
[270] BOJ Archive (1989m), pp.1–3.

July–September quarter of 1989.[271] Then, among circumstances where "no change was observed in strong demand for bank loans in spite of increase in market interest rates and lending rates," the Bank took a direction for the October–December quarter of 1989 to "call for more restraint in bank loan plans" than in the previous quarter. The Bank maintained the same direction for the January–March quarter of 1990. The major banks formulated their loan plans with more discipline, consistent with the Bank's intention.[272] The Bank also called for restraint in bank lending against the regional banks, but reconciliation among them was difficult to achieve. Strong demand for bank loans was seen in their regional areas. The regional banks' recognition that "the business opportunity should not be missed" derived their "excessively aggressive lending attitude" and resulted in a continuing higher growth rate of their loans relative to those provided by the major banks (Chart 5 (1)-VII).[273]

On the Bank's rate raise in December 1989, a newspaper article[274] reported a possible rate raise before the official release, and other articles reported that the finance minister Hashimoto "told the rate raise be called off." The head of Policy Planning Department of the BOJ, Mr. Tamura, made a comment denoting that "the news reports insisting that the Bank already made decision to raise the rate were not related with reality."[275] After all, the Bank raised the official discount rate six days after the first speculative article.

4. Japan's economic conditions (from early 1990 to summer 1990)

From early 1990, Japan's economy continued to steadily expand mainly led by buoyant corporate fixed investment and steady growth of household income under favorable conditions of income and employment (Chart 1 (1)-VII). The Bank particularly assessed that growth of investment for purposes other than capacity expansion would be expected to remain high in response to the progress of technological innovation.[276] On the price front, consumer prices and wholesale prices remained stable, but upward pressures on prices from economic conditions remained, such as increasing wage costs under tight labor market conditions and raising import prices due to yen depreciation. In addition, upward pressures on prices from financial conditions were strengthened mainly by a continuous increase in land prices and a higher growth rate in money supply with a backdrop of accelerated funding behaviors and heightened further anticipation for higher interest rates. The Bank assessed that "a risk of resurgent inflation is higher than a risk of economic downturn"

[271] BOJ Archive (1989h), pp.2–4.
[272] BOJ Archive (1989j), pp.2–3. Also, see BOJ Archive (1989p), pp.2–3.
[273] BOJ Archive (1989l), pp.4–5.
[274] Yomiuri Shimbun (1989), p.1.
[275] BOJ Archive (1989n), pp.1–2 and Nihon Keizai Shimbun (1989b), p.3.
[276] BOJ (1990c), pp.1–2, 10–11.

(Charts 2 (1), (2), (4)-VII, 5 (2)-VII and 6 (2)-VII).[277]

Meanwhile, stock prices declined in early 1990 after the yen's depreciation and decreasing bond prices (increasing long-term yield), and the triple declines of stock, bond and exchange rate occurred in spring 1990.[278] In short-term money markets, market interest rates increased from late February onward in anticipation of a next raise in the official discount rate. Turmoil broadened in financial markets, such as a sharp drop in stock prices (in the Nikkei Stock Average) with a drop of 1,569 yen on February 26 from the previous day, due to overseas news reports pointing out "a stance of the Ministry of Finance against tightening and an uncertainty in monetary policy formulation." Market participants strongly wanted "to create a circumstance indicating an end of further rate raises" by raising the official discount rate quickly and largely (Charts 4-VII and 6 (1)-VII).[279]

5. Monetary policy response (from early 1990 to summer 1990)

In the aforementioned circumstances, the Bank took a fourth action to raise the official discount rate from 4.25 percent to 5.25 percent on March 20, as "the final precautionary measure to forestall price increases in advance" (Chart 4-VII). The raise of 1 percentage point was determined, from the viewpoint that "a raise should be large enough for financial markets to make them believe a cease of further rate raises and thereby curtailing anticipation in money markets and capital markets." The Bank also considered that "a raise should not be too large for markets to concern about bringing a surge in market interest rates or halting economic growth."[280]

The Bank also continued to guide loan plans by commercial banks in window guidance in accordance with the rate raises, and tried to tighten further restraints on bank loans provided by the regional banks, with were increasing, while maintaining restraints on bank loans provided by the major banks. Regarding the major banks, such as city banks, long-term credit banks and trust banks, the BOJ recognized that "their management at the head office was shifting their policy from a quantity-oriented to a quality-oriented lending attitude."[281] Meanwhile, regarding the regional banks, it was seen that as "their tendency for quantity-oriented lending and herding was basically unchanged."[282] The growth rate of commercial bank lending accelerated in the first half of 1990 mainly due to the regional banks, and the year-on-year growth rate of money supply also increased (Chart 5 (1) and

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[277] BOJ Archives (1990b), p.2. Also, see BOJ Archives (1990e), pp.5–6 and BOJ (1990c), pp.15–16.
[278] BOJ Archives (1990e), p.1.
[279] BOJ Archives (1990c), p.2.
[280] BOJ Archives (1990c), pp.4–5. Also see BOJ (1990a).
[281] BOJ Archives (1990d), p.4.
[282] BOJ Archives (1990f), p.5.

(2)-VII).

Facing the accelerated growth in bank lending in spite of the tightened restraint in guiding commercial banks' loan plans, the BOJ recognized that the borrowers of commercial banks were very confident in their business profitability under favorable business conditions and that "immediate changes such as downward revision in corporate fixed investment would not be very likely to prevail."[283] The Bank also considered that "the traditional lending behavior of the past monetary easing period strongly remained in lender's policy"[284] with a perspective of the lenders such as the regional banks.[285]

After the rate raise in March 1990, the Bank basically recognized the increase in interest rates and drop in stock prices in early 1990 as a "contraction of bubble" owing to "the deeper penetration of lagged effect of the previous rate raises." The Bank also assessed that "active entrepreneurship and economic dynamism remained healthily" and "the important challenge with top priority was still a prevention of inflation." At the same time, the Bank also became cautious about downside risks of future economic conditions, considering that "In face of rapid changes in financial circumstances, closer attention than before should be paid to a possibility whether economic activity would worsen sharply." Furthermore, the Bank recognized that "a possibility of upcoming difficulties for nonbank and other financial institutions would not be ruled out," and that "if a partial repercussion of asset prices spilled over to land prices then a further spread of detrimental impact would be inevitable." With the above recognition, the Bank came to consider that "development of economic conditions and changes in financial system and circumstances should be assessed without prejudice."[286]

However, in July 1990, the Bank came to recognize that the economic activity led by corporate fixed investment and personal consumption was "stronger than expected in spite of the so-called triple decline in early 1990," and that "potential upward pressure for prices might be piling up again." At the same time, the Bank also considered that "prices in the near term were stable in general," and that "there would be a room for the previous rate raises to be permeated further." For these considerations, the Bank assessed that "the current circumstances were not too urgent to require an immediate policy action" and then maintained the same level of tightening as that in March 1990.[287]

Regarding a relationship between asset prices and monetary policy implementation, the

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[283] BOJ Archives (1990d), p.2.

[284] BOJ Archives (1990a), p.5.

[285] In this regard, Iwata (1993, p.183) assessed that the Bank's stance to avoid large fluctuations in interest rates consequently led to large fluctuations in money supply.

[286] BOJ Archives (1990e), pp.1–2, 5 ,7–8. Also, see BOJ(1990b), pp.3–5, 29.

[287] BOJ Archives (1990g), pp.4–6.

Bank understood an outer opinion that a decline in land prices "would worsen business of commercial banks substantially and the policy authorities would be intimidated for actions bringing such circumstance." Then, the Bank regarded this opinion as "a complete misunderstanding" and assessed that a possibility of asset price decline would not constrain maintenance of tightened policy in the near term under a solid economic growth with stock prices bottoming out.[288]

In addition, regarding "financial market instability brought by speculation about a possible rate raise" in March 1990, the Bank "keenly acknowledged again a difficulty in monetary policy implementation during a period of greater market influence." Accordingly, the Bank recognized that "monetary policy formulation and money market operations in a time of greater market influence should always be studied continuously from various aspects including the Bank's stances on financial markets and media," and considered that future tasks remained in its communication with financial markets.[289]

6. Changing circumstances around international policy coordination (from spring 1989 to summer 1990)

As stated, the period between the Plaza accord and the Louvre accord included a sub-period of March and April 1986 when the central banks of Japan, the U.S. and Germany took closer communication with one another beforehand and lowered their discount rates almost simultaneously. There also existed another sub-period between October 1986 and February 1987 when an achievement of international accordance for stable foreign exchange rates took priority over a reduction of the official discount rate by the Bank, under the buildup to international macroeconomic coordination such as fiscal and monetary policies among major countries such as the U.S. and Japan. Regarding these developments, then-Governor Sumita mentioned in a speech in December 1989 that the specific goals in the international policy coordination during this period were "(1) symmetric actions by the major countries with either surplus or deficits in adjusting each policy and thereby rectifying fundamental economic conditions such as external imbalances in particular; and (2) coordinated actions by policy authorities in each country one another for achieving exchange rate stability."[290]

An aggravation of external imbalances ceased in 1987 among Japan, the U.S., and other major countries. From 1988 afterward, they started to improve and major industrial countries maintained high growth in general.[291] The Bank considered around 1989 and

[288] BOJ Archives (1990g), pp.6–7.
[289] BOJ Archives (1990e), pp.3–4.
[290] BOJ (1989i), p.46.
[291] BOJ (1989i), p.46.

1990 that "Japan's economy would currently be less likely to be worsened immediately by the developments in the U.S. or Europe mainly through foreign exchange rates." The Bank also assessed that "currently the Bank would be able to shift a weight of consideration less for external factors and more for domestic factors in formulating and implementing monetary policy."[292] In this regard, the Bank considered that "for the countries with deficits as well as countries with surplus, favorable domestic economic conditions should be maintained first" to achieve the goals in the international policy coordination.[293]

Regarding the changes in circumstances for international policy coordination, the BIS noted in the annual report that "the policy implications of the need to bring down current-account deficits or surpluses were relatively obvious" because a reduction in current account imbalances was a major issue for international policy coordination. BIS also noted that "with the reduction of current-account imbalances international policy co-ordination … lost a clear focus in 1990."[294]

B. Further Monetary Tightening and a Continuation of Tight Monetary Policy (from Summer 1990 to around May 1991)

1. Advent of the Gulf war and conditions of major overseas economies

Against a backdrop of the Iraqi invasion of Kuwait in early August 1990, oil prices temporarily surged during fall 1990 and then dropped, with the WTI price at 18.6 dollars per barrel in July 1990, peaking at 35.9 dollar in October 1990, and then falling to 19.9 dollars in March 1991 (Chart 2 (3)-VII).

The U.S. in a mature stage of economic expansion experienced a decline in housing investment and a slower growth in consumption occurred during the former half of 1990, partly due to the past increase in interest rates. Then from fall 1990 onward, personal consumption declined further due to dampened consumer confidence by oil price rises and a lower growth in real income. The U.S. was in a recession until mid-1991, for the first time since 1982.[295] The unemployment rate, once being in the lower part of the 5 percent range from spring 1988, started to rise after mid-1990 and reached around 7 percent in spring 1991 (Charts 7 (1) and (2)-VII). At the same time, under declining prices in commercial real estate, U.S. financial institutions experienced a surge in nonperforming loans and a worsening profitability from summer 1990 onward, and then their attitude in bank lending became more cautious.[296] The FRB, from the viewpoint of avoiding unintentional and

292 BOJ Archives (1990g), p.3.
293 BOJ (1989i), p.46.
294 BIS (1991), p.8. It mainly covers fiscal year of 1990.
295 BOJ (1990f), pp.6, 16–17.
296 BOJ (1990f), pp.18, BIS (1990), pp.106–107, and BIS (1991), pp.104–106.

excessive tightening, lowered the target for the federal funds rate in July 1990, and then lowered the target rate three times in October 1990 and afterwards in response to a further tightening of credit conditions by commercial banks and a risk of further stagnation in economic activity. Furthermore, the FRB lowered its discount rate three times from 7 percent to 5.5 percent between December 1990 and April 1991, and also lowered the target of the federal funds rate (Chart 8 (1)-VII).[297]

In Germany (former West Germany area), the economy maintained buoyancy. Consumption and corporate fixed investment expanded under the currency unification in July 1990 (introduction of the German mark in East Germany) and an increased number of immigrants from East Germany, in addition to a rapid fiscal expansion for reconstruction and redemption of East Germany (Chart 9 (1)-VII).[298] The Bundesbank raised the Lombard rate twice in November 1990 and February 1991 and then raised the discount rate from 6 percent to 6.5 percent in February 1991, in order to curb strong inflation pressure under the strong fiscal expansion and the requests of higher wages in the former West Germany area (Chart 10 (1)-VII).[299]

