

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

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

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

*BOJ policymakers partly forecasted the course of events. First, the BOJ started underwriting during the Takahashi economic policy period (1931–36). Once it started, it was difficult for the BOJ to stop underwriting bonds. The BOJ was forced to continue underwriting deficit-financing bonds because of expanding financial demand. Second, the MOF used very complex and irregular budgeting methods beginning with the budget process of fiscal 1936. This created a large deferred fiscal burden that concealed the realities of fiscal deficits.*

Keywords: Direct underwriting of deficit-financing bonds by the BOJ (BOJ underwriting); Joint Research Committee; Currency system; Market operation by selling government bonds; Continuing expenditure; Deferred fiscal burden

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## I. Introduction

Finance Minister Junnosuke Inoue's lifting of the gold embargo in Japan in January 1930 and shifting to a tight fiscal policy (the so-called Inoue economic policy, 1929–31) caused an outflow of specie and severe deflation. The exhausted economy and spread of military action in China (the Manchurian incident) required an expansion of public finance. During this critical period, an experienced finance minister, Korekiyo Takahashi, returned to office. The shift to an active fiscal and monetary policy and the introduction of a virtual fiat money system (the so-called Takahashi economic policy, 1931–36) enabled the government to meet its new fiscal requirements, such as those stemming from sending troops to Manchuria, and public works expenditures.

To appropriate additional sources of fiscal revenue, the BOJ started direct underwriting of new deficit-financing bonds (BOJ underwriting) on November 25, 1932. As became clear later in the course of self-criticism by the BOJ and the Ministry of Finance (MOF), this was a very important decision in the financial history of Japan.<sup>1</sup> Therefore, innumerable attempts have been made to clarify the economic effects of BOJ underwriting.<sup>2</sup> On the other hand, little effort has been made to evaluate the “politico-economic” aspects, such as the policy formation process, the decision-making process, and the implementation process of BOJ underwriting. This paper thus examines the issue of BOJ underwriting from a politico-economic viewpoint and indicates that Inoue's subordinates (in the MOF and the BOJ) argued for a more expansive monetary and fiscal system even under tight budget conditions.

First, this study examines the policy formation process. On this point, previous works point out that Takahashi's ideas and efforts were based on advice from Eigo Fukai, BOJ Vice-Governor, who emphasized the need to stimulate business by supplying money through the financial market operation of buying GBs (buying operations). The impact on the Japanese economy of Fukai's proposal and Takahashi's decision is well known.<sup>3</sup> However, it is unclear why Takahashi chose BOJ underwriting over buying operations, even though the former was a more direct way of granting credit to the government than the latter. Shima (1983), who emphasized the personal relationship between Takahashi and Fukai, has written the only study on this issue. Due to the lack of records, the roles of political actors other than Takahashi and Fukai, and the thoughts of other members of the MOF and the BOJ concerning policy and system design, are unclear.<sup>4</sup>

Second, this study investigates the decision-making process. Most research examining political interaction between the MOF and the BOJ assumed a “financial

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

2. For a discussion on the changes in economic structure after BOJ underwriting, see Nakamura (1994), lecture No. 2.

3. See Bank of Japan (1970) and Miwa (1979).

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

subordination hypothesis,”<sup>5</sup> which asserts that monetary policy was subordinate to fiscal policy. In previous literature, the BOJ has been regarded as a passive agent, lacking the capacity for making independent decisions. Also, the BOJ’s ideological confrontations and compromises with the MOF have rarely been discussed. However, we should pay attention to the BOJ’s advantages in monetary control. This study shows that BOJ officials did not consistently oppose underwriting, although they were basically cautious about it, and that discretionary selling operations were systematized in exchange for accepting the underwriting because the BOJ officials wanted to reinforce their influence over financial institutions.

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

This paper is organized as follows. Section II examines the views and system design of the BOJ and MOF officials in relation to the monetary system and BOJ underwriting. It has been generally assumed that BOJ underwriting was initiated because the BOJ was persuaded by Takahashi’s firm request and accepted it as a temporary measure.<sup>6</sup> This paper reexamines this assertion and clarifies the origins of the new monetary control system and the BOJ underwriting, by analyzing discussions from the Joint Research Committee of the MOF and BOJ for Improving the BOJ System (the Joint Research Committee), established in February 1930. In Section III, the relationship between fiscal and monetary policy is discussed. In the Takahashi economic policy period, as business recovery emerged, the issuance of deficit-financing bonds was reduced and domestic prices were stabilized (the shift to a tight fiscal policy, 1935–36). However, this process adopted very problematic budgeting methods and the shift to a tight money policy failed. Consequently, the BOJ underwriting continued.