2. Japan's economic conditions after the advent of the Gulf war

During the period between summer 1990 and fall 1990, Japan's economy was considered to be on an expansionary trend led by domestic demand, such as steady growth in corporate fixed investment under firms' bullish attitude in face of technological developments and labor shortage, and growth in personal consumption mirroring favorable conditions in employment and income.[300] Product market conditions remained tight and the corporate sector was experiencing an intensifying labor shortage in the labor market, regardless of type of industry or size of firm (Charts 1 (1) and 2 (4)-VII).[301] Although somewhat losing momentum, land price increases remained high, particularly in areas other than Tokyo (Chart 6 (2)-VII). On the financial front, the year-on-year growth rate of money supply peaked in April and May 1990 and then slightly decelerated, but the growth rate was still high, at a double digit level (Chart 5 (2)-VII). Meanwhile, both long- and short-term market interest rates rose considerably in face of increases in crude oil prices with anticipation of tightening (Chart 4-VII).[302]

On the price front, wholesale prices were generally stable except those of oil-related

[297] BOJ (1990f), pp.18 and BIS (1991), pp.155–156.
[298] BOJ (1990f), pp.6, 20.
[299] BOJ (1990f), p.21 and BIS (1991), p.157.
[300] BOJ (1990e), pp.1–2, 4, 10–12.
[301] BOJ (1990e), p.6.
[302] BOJ (1990e), pp.14–16. Also, see BOJ Archives (1990h), p.3.

products which surged after the Gulf crisis. Meanwhile, conditions in demand and supply were generally tighter, and the increasing costs in wages and distribution were gradually accelerating consumer prices. Under these circumstances, a further buildup of inflationary pressure should have been a concern (Charts 2 (1) and (2)-VII).[303]

In foreign exchange markets, yen appreciation along with dollar depreciation occurred again from May 1990 onward mainly due to declining interest rates and economic weakness in the U.S. as well as increasing interest rates in Japan (Charts 3 (1)-VII).[304]

3. Monetary tightening and a tight policy maintained after the Gulf war (from August 1990 to spring 1991)

The Bank recognized that "economic activity was very strong, market conditions in products and labor were tighter, and the recent increase in wages appeared to be noteworthy" in Japan's economy, and that "eased monetary conditions were not fully changed such as appeared remained high growth rate" in money supply. The Bank also considered that "current circumstances should not be left in terms of preventing inflation." Under these circumstances, the Gulf crisis was recognized as an additional shock for inflation because its nature was similar to the two oil crises in the past although the size of the shock was smaller.[305] In light of the experiences of the past two oil crises, the Bank assessed that "inflation in import prices and decrease in real economic growth could not be unavoidable" as "the first-round effect" of an increase in oil prices, and that the main issue was "how to avoid rapid increase in domestic prices stimulated by the surge in oil prices as the second-round effect." The Bank assessed that "avoiding inflation in domestic prices by rapid and preemptive policy action" was the best choice and decided to raise its official discount rate by 0.75 percentage points, from 5.25 percent to 6 percent, on August 30 (Chart 4-VII).[306] On this occasion, the Bank recognized as the internal assessment that "the intention of the raise this time was to adjust aggregate demand, stepping up from the other past raises in this tightening phase as precautionary raises," and strongly acknowledged its stance of containing inflation by weakening economic growth with tightening policy.[307]

Commercial banks "considerably restrained loan plans in accordance with tightened monetary policy stance" in response to the Bank's request to do so in window guidance for the October–December quarter of 1990, with a recognition that demand for funds in

[303] BOJ (1990e), pp.6–7, 13.
[304] BIS (1991), pp.180–181.
[305] BOJ Archives (1990h), pp.1–2.
[306] BOJ Archives (1990k), p.2.
[307] BOJ Archives (1990h), p.2.

equipment and operations by small and medium-sized firms "was still strong owing to strong business sentiments and higher profit." With a possibility of abolishing window guidance in the future in mind, the Bank also strongly recommended to commercial banks in the guidance that "solidifying stronger managerial base voluntarily and drastically" should be strongly encouraged. The Bank also considered a departure from the "simple quantity-oriented tendency and a herding culture" in the behavior of commercial banks familiar with past window guidance as an "urgent necessity for stronger capital base and higher profitability." In the Bank's recognition, each of the commercial banks understood the BOJ's intention in the guidance under "their potential momentum surfacing for an internal control for a tendency of quantity orientation as well as a reappraisal of their loan assets." As a result, the year-on-year change of the increase in loan plans by the major banks for the October–December quarter of 1990 recorded the largest decline (-32.4 percent) since the tightening phase in 1973 and 1974, and the year-on-year growth rate of the loans provided by the major banks at the end of 1990 was likely to decline solidly.[308] The regional banks made their loan plans with further restraint than that they had done in the July–September quarter with efforts to restrain bank loans outstanding, with a view of "fortifying profit base and satisfying regulatory capital adequacy requirements of the BIS" (Chart 5 (1)-VII).[309]

In November 1990 and afterwards, the growth rate of money supply sharply declined, from the 12.0 percent year-on-year change of M2+CD in September 1990 to 3.6 percent in May 1991 (Chart 5(2)-VII). In this period, the effect of higher interest rates permeated, lending rates of bank loans rose, and the sentiment of easy corporate finance receded. Demand for funds weakened owing to slower economic growth and less asset transaction, as well as a drop in both fundraising and investment by firms simultaneously. In addition, the Ministry of Finance imposed quantitative restrictions on lending to real estate-related industries (which were introduced in March 1990 and ceased in December 1991) and also requested commercial banks to report their current status of bank lending for the three industries of real estate, construction, and non-banks (leasing and finance companies). Commercial banks clarified their direction of larger importance on credit risks and profitability, and their lending stance became more cautious mainly for such industries as real estate, in order to achieve BIS capital adequacy standards (above 8 percent for the financial year ending March 1993 and above 7.25 percent for the financial year ending March 1991 as a transition period). The Bank assessed that the above-noted developments

[308] BOJ Archives (1990i), pp.1–5, attachment p.7. The loan plans covered only yen denominated loans provided by domestic branches. (They neither covered foreign currency denominated loans nor loans provided by overseas branches.)

[309] BOJ Archives (1990j), pp.2–3.

caused the sharp decline in the growth rate of money supply.[310] Judging from the velocity of money and the ratio of liquidity to sales in the corporate sector, however, the Bank assessed that overall liquidity relative to economic activity was "still at a fairly high level against the background of substantial money stock increases in the past."[311] Meanwhile, from spring 1990 to October 1990, the yen appreciated mainly due to the U.S. economic downturn and smaller interest differentials, and then remained at a level between 130 and 140 yen to the dollar (Chart 3 (1)-VII). Long-term interest rates declined, reflecting heightened expectations for lower rates under dropping oil prices, the yen's appreciation, and the U.S. monetary easing (Chart 4-VII).[312]

As for the real economy from fall 1990 to spring 1991, Japan's economic growth moderated gradually mainly due to slower domestic demand, such as corporate fixed investments and personal consumption, but overall economic activity was still at a high level and products and labor market conditions remained tight (Chart 1 (1)-VII). Under these circumstances, prices were considered to remain broadly within a stable range. At the same time, it was noted that a surge in costs of goods and labor as well as a surge in oil prices started to be passed on to prices in products and services. The year-on-year change in consumer prices shifted upward from the 2 percent level before the Gulf crisis to a level around 4 percent during the period between fall 1990 and spring 1991 (Charts 2 (1), (2) and (3)-VII).[313] Furthermore, stock prices, which had been declining in 1990, regained their footing in spring 1991. The surge in land prices remained high, particularly in regional areas where the year-on-year change increased to the double-digit level, although overall growth was somewhat moderating (Charts 6 (1) and (2)-VII). The Bank recognized that land price increases in the second half of the 1980s occurred "partly due to real demand for economic activity" as well as "a belief of land prices on an uptrend without decline."[314]

The Bank assessed that "the pace of economic expansion moderated but overall economic activity was still at a fairly high level," and that "market conditions in demand and supply as the most important aspect for future development in prices remained tight."[315] The Bank also considered that "in the current circumstance land prices should rather tend to be moderated than be cautious for large falls."[316] The Bank regarded "securing price

[310] BOJ (1991a), pp.1–2, BOJ (1991b), p.16, and BOJ (1991c), pp.1, 6, 12. Also, see MOF (2003a), pp.171–173 and BOJ (1989e), pp.54–55 for BIS capital adequacy requirement.
[311] BOJ (1991b), pp.16–18.
[312] BOJ (1991c), p.5.
[313] BOJ (1991a), pp.1–2, BOJ (1991b), pp.1–2, 7, and BOJ (1991c), p.1.
[314] BOJ Archives (1990k), p.9.
[315] BOJ Archives (1991b), p.2.
[316] BOJ Archives (1990k), p.9.

stability by calming inflationary expectations" as the greater priority, and then maintained the high level of its official discount rate until May 1991, "to pursue prudent policy management with price stability as its prime objective, while simultaneously keeping a close eye on various developments and the effects of interest rate increases to date" (Chart 4-VII).[317]

In late 1990, the lending stance of commercial banks became more cautious, and the financial difficulties of some firms in the real estate-related and nonbank industries surfaced. The Bank recognized that "the firms with speculative investments for real estates and securities excessively in the past would not be able to avoid confronting severe funding difficulty in the future, and a risk of their failure badly involving large lenders such as finance companies and commercial banks would not be ruled out perfectly."[318] At the same time, the Bank recognized that "monetary policy implementation in the future should be considerate so as not to repeatedly ignite asset price inflation at all."[319] The Bank also assessed that "it would be difficult in a near term to imagine a circumstance where a sound firm would face severe difficulties in funding."[320] Consequently, the Bank acknowledged that it should "encourage market mechanisms to make the firms with excessive speculative investments disappear autonomously," for "normalization of the bubble economy and the sound development of Japan's economy while accepting risks to some extent."[321]

As stated above, the Bank maintained the monetary tightening until mid-1991 with a perspective that a normalization of the bubble economy would lead to a sound development of Japan's economy. In July 1991, the Bank turned to monetary easing, but the readjustment process of balance sheets in Japan's economy thereafter continued for more than ten years during the 1990s and early 2000s. With the knowledge of hindsight, the Bank's assessment about the impact of financial imbalance on macroeconomic development in the medium to long term, and the resultant adjustment processes in balance sheets was not adequate, particularly for the financial imbalance represented in the large fluctuation in asset prices and money supply. The adjustment had probably amplified the fluctuation in economic conditions as a result. A reflection of this lesson appears to evolve into a perspective on the Bank's monetary policy formulation that financial imbalances should be examined as a risk in terms of achieving price stability in the medium to long term.

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317 BOJ (1991a), p.4.
318 BOJ Archives (1990l), p.3.
319 BOJ Archives (1991b), p.3.
320 BOJ Archives (1991a), p.2.
321 BOJ Archives (1990l), p.3.

C. End of Monetary Tightening (around June and July 1991)

1. Policy rate reduction in July 1991

In the former half of 1991, Japan's economy continued to expand, under favorable income conditions in firms and households. Around summer 1991, however, the growth of domestic demand started to decelerate partly because monetary tightening and accumulation of capital stock in the past came to moderate growth in fixed investment. Also, the product market eased somewhat and the labor market stopped tightening, among tight conditions of markets in general. Regarding prices, the pace of increase in wholesale prices decelerated owing to lower prices in oil related products, and the year-on-year change in consumer prices moderated somewhat (Charts 1 (1)-VII, 2(2) and (2)-VII). On the financial front, money supply growth sharply decelerated against the backdrop of permeation of higher interest rates and cautious lending attitude by commercial banks (Charts 5 (2)-VII). Firms' financing was less easy than that in previous quarters, although corporate liquidity was more abundant than that in the past phase of monetary tightening. In light of these financial and economic developments, in particular some weakening of inflationary pressures and declines in both short and long-term market interest rates from their respective peaks, the Bank lowered the official discount rate by 0.5 percentage points, from 6 percent to 5.5 percent on July 1, 1991 (Charts 4-VII).[322,323]

Looking at editorials of major newspapers discussing the rate reduction by the Bank on July 1991, both the timing and the magnitude of the reduction were assessed as appropriate in general. For example, the *Nihon keizai shimbun* noted that "the reduction of the rate was appropriate, in light of a slower pace of economic growth, stable prices including land prices, and a stagnation of world economy."[324] Also, the *Yomiuri shimbun* noted that "the Bank's policy decision was appropriate in terms of the timing of implementation and extent of rate reduction."[325] The *Mainichi* newspaper stated that "economic activity remained strong in corporate fixed investment and personal consumption, but the turnaround of monetary policy stance at this timing appeared to be appropriate if economic conditions in a year ahead were envisaged."[326] On the other hand, the *Asahi shimbun* recognized that "the

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[322] BOJ Archives (1991e), pp.1–2 and BOJ (1991d), pp.1–2.

[323] There are various discussions regarding this point. For example, Kuroda (2005, p.100) assessed that monetary policy from 1990 onward "lagged behind the subsequent economic downturn and deflation under way." Iwata (1993, p.215) also noted out that the Bank "implemented monetary policy in 1991 absorbing briskly excess liquidity" (which occurred by insufficient tightening in the past), and that "this policy was considered to rapidly lower the growth rate of money supply, to derive a rapid drop in asset prices, and to cause a sharp decline in real GNP."

[324] Nihon Keizai Shimbun (1991b), p.2.

[325] Yomiuri Shimbun (1991), p.3.

[326] Mainichi Shimbun (1991), p.5.

recent Tankan survey by the Bank of Japan indicated persistent strong economic activity in spite of decelerating economic growth," and regarded the timing of the reduction as too early by noting that "the reason of the rate reduction at this earlier timing appeared to be doubtful."[327] As stated above, it was difficult to find media opinions to the effect that the rate reduction was tardy in those days.

2. Abolition of window guidance

From spring 1981 onward, the Bank showed and maintained a basic attitude of "respecting loan plans at discretions" of each commercial bank. However, from 1987 the Bank asked each commercial bank to apply discipline in making loan plans on every quarter, and thereby restarted to use window guidance as a supplement tool of monetary policy. Particularly, in the tightening phase from 1989 to the first half of 1991, the Bank strengthened the guidance by asking commercial banks to suppress lending such that the increase of loans should be reduced below that of the same period in the previous year. And in June 1991 the Bank abolished the window guidance for the July–September quarter of 1991 and afterwards, with the judgment that a growth of bank lending by each bank would be moderate without guidance on loan plans. Specifically, instead of ex-ante submission of loan plans by each bank, with them abiding by it for the following quarter, bank lending "was left to its discretion of each bank formulating a loan plan."[328]

Under the progress of financial deregulation, the Bank gradually strengthened its recognition that the framework for window guidance, whereby the Bank adjusted the loan plans of commercial banks in advance with the herding culture in consideration, was becoming out of date. In this regard, the further progress of financial deregulation appeared to be changing the managerial policy of commercial banks for both greater discretion and discipline. It was also recognized under window guidance that "each share of banks in the past loan plans tended to remain as ossification in a following quarter" regardless of funding costs or profitability of commercial banks. The Bank acknowledged that the adverse effect of window guidance was increasingly problematic.[329] Based on these considerations, the Bank pointed out three reasons why window guidance was to be abolished at that time. First, "quantitative expansionism of herding culture receded and financial conditions of respective banks appeared to be fully considered in the decision making" of lending activity by commercial banks. Second, commercial banks were reflecting on the excessively active lending attitude of the past and "re-adoption of more

[327] Asahi Shimbun (1991), p.2.
[328] BOJ Archives (1991c), p.1.
[329] Kinyu Zaisei Jijo (1991), pp.16–17.

prudent lending policy” was becoming prevalent among them. Third, “owing to the solid permeation of the past interest rate policy as well as the restrictive effect of BIS regulatory capital standards, the growth of bank lending was likely be modest even if the formulation of loan plans was totally left to discretion by respective commercial banks.” (See Column 4 for the historical development of window guidance and its abolition.)[330]

Column 4. Development of Window Guidance

Window Guidance[331] was “a supplementary policy tool supporting the other policy tools for controlling market interest rates, such as the changes in the official discount rate, the securities and bills operations, and the changes in reserve requirement ratio,” such that “the Bank request for its client financial institutions to keep the respective loan plans to the adequate extent being consistent with the current financial conditions.” Window guidance was initiated in July 1947 when the section for credit bank surveillance was established at the Market Operations Department (the Banking Department then), and in the tightening phase in 1957 the Bank solidified the role of the guidance as a complementary tool for the Bank’s lending policy. In May 1957, then-Governor Yamagiwa first emphasized the necessity of the guidance by using the term “window guidance.” The June 1957 issue of the Bank’s monthly bulletin referred to window guidance for the first time.

The financial institutions and their categories subject to the guidance were city banks as well as the Industrial Bank of Japan in July 1947, and then both the city banks and three long term credit banks in May 1957. In January 1964 the city banks, long term credit banks, trust banks, regional banks were covered, and then in April 1973 the coverage was enlarged by additionally including *sogo* banks (mutual financing banks) and some large *shinkin* banks (credit cooperatives). Some large foreign banks in Japan were subject to the guidance for a period of time.

Specific contents of the guidance varied across periods. Up to around 1963 the Bank requested banks to limit the increase of lending on a monthly basis. In the tightening phase of 1964 the Bank adopted a framework (“directive for increase in lending”) under which the Bank decided the total allocation for the increases of lending by respective banks on a quarterly basis and then decided the increments for respective banks in line with recent shares of their loans outstanding. Then in the loosened period the Bank chose “the guidance for positions of funds” where the guidance focused on the positions of funding and investments by respective banks. In the short tightening phase the Bank adopted “restraint loan guidance” where the Bank requested revision of the loan plans submitted by respective

330 BOJ Archives (1991c), pp.2–3.
331 The text and reference without specific notes in this column are based on BOJ Archives (1991d).

banks as necessary. In the complete tightening phase, the Bank allocated the increases of lending by respective banks according to "directive for increase in lending" with recent shares of their loans outstanding, in addition to various factors such as the position of funds.

From spring 1981 onward, the Bank's attitude toward commercial banks was to accept their formulation of loan plans at their discretion. In the period of accommodative monetary policy from 1987 onward the Bank requested commercial banks to adopt a "prudent lending attitude" (moral suasion) while maintaining the attitude of respecting the autonomous formulation of their loan plans as a principle. After the raise in the official discount rate in May 1989, for the purpose of containing loans quantitatively and directly against increasing demands for loans related to land and financial investments, the Bank tried to tighten the guidance by adjusting the increments of loans for respective banks. The principle of "respecting autonomous formulation" was becoming a mere slogan and losing substance in nature.

Window guidance "was not a legally binding guidance" but "a demand for cooperation in nature" by the BOJ for commercial banks. Meanwhile, commercial banks also expected to lower the risk of a liquidity shortage in daily funding management by maintaining a good relationship with the BOJ functioning as a Lender of Last Resort (LLR). In addition, the official discount rate was lower than short-term market rates (such as the call rate) in the 1980s. Under such circumstances, there was a consideration in the Bank that for commercial banks "their borrowing from the Bank of Japan was beneficial so that commercial banks as beneficiaries should cooperate with the policy of the Bank of Japan."[332] Meanwhile, the commercial banks gradually considered that the borrowing from the central bank was slowly becoming less beneficial, owing to an end of Japan's high growth period with vigorous domestic demand, a dissipation of the so-called over-loan situation with greater loans than deposits for commercial banks, and a development of secondary bond markets in the 1980s allowing them to increase liquidity in ordinary times.

Among an acceleration of financial deregulations after a release of the report of the Japan-U.S. Yen-Dollar Committee in 1984, such as the removal of the yen-swap limit, deregulation measures for euroyen transactions and gradual deregulation of interest rates for deposits,[333] the Bank considered it necessary to make "further effective use of interest rates" in monetary policy implementation.[334] Furthermore, among the increasing proportion of instruments with freely-determined market interest rates for both sides of funding and investments at commercial banks, the Bank also recognized a "securing managerial

[332] Kure (1973), p.160.
[333] BOJ Archives (1985c), p.5.
[334] BOJ Archives (1985a), p.7.

soundness based on independent judgments of respective financial institutions by their own" as another important perspective.[335]

At the same time, in October 1985, the Bank recognized that "although a proportion of market-based funding by financial institutions was growing under progress of financial deregulations, the proportion was just around twenty percent even for city banks in terms of total amount outstanding, so there appeared to exist a constraint in the transmission mechanisms of interest rate policy." The Bank also assessed that "window guidance still played an important role of permeating policy intention and gathering information through daily oversight of funding for commercial banks." The Bank therefore considered that "the functions and the framework of the guidance should be maintained as a supplementary policy tool of the interest rate managements."[336]

After the removal of the yen-swap limit in 1984, arbitrage between the yen-denominated loans provided by domestic branches and impact loans (foreign currency denominated loans) became increasingly active, and then from fall 1986 onward the interest rates declined further. Under these circumstances, the high growth rate of impact loans, which were not subject to the guidance, became outstanding.[337] Against this background, the BOJ strongly recommended to city banks, long-term credit banks and trust banks in the guidance that the growth of impact loans "should be as consistent as possible with the growth in the yen-denominated loans" for the April–June quarter of 1987.[338] However, in light of "the attitude of respecting autonomous formulation of loan plans as a basic principle," the Bank considered that "a tighter guidance in a wider range would possibly be difficult in practice and thus would not necessarily be adequate" for impact loans, which remained outside the scope of the guidance.[339] Furthermore, regarding the formulation of loan plans as the managerial core of a financial institution, the Bank assessed the role and framework of window guidance itself by adjusting the allocation of lending increments beforehand according to "a balance of share in respective banks." The BOJ came to recognize that the guidance "gradually became contradictory with the broader policy direction where respective commercial banks should pursue their own managerial policies with discretion for bank lending as asset side in line with a further progress in deregulation in funding as a liability side.[340] After the money market reform on November 1988, the Bank tried to "implement policy operations with a greater focus on effective usage of interest rate

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335 BOJ Archives (1985f), p.6.
336 BOJ Archives (1985g), attachment #1, p.9.
337 BOJ Archives (1987f), pp.1–3.
338 BOJ Archives (1987f), pp.1–2.
339 BOJ Archives (1987f), p.2.
340 BOJ Archives (1987e), pp.1–2.

functions," and thus market interest rates "became more influential on lending behavior by financial institutions."[341] Furthermore, the Bank assessed that "the impact of the rate raises was becoming both wider and more direct, under a surge in loans with lending rates linking to market interest rates (instead of lending rates in correspondence with the official discount rate) and a greater corporate funding from capital markets." In this regard, the Bank considered that "transmission channels of monetary policy became more diversified than before under the recent progress of financial deregulations.[342]

In face of these considerations, the role and framework of window guidance had to be reconsidered. However, in the tightening phase from May 1989 "a level of overall liquidity so far accumulated in the period of long-lasting monetary easing remained fairly high in relation to economic activity." The Bank assessed that it should put more weight on curbing inflationary pressure in the near term and it "should induce the ever lower growth rate of bank loans than before." Accordingly, the Bank adjusted portions of loan increments for respective commercial banks with a policy "requesting a further discipline in formulating loan plans with respect to both quantity and quality" and thereby tightened window guidance.[343]

Then in June 1991 the Bank disclosed the abolition of the window guidance for the July–September quarter of 1991 and afterwards. Regarding the backgrounds, first, the Bank pointed out that "a herding culture of quantity expansionism weakened and managerial decisions according to conditions of respective banks were considerably recognized" in lending activity by commercial banks and that "function of interest rates tended to work more effectively in lending activity by commercial banks." Second, it appeared to the Bank that respective commercial banks recognized "an actualization of credit risks" such as failures in nonbank or real estate-related firms and conducted reforms toward a "more prudent lending attitude" along with a review of the easy lending attitude of the past. Third, as partly seen in developments in money supply, the Bank considered that "the growth in bank lending would be moderate even if formulation of loan plans were totally left to discretion of respective commercial banks, owing to solid permeation of the past rate raises and the BIS regulatory capital standards."[344]

Column 5. Role of Money Supply

After the late 1960s, a view that money supply should be weighed heavily as an

[341] BOJ Archives (1989h), p.2.
[342] BOJ Archives (1989i), p.5.
[343] BOJ Archives (1989h), pp.1–2.
[344] BOJ Archives (1991c), pp.2–3.

intermediate target in monetary policy implementation was strengthened mainly in the Western countries, and central banks in these countries started to disclose a target of growth rate of M1 or M2 as a monetary objective.[345] Regarding the background, three reasons are pointed out. First, under the higher inflation of the industrial countries after the late 1960s, the monetary policy with relatively less emphasis on monetary aggregates was heavily criticized for the acceleration in money supply and resultant high inflation. Second, with high and volatile inflation in the economy at that time, nominal interest rates might not be effective indicators for monetary policy implementation due to discrepancy between nominal interest rates and real interest rates. Third, in contrast to a greater criticism of Keynesian policy as a source of stagflation, the monetarist view that excessive increases in money supply simply caused inflation without increasing real output in the long run was widely accepted.[346]

After the second half of the 1970s, the Bank gave greater importance to money supply than before in monetary policy implementation in light of "excessive liquidity" around the first oil crisis and the subsequent high inflation.[347] Specifically, the Bank published an article entitled "The importance of the money supply in Japan"[348] in 1975, and then the Bank started to publish in the first month of every quarter a forecast of the increase in the money supply for that quarter, for the July–September quarter of 1978 and afterwards.[349]

At the same time, the Bank of Japan never adopted money supply as a formal monetary objective, contrary to the central banks in the U.S. and Europe adopting money supply as an intermediate target. The Bank rather considered money supply deserving close attention within overall developments of other indicators. In this regard, the research paper in July 1975 stated that "in the process of realizing optimum economic development while maintaining stable prices, sufficient attention should be paid to the money supply in the operation of monetary policy in order to prevent excesses." Meanwhile, it also wrote that "in view of the fact that the quantitative relation between the money supply and prices is

345 Tachi (1982), p.209. Also, see BOJ (1975a), p.1.

346 Tachi (1982), p.211.

347 Nakagawa (1981), pp.63, 67, 189–194. Specifically, he noted the recognition (p.67) that heavy competition remained for lending by commercial banks around the first oil crisis and brought about easier monetary conditions quantitatively, and this caused a problematic increase of money supply in fall 1972, reaching 28 percent in the year-on-year growth rate. In addition, he also remembered the advice given to then-Governor Teiichiro Morinaga at his inauguration in December 1974 (p.63) that monetary policy should be eased at a measured pace to avoid excessive relaxation and also in this regard that attention should be paid for developments of money supply.

348 BOJ (1975b).

349 BOJ (1978), p.39. It stated that "the Bank of Japan closely monitored the development of money supply together with other indicators, and the purpose for announcing a forecast was to further enhance attention and understanding for various sectors in the developments of money supply." The words "forecast" and "projection" were used interchangeably.

subject to change depending on the economic situation, it is not desirable or appropriate to set a specific target of growth of the stock of M2 and attempt to realize the target mechanically." In this regard, the Bank maintained this basic direction afterwards.[350]

As the backdrop of the Bank's intention about this direction, the *Centennial History of the Bank of Japan* pointed out two factors. First, the relationship between money supply and prices or economic activity would change according to time and economic conditions and the Bank considered it difficult to publish a sufficiently stable official target. Second, the official target in the form of a fixed number with normative significance could later be interpreted regardless of the Bank's intention in transient economic conditions, and it could be detrimental to flexibility and options in smooth implementation of monetary policy.[351]

In the 1980s, financial deregulation caused two changes. First, an outstanding amount of quasi-money assets (such as government bonds and postal savings) were on an uptrend and arbitrage transactions between money and quasi-money were stimulated. Various monetary aggregates were examined for grasping the liquidity of the overall economy more adequately and thereby improving monetary indicators.[352] Second, prices remained stable in spite of the high growth rate in money supply, and it was noted around 1988 that the relation between the rates of inflation and money growth were considered to become blurred.[353]

Under these circumstances, the Bank's stance for monetary policy implementation was to prepare "for action in an appropriate and timely manner, through close monitoring developments in domestic and overseas economic conditions" including that of money supply, "so as not to damage conditions for price stability by a development of money."[354,355] For example, the higher growth rates in money warranted attention in 1988, and the Bank considered that "the growth rate of money supply was at a considerably high level, although its pace was mildly decelerating." Meanwhile, the Bank "intended to

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350 BOJ (1975b), p.2. It should be noted that some of the document is available in two languages because the English version was released in October 1975 after the release of the original paper in Japanese in July 1975. From a contemporaneous perspective, we basically refer to the earlier date of the Japanese version in the body text while taking a citation from the English version.

351 See BOJ (1986a), pp.474–482 for the background discussion.

352 BOJ (1984c), pp.11–18.

353 BOJ (1988a), pp.1–2,8–18.

354 The Governor's response to questions at the upper house budget committee (August 23,1988). See the search system (http://kokkai.ndl.go.jp) for transcripts in the Diet by the National diet library.

355 Also during the former half of the 1980s, the growth rate of money supply was regarded as an important indicator. The Bank considered that the ideal growth rate of money supply was hard to specify and that the "monetary control mechanism should be monitored carefully in addition to developments in prices" (the Governor's response to questions at the upper house budget committee, on March 31, 1983).

maintain the current basic stance for monetary policy implementation for the time being"[356] and maintained an accommodative policy mainly because prices were stable. As stated, money supply was to be considered as an important indicator within developments of other indicators in monetary policy formulation, but it appears that the information from this indicator could not be utilized practically at the stage of monetary policy formulation.[357]

In a speech by then-Governor Yasushi Mieno in August 1994, he recalled monetary policy implementation in the latter half of the 1980s. The speech stated that "money supply clearly displayed relatively irregular movement among various indicators, but our expertise and confidence was not enough to read precise implication of changes in money supply along with a sufficient assessment of other contemporary incidents such as greater shifts of funds among financial instruments and volatile asset prices." Furthermore, it was added as the resultant lessons and tasks that "a central bank should sharpen the insights for the developments of the economy including that of money supply and the expertise for monitoring on the basis of deep understanding of history."[358] The reflection of the experiences in the second half of 1980s appears to have evolved into a perspective on the Bank's monetary policy formulation that financial imbalances should be examined as a risk for achieving price stability in the medium to long term.

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[356] BOJ Archives (1988k), p.9.

[357] In this regard, it was pointed out in the literature that money supply remained relatively stable in the first half of the 1980s, but became volatile in the latter half (see Suzuki [1993], pp.141–142 and Iwata [1993], pp.196, 210 for examples). For the background, there are some views suggesting that "unintentional inclination of the Bank toward the lesser attention for money supply would partly contribute to the background" (See Suzuki [1993]). However, considering the views mainly by the Bank in the body text, it appears that the difference in developments of money supply between the first half and the second half the of 1980s was mainly attributed to the existence of changes in external conditions causing large swings in money during the respective periods, rather than the existence of changes in the Bank's stance regarding monetary policy implementation.

[358] Speech by then-Governor Mieno on August 31, 1994, taken from Mieno (1995), p.40.

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Exhibit

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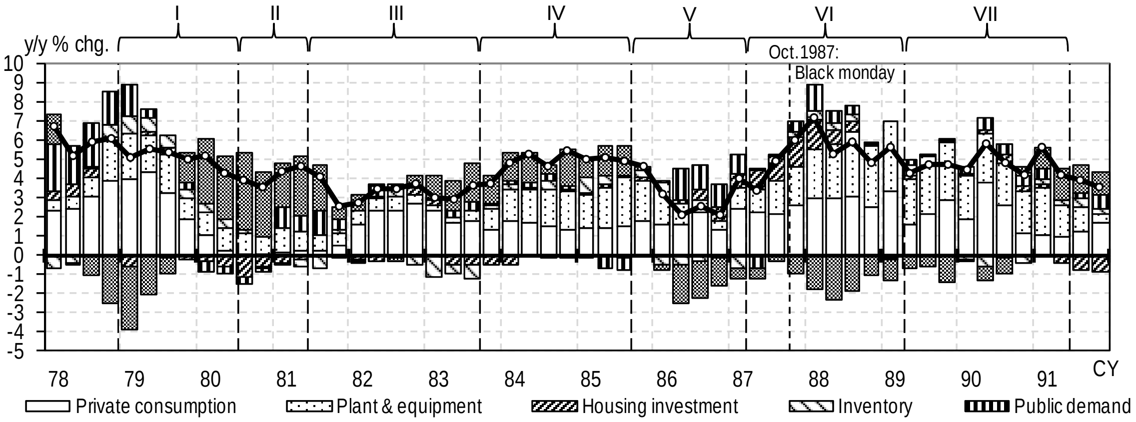
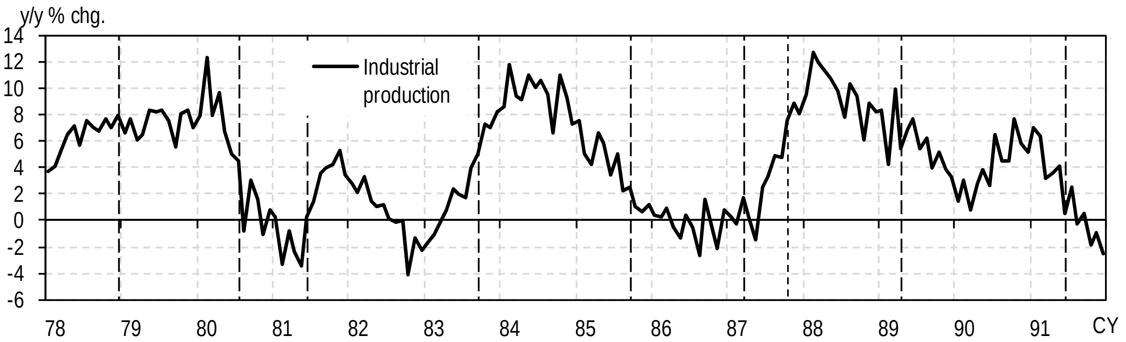
Economic Conditions

(1) Real Economic Growth Rate



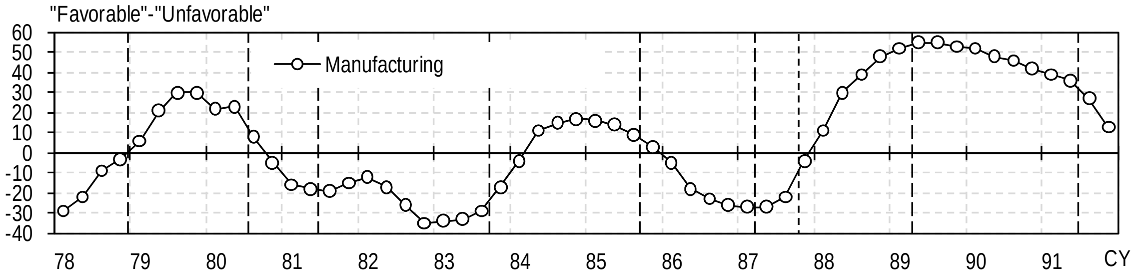
Note: Data in 1978, 1979–1983, 1984–1988 and 1989–1991 are prices in 1970, 1975, 1980 and 1985, respectively.
Source: Economic Planning Agency (currently Cabinet Office)

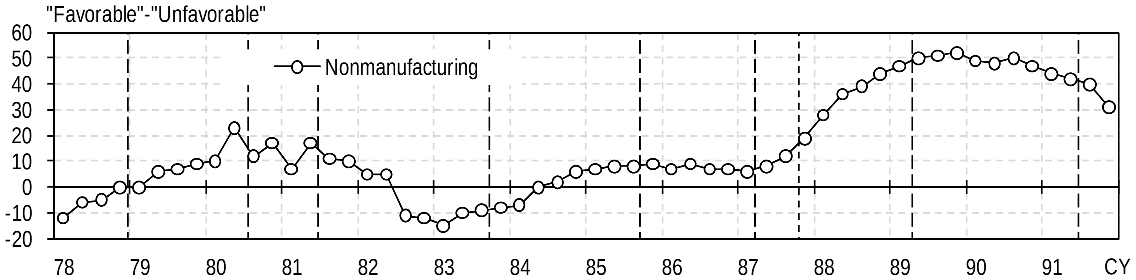
(2) Industrial Production



Note: 1990 Base.
Source: Ministry of International Trade and Industry (currently Ministry of Economy, Trade and Industry)

(3) Diffusion Index of Business Conditions, Principal Enterprises



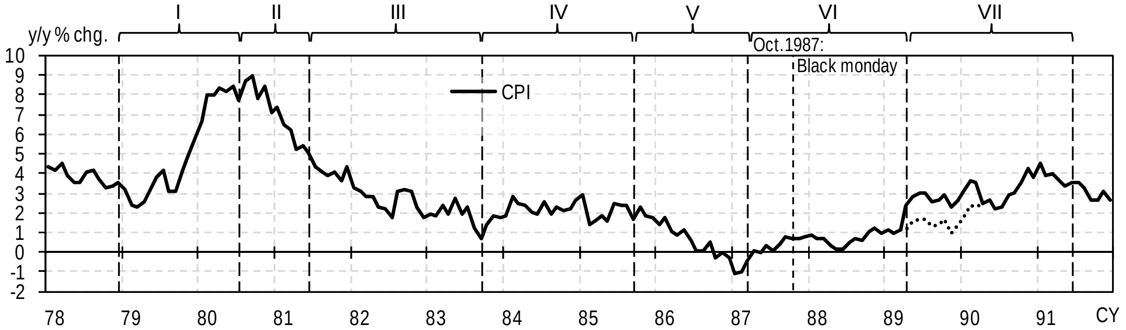


Source: Bank of Japan, *Economic Statistics Annual*

Chart 2

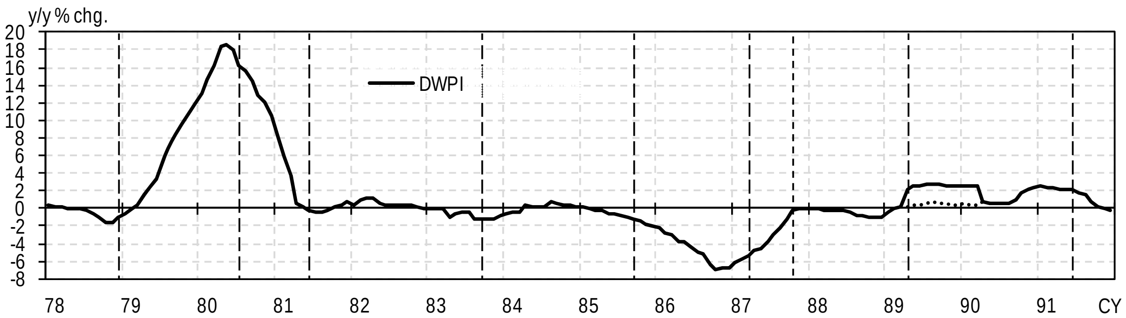
Prices

(1) Consumer Price Index



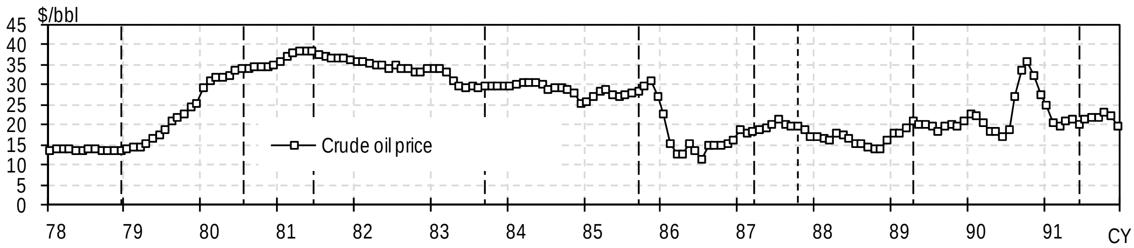
Note: Data from January 1978 to June 1981, from July 1981 to June 1986, from July 1986 to June 1991, and from July 1991 onward have the base year of 1975, 1980, 1985 and 1990, respectively. The dotted line from April 1989 to March 1990 is data adjusted for value-added tax in April 1989 by subtracting the difference of the year-on-year rates between March and April 1989.
Sources: Cabinet Office; Bank of Japan, *Economic Statistics Monthly/Annual*

(2) Domestic Wholesale Price Index



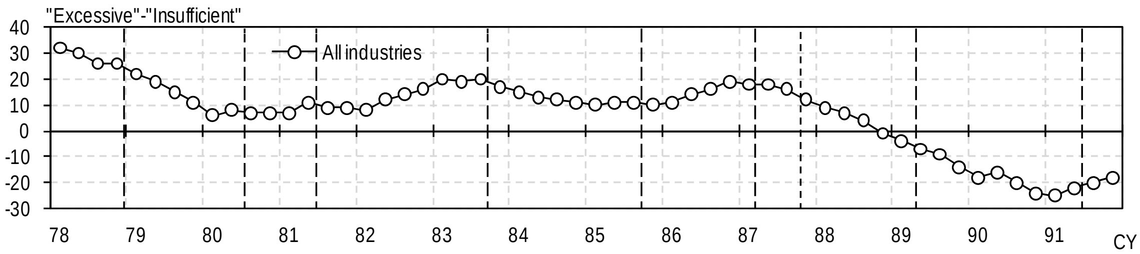
Note: Data from 1978 to 1981, from 1982 to 1986, from 1987 to 1991 have the base year of 1975 (special grouping, domestic), 1980, and 1985, respectively. The dotted line from April 1989 to March 1990 is data adjusted for value-added tax in April 1989 by subtracting the difference of the year-on-year rates between March and April 1989.
Source: Bank of Japan, *Economic Statistics Monthly/Annual*

(3) Crude Oil Price



Note: Data until 1983 are prices of imports. Data from 1984 onward are WTI monthly averages.
Sources: Toyo Keizai, *Economic Statistics Annual*; FRB St. Louis, *FRED database*

(4) Diffusion Index of Number of Employees, Principal Enterprises

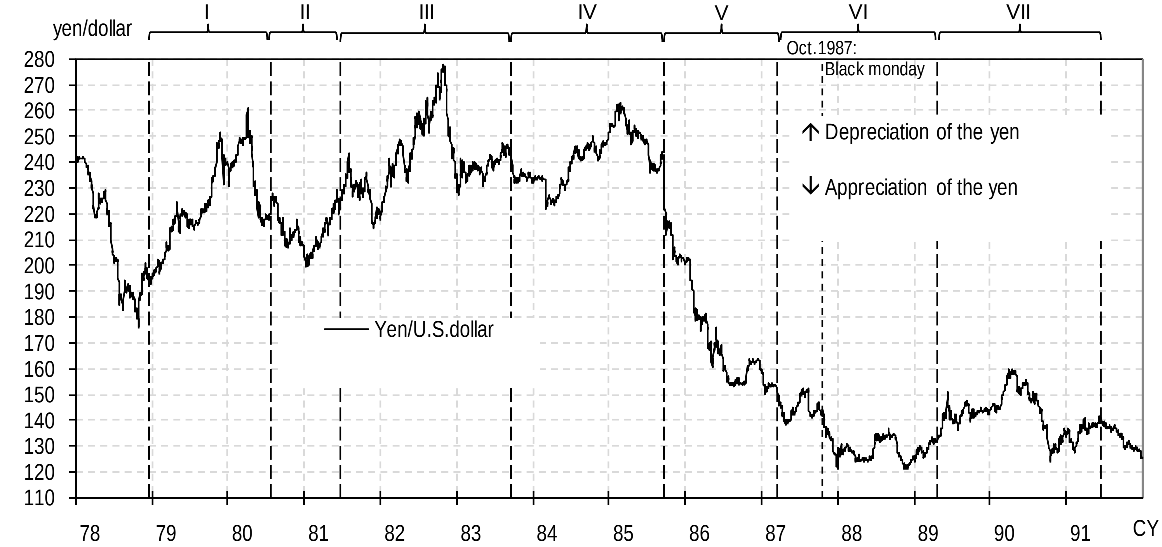


Source: Bank of Japan, *Economic Statistics Monthly/Annual*

Chart 3

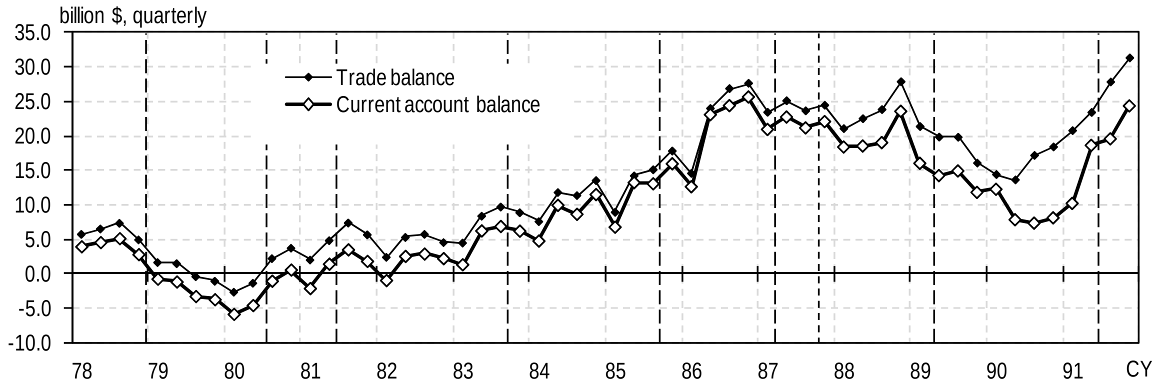
Exchange Rate, External Balance and Public Finance

(1) Exchange Rate



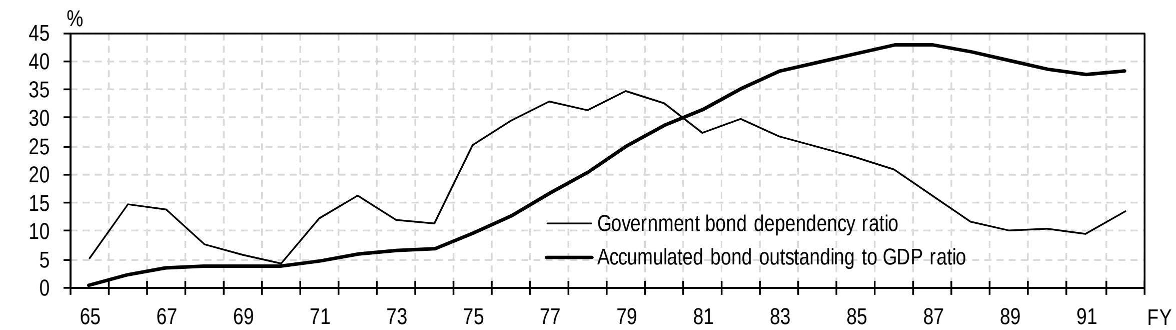
Note: Data are from the end of the day in the Tokyo foreign exchange market.
Sources: Toyo Keizai, *Kawase kinri souran* (Comprehensive interest and exchange rates); Gaikoku kawase johosha, *Gaitame nenkan* (Foreign exchange annual)

(2) External Balance



Source: Bank of Japan, *Economic Statistics Monthly/Annual*

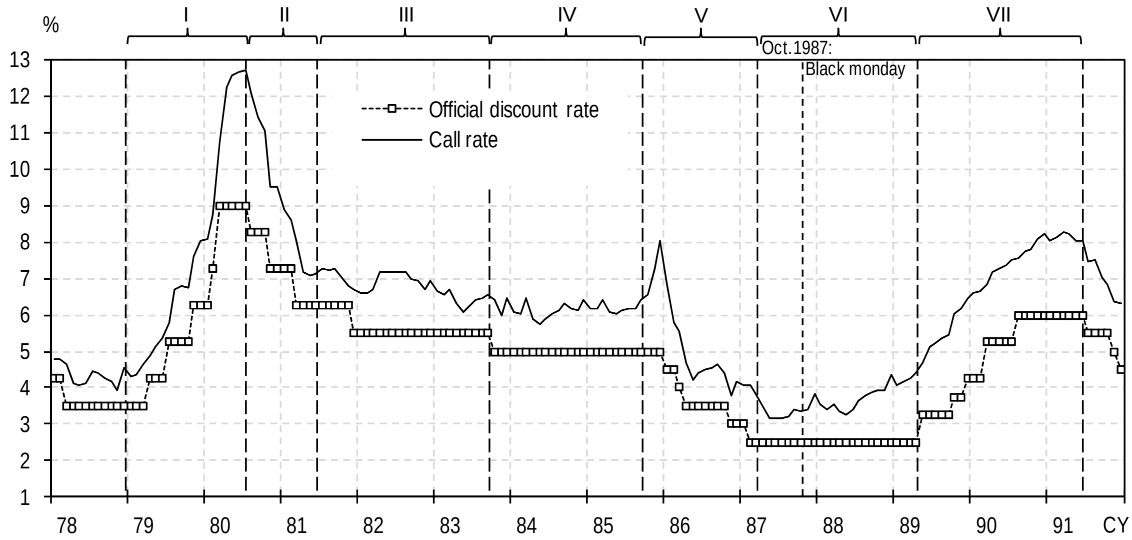
(3) Fiscal Conditions

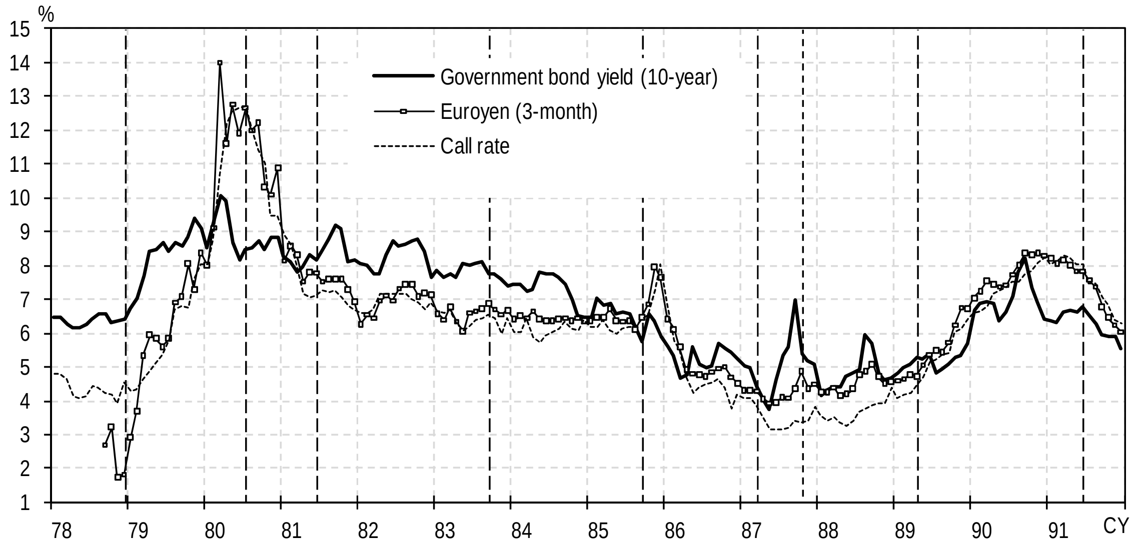


Source: Ministry of Finance, *Showa zaiseishi showa 49-63nendo dai5kan* (The history of public finance during the fiscal years from 1974 to 1988, Vol.5)

Chart 4

Interest Rates





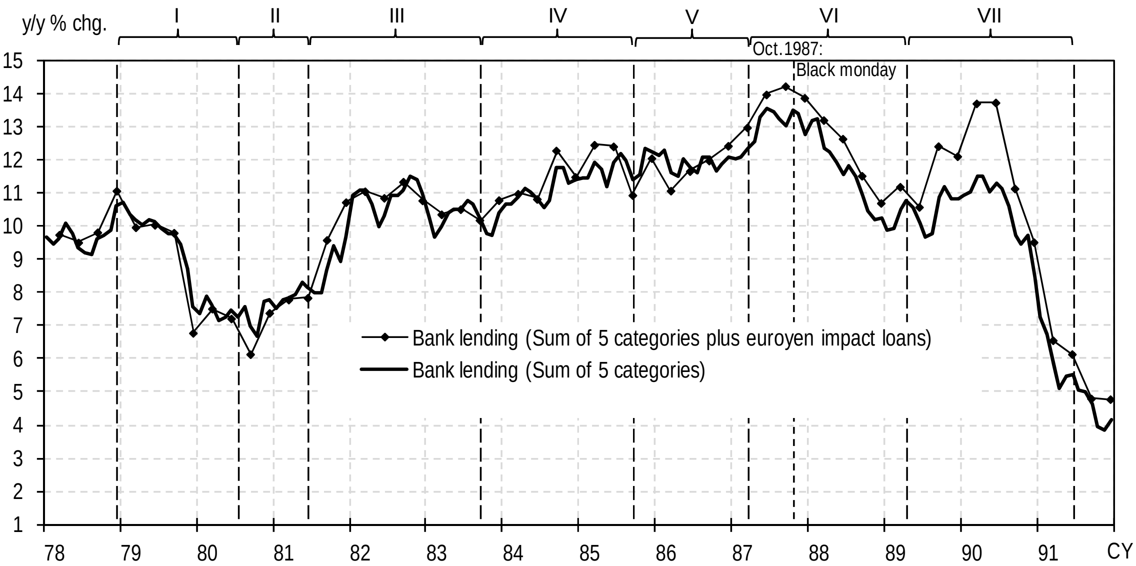
Note: The official discount rate is that at the end of month. The call rate until October 1988 and from November 1988 onward is the monthly average of overnight collateralized and uncollateralized, respectively. Government bond yield is for over-the-counter sales (end of the month). Euroyen rates are London Interbank Offer Rates on three-month deposits (monthly average).

Sources: Bank of Japan, *Economic Statistics Monthly/Annual*; IMF, *International Financial Statistics*

Chart 5

Bank Lending and Money

(1) Bank Lending

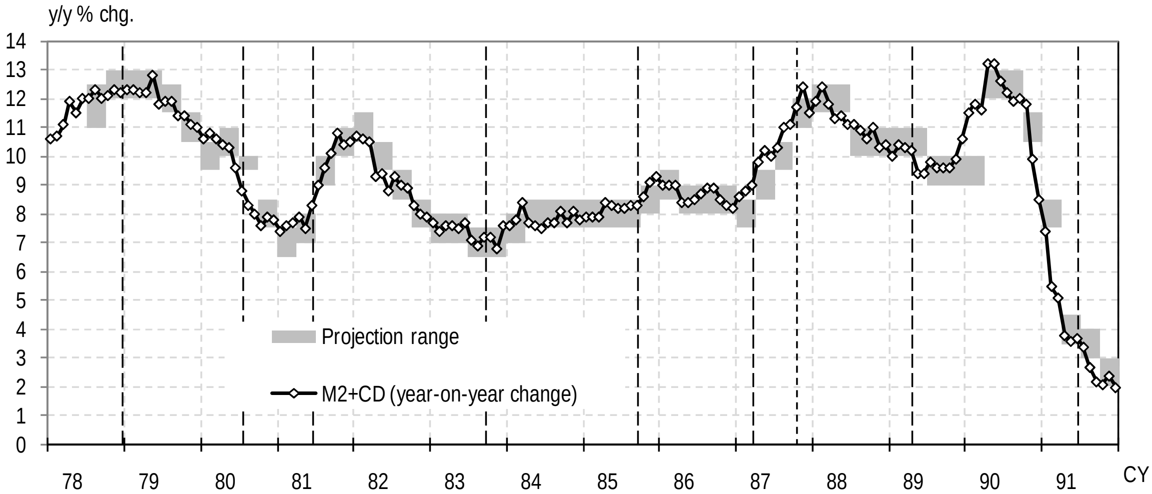


Note: Data include only those for banking accounts in five bank categories: city banks, long-term credit banks, trust banks, regional banks, and regional banks II. The figure of each month is the average of both the year-on-year rate at the end of the current month and the year-on-year rate at the end of previous month. Lending is denominated both in yen and foreign currency for both residents and nonresidents and offshore lending. Lending include only that by domestic branches, not overseas branches.

Euroyen impact loans are bank lending for domestic borrowers provided by overseas branches of Japanese banks permitted for foreign exchange business. Data are from the end of March and September each year. Data for June and December are linearly incorporated.

Sources: Bank of Japan, *Economic Statistics Monthly/Annual*; Ministry of Finance, *Ginkokyoku nenpo* (Banking bureau annual)

(2) Money

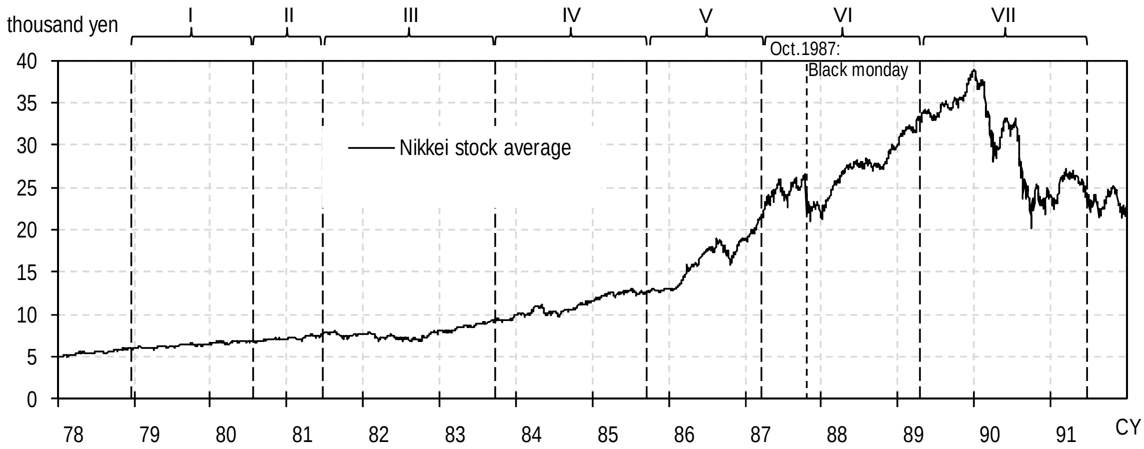


Note: Projection ranges are drawn such that a projection of “around 8 percent” covers a range from 7.5 to 8.5.

Sources: Bank of Japan, *Economic Statistics Monthly/Annual*, *Monthly Bulletin*, et al.

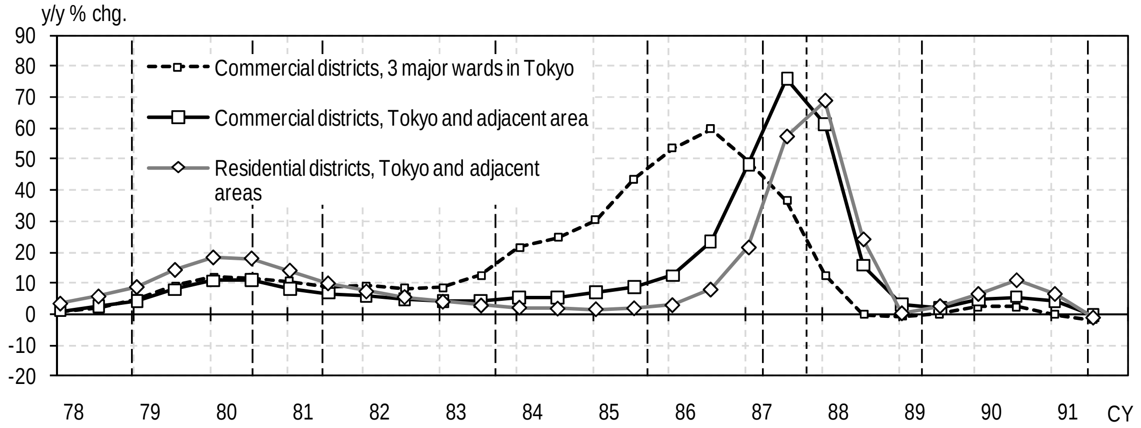
Asset Prices

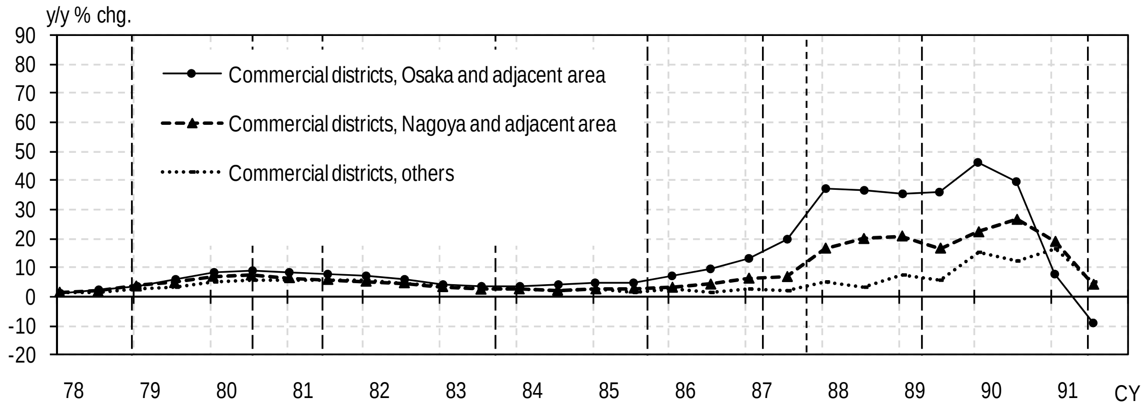
(1) Stock Prices



Source: The Nikkei Inc.

(2) Land Prices





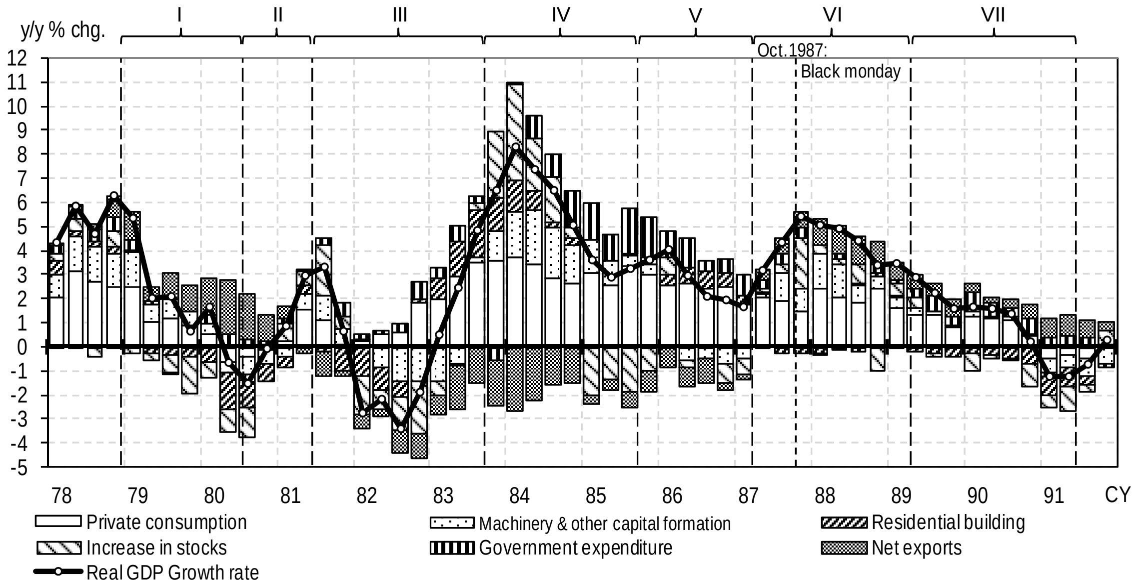
Note: The year-on-year rate at the beginning of January and July. January data are land prices officially published by the National Land Agency, and July data are prefectural land prices.

Sources: National Land Agency (currently Ministry of Land, Infrastructure, Transport and Tourism), *Officially Published Land Prices*; The Diamond Inc., *Tochikakakuno suiito bunseki* (Development and analysis of land prices)

Chart 7

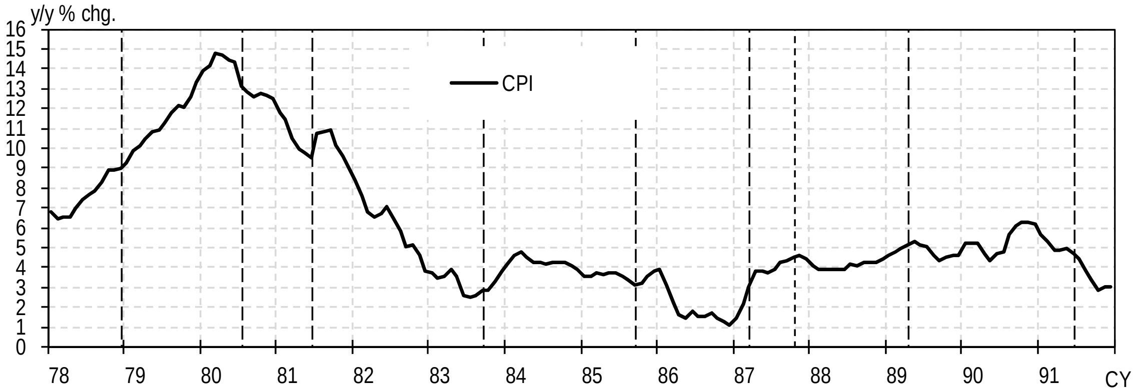
Economic Conditions in the United States (1)

(1) Real Economic Growth Rate



Note: Data until 1988 and from 1989 onward are constant prices in 1982 and 1987, respectively.
Source: OECD, *Quarterly National Accounts*

(2) Consumer Price Index



Source: Department of Labor, Bureau of Labor Statistics

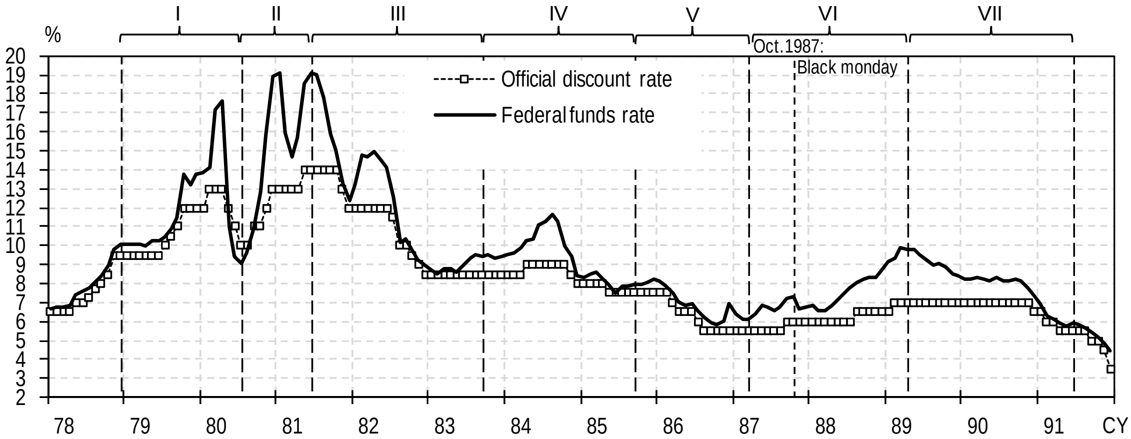
(3) Unemployment Rate

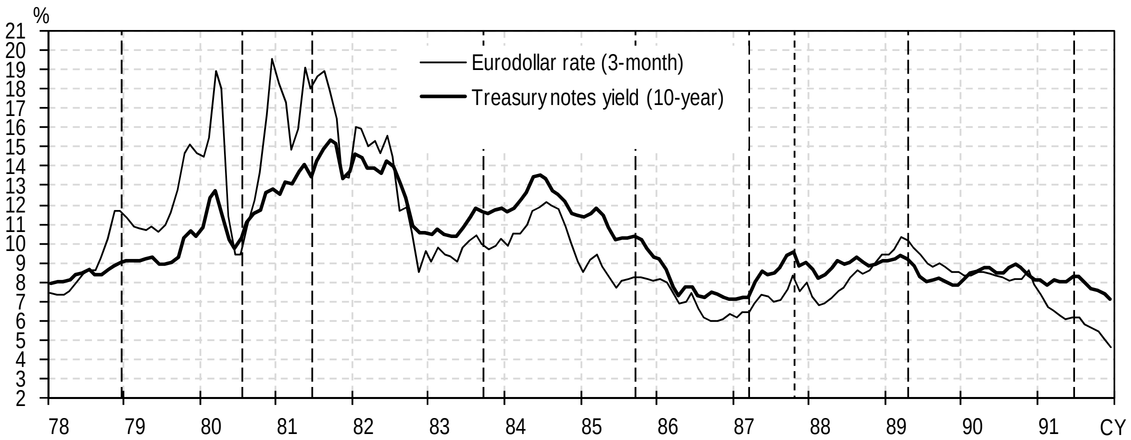
Note: Nonagricultural industries, civilian labor force, seasonally adjusted.
Source: Department of Labor, Bureau of Labor Statistics

Chart 8

Economic Conditions in the United States (2)

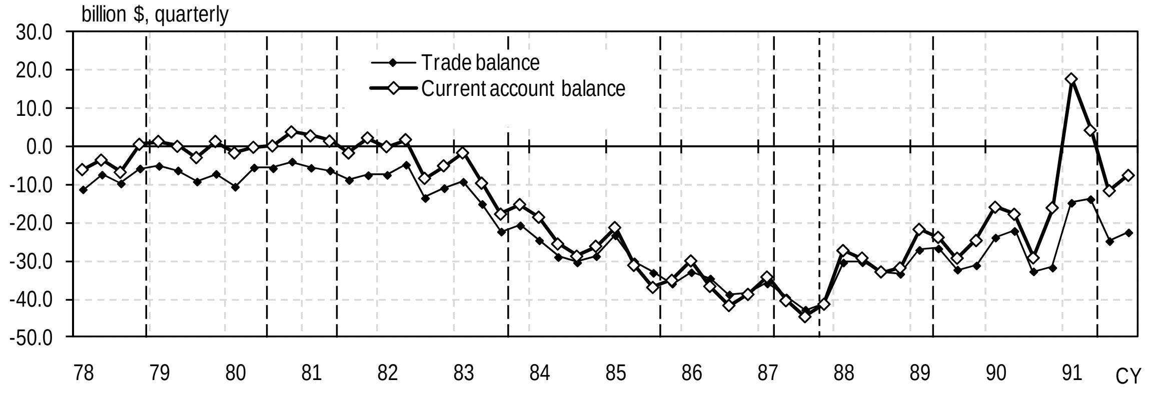
(1) Interest Rates





Note: The official discount rate is that at the end of the month. The federal funds rate, eurodollar rate, and treasury notes yield are monthly averages.
Sources: Bank of Japan, *Foreign Economic Statistics Annual* and *Economic Statistics Monthly*; IMF, *International Financial Statistic*; Nomura Research Institute, *Shouken toukei youran* (Securities statistics directory)

(2) External Balances

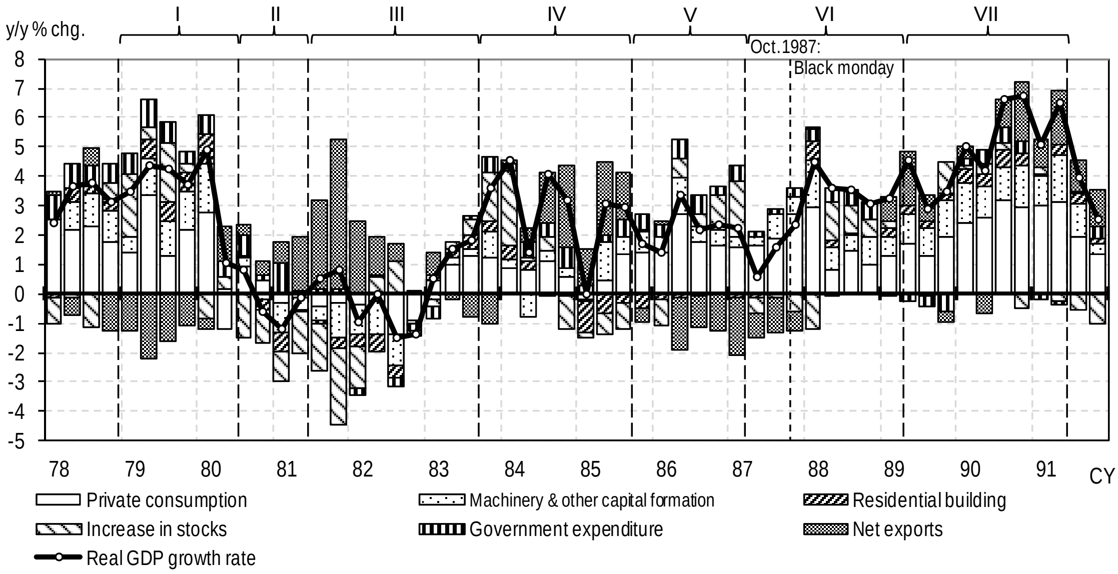


Source: IMF, *International Financial Statistics*

Chart 9

Economic Conditions in West Germany (1)

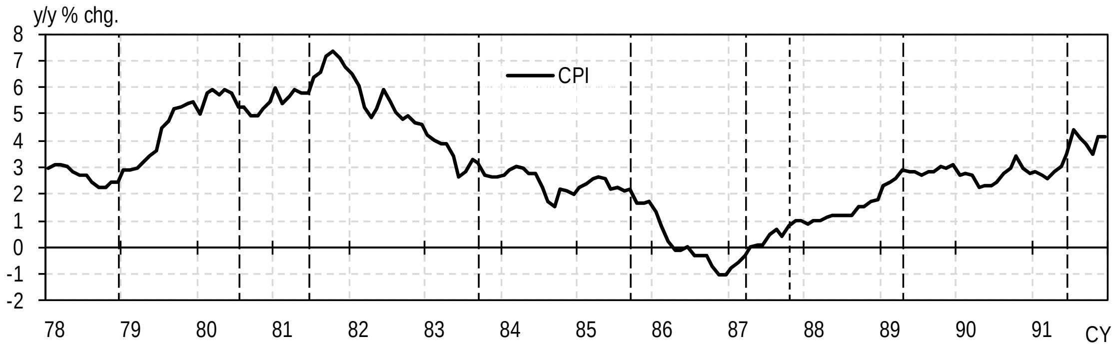
(1) Real Economic Growth Rate



Note: Data until 1988 and from 1989 onward are constant prices in 1980 and 1991, respectively. Data from October 1990 onward covers the area of former West Germany.

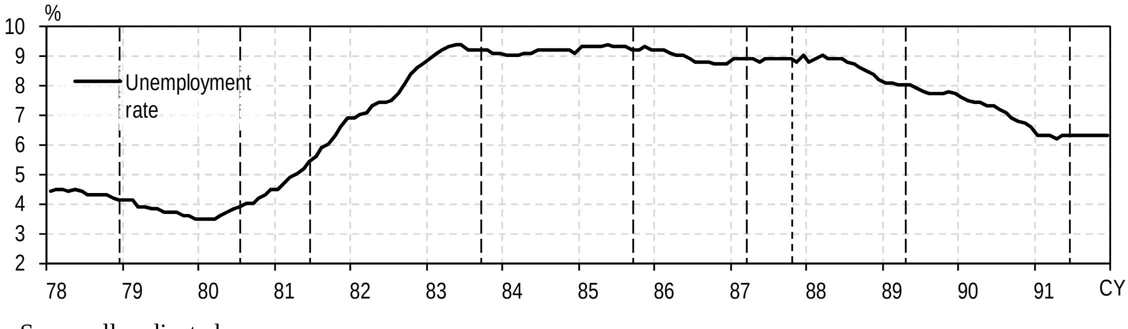
Sources: OECD, *Quarterly National Accounts*

(2) Consumer Price Index



Source: IMF, *International Financial Statistics*

(3) Unemployment Rate



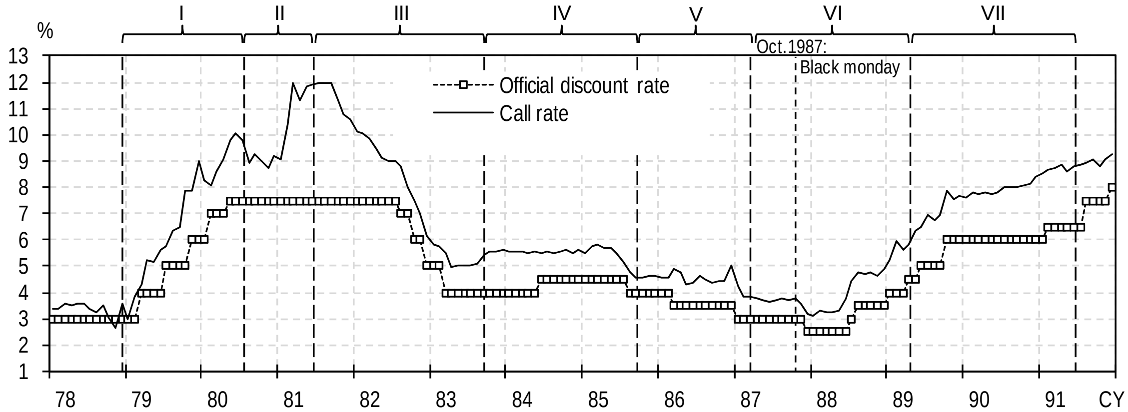
Note: Seasonally adjusted.

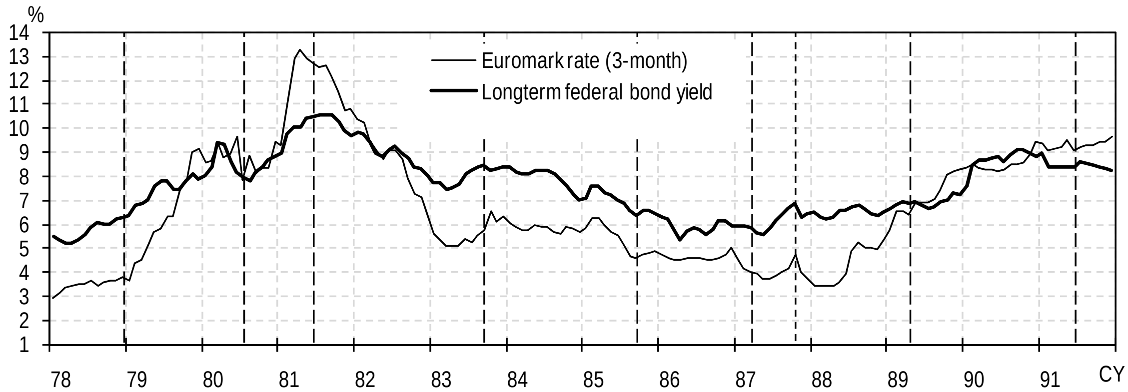
Source: OECD, *Historical Statistics*

Chart 10

Economic Conditions in West Germany (2)

(1) Interest Rates

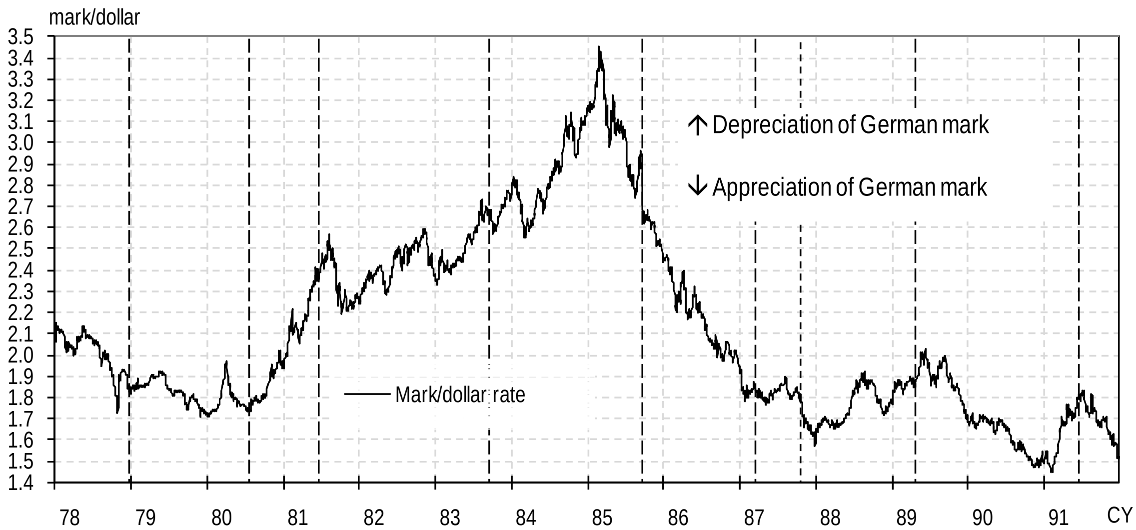




Note: The official discount rate is that at the end of the month. The call rate, euromark rate, and long-term federal bond yield are monthly averages.

Sources: Bank of Japan, *Foreign Economic Statistics Annual* and *Economic Statistics Monthly*; IMF, *International Financial Statistics*; Nomura Research Institute, *Shouken toukei youran* (Securities statistics directory)

(2) Exchange Rate

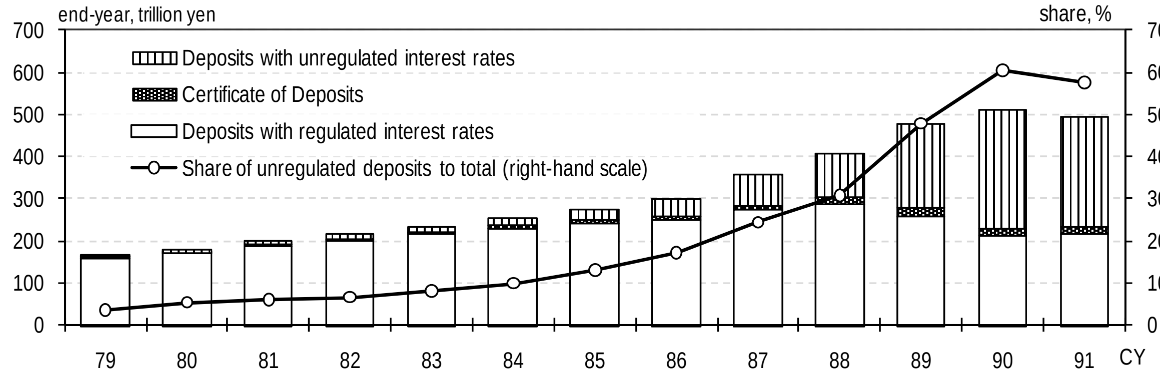


Source: Bloomberg

Chart 11

Progress in Financial Deregulation

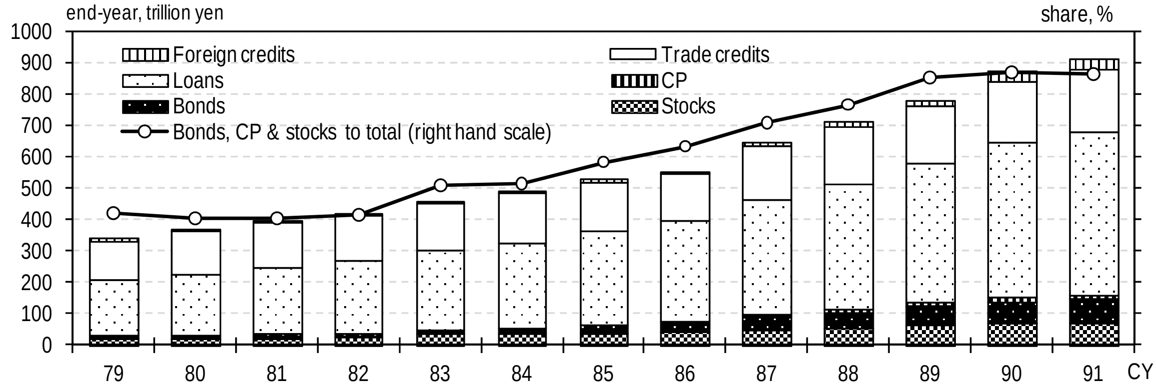
(1) Increase in Time Deposits with Unregulated Interest Rates



Note: Deposits with unregulated interest rates are the sums of: time deposits with unregulated interest rates, money market certificates (MMC), small denomination MMC, nonresident yen deposits and foreign currency deposits in five bank categories (city banks, long-term credit banks, trust banks, regional banks, and regional banks II [formerly *sogo* banks of mutual loan business]).

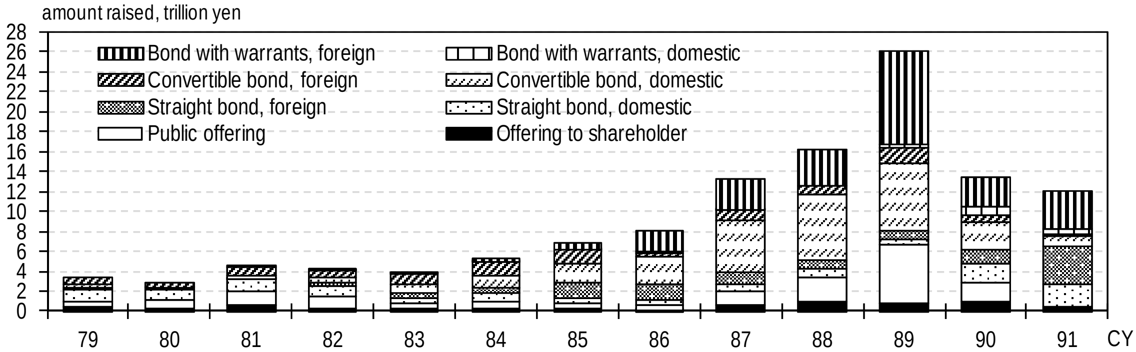
Source: Bank of Japan, *Economic Statistics Annual*

(2) Firms' Funding from the Flow of Funds



Source: Bank of Japan, *Economic Statistics Annual*

(3) Firms' Security Financing



Source: Tokyo Stock Exchange, *Annual Securities Statistics*

Chart 12

Major Events in the 1980s

Year	Month	Events	Prime Minster	Finance Minister	BOJ Governor
1978	 Dec.	 Second oil crisis	Takeo Fukuda (Dec.1976–) Masayoshi Ohira (Dec.1978–)	Tatsuo Murayama (Nov.1977–) Ippei Kaneko (Dec.1978–)	Teiichiro Morinaga (Dec.1974–)
’79	Apr.	BOJ starts to raise the official discount rate (until Mar. 1980)		Noboru Takeshita (Nov.1979–)	Haruo Mayekawa (Dec.1979–)
’80	Aug.	BOJ starts to lower the official discount rate (until Dec. 1981)	Zenko Suzuki (Jul.1980–)	Michio Watanabe (Jul.1980–)	
’81	Jan. Apr. –Jun.	The Reagan administration starts “Window guidance” allowing commercial banks to lend as they wish (until Mar. 1987)			
’82	Mar.	BOJ raises short-term interest rates without a change in the official discount rate (until fall 1982)	Yasuhiro Nakasone (Nov.1982–)	Noboru Takeshita (Nov.1982–)	
’83	Oct. Nov.	Official discount rate is lowered Official visit of U.S. President Reagan to Japan			
’84	May	Publication of the “Yen-Dollar Meeting Report”			Satoshi Sumita (Dec.1984–)
’85	Sep. Oct.	Plaza accord BOJ leaves short-term interest rates at a higher level (until Dec. 1985)			
’86	Jan.	BOJ starts to lower the official discount rate (until Feb. 1987)		Kiichi Miyazawa (Jul.1986–)	
’87	Feb. Oct.	Louvre accord Black Monday	Noboru Takeshita (Nov.1987–)		
’88	Nov.	Money market reforms jointly by BOJ and money market dealer		Noboru Takeshita (Dec.1988–) Tatsuo Murayama (Dec.1988–)	
’89	May	BOJ starts to raise the official discount rate (until Mar. 1980)	Sosuke Uno (Jun.1989–) Toshiki Kaifu (Aug.1989–)	Ryutaro Hashimoto (Aug.1989–)	Yasushi Mieno (Dec.1989 – Dec.1994)
’90	Aug.	Iraq invades Kuwait			
’91	Jun. Jul.	Abolition of “window guidance” BOJ starts to lower the official discount rate	Kiichi Miyazawa (Nov.1991– Aug.1993)	Toshiki Kaifu (Oct.1991–) Tsutomu Hata (Nov.1991– Dec.1992)	

Chart 13

Major Economic Friction between Japan and the United States

- Textiles
  Jan. 1962: Long-term arrangement regarding the international trade in cotton textiles
  Jan. 1972: Extension of the arrangement and tightening of voluntary export restraint

- Iron and steel industry
  Jun. 1966: Start of voluntary export restraint
  Jan. 1969: Tightening of voluntary export restraint
  Feb. 1978: Start of "trigger price system" (antidumping investigation for prices below predetermined trigger prices)

- Color TV sets
  Mar. 1968: Anti-dumping lawsuit against Japanese manufacturers
  Jul. 1977: Start of voluntary export restraint

- Automobile industry
  May 1981: Start of voluntary export restraint (1.68 million cars per year, until Mar. 1984)
  Apr. 1984: Extension of voluntary export restraint (1.85 million cars per year)
  Apr. 1985: Extension of voluntary export restraint (2.3 million cars per year, until Apr. 1990)

- Financial industry
  Nov. 1983: Official visit of President Reagan to Japan
  May 1984: Publication of the "Yen-Dollar Meeting Report"

- Semiconductors
  Jun. 1985: Filing of a Section 301 petition under the Omnibus Trade Act to the USTR and anti-dumping lawsuit against Japanese manufacturers by the U.S. Semiconductor Industry Association
  Sep. 1986: Signing of the Japan-U.S. semiconductor trade agreement (expansion of opportunities to the Japanese market; prevention of dumping)
  Apr. 1987: Sanction in response to Japan's inability to enforce the agreement (raising tariffs an additional 100%)

- Macroeconomic policy
  Sep. 1985: Plaza accord
  May 1986: Baker's proposal regarding "multilateral surveillance"
  Oct. 1986: Baker's meeting with Miyazawa and announcement of the joint communiqué by the U.S. Secretary of Treasury and Japanese Minister of Finance
  Feb. 1987: Louvre accord

- Structural impediments initiative
  May 1989: The U.S. Trade Representative identified Japan as an unfair trading partner regarding trades in sectors such as supercomputers.
  Jun. 1990 : Joint report on the Structural Impediments Initiative by the U.S.-Japan working group

Sources: *Tsusho hakusho 1990* (Report of trade and commerce in 1990); Komine (2011), et al.