## **II. The BOJ and the MOF in the Joint Research Committee**

### **A. Discussions of the Currency System and the Limits of the BOJ’s Purchase of GBs**

Discussion of the BOJ’s institutional reform started with the establishment of the Research Committee on Financial Systems in 1926.<sup>7</sup> Its establishment was an MOF

5. This term is from Mabuchi (1994). Although the expression is different, see also Endo (1954) and Ouchi (1976). For discussion of the relationship between monetary and fiscal policy, see Colm (1955) and Schmolders (1981).

6. Bank of Japan (1984), p. 54.

7. Yoshino (1962), chapter 2, section 4.

initiative, and it tended to reflect MOF opinions.<sup>8</sup> After the report “Research on the Commercial Bank System” was submitted to this committee, the Banking Law was formulated in 1927. The document “Research on the BOJ” was drawn up in June 1927 and addressed reforms in the central banking system,<sup>9</sup> which could be regarded as a summation of the arguments for BOJ reform in the second half of the Taisho Period.<sup>10</sup> However, due to the financial crisis in March 1927, the committee never deliberated on the reforms. After this crisis passed, the MOF and the BOJ agreed to reexamine the central banking system. Thus, in February 1930, the Joint Research Committee was established as an unofficial entity,<sup>11</sup> and it would continue functioning until 1931. Although the results of this committee’s arguments were never enacted either, due to the Manchurian incident, the contents are both extensive and bold. The members discussed banknote issuance systems, organization, business activities (especially the relationship between the central bank and the market, and matters that needed authorization of the government), payment to the government, arrangement of statutes, and other issues. I will now clarify the historical position of the report of the 1930–31 Joint Research Committee, by comparing it with the final version of “Research on the BOJ,” which was drawn up by the 1927 Research Committee on Financial Systems.

First, members of the MOF and the BOJ were interested in discussing a system of banknote issuance. At the time, the Japanese banknote issuance system was called the “elastic limit system.” Under this system, banknotes were issued as a statutory issue dependent on specie reserves, as a fiducial issue subject to certain limits by legislation, and as an excess issue. The excess issue was regarded as exceptional, and the BOJ had to pay a tax on it. However, the outflow of gold after the lifting of the gold embargo in January 1930 made excess issuance a normal condition. The BOJ and the MOF both regarded this condition as problematic,<sup>12</sup> and were inclined to make the banknote issuance system flexible. They stated that “the chief aim of the system of banknote issuance is not only to secure convertibility but also to maintain the flexibility of the currency.”

“Research on the BOJ” opted to revise upward the maximum limit of fiduciary issue. In August 1928, the MOF expressed its intention to adopt a proportional reserve system as follows: “As a reserve specie for conversion, the BOJ can hold either gold coins, gold bullion, silver coins, or silver bullion the equivalent to at least 40 percent of the total amount of banknotes issued.”<sup>13</sup> This implies that the limit of banknote issuance was 2.5 times that of the specie reserve. Given that the amount of BOJ specie holdings was ¥826 million in 1930, BOJ banknote issuance of ¥2,065 million was theoretically possible.

This was a substantial extension compared with the maximum limit of fiduciary issue at that time (¥120 million). It is unlikely that the MOF planned such an

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8. Yoshino (1962), p. 283. The Preparatory Committee on Financial Systems was established by the MOF. The Chief Secretary to the Exchequer was the chairman, and the MOF’s highest officials were committee members.

9. Bank of Japan (1973).

10. Yoshino (1962), p. 289.

11. “The Report for Improving the BOJ’s System, Vol. 1, No. 1-1,” the first meeting, BOJ archive.

12. “Nihon-Ginko-Enkakushi (The Collection of Historical Records of the Bank of Japan), Series 3, Overview 1.”

13. “The Report for Improving the BOJ’s System, Vol. 1, No. 1-1,” the first meeting, BOJ archive.

extreme expansion of currency issue under the tight fiscal rules of the gold standard. Rather, it seems that the MOF's real aim was to control or restrain specie and make banknote issuance flexible by adopting a proportional reserve system.<sup>14</sup> Just after returning to the gold standard in December 1929, the specie reserve was ¥1,073 million. However, it decreased by ¥309 million during 1930 and by an additional ¥400 million by the end of 1931, and the amount of BOJ note issuance also decreased by about ¥200 million during 1930. Since the BOJ and the MOF maintained a high interest rate policy to reduce specie outflow, bank loans decreased and the depression deepened further. Consequently, a sharp decrease in tax revenues resulted, leading to a decline in revenue, which significantly damaged the credibility of the MOF's fiscal and monetary control.<sup>15</sup>

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

The BOJ responded to the MOF's above discussion in the Joint Research Committee as follows:<sup>16</sup>

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

However, as a BOJ committee member stated, the BOJ was neither directly opposed to the proportional reserve system nor seriously concerned with the choice of a banknote issuance system. Rather, whichever system was adopted, the central

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14. In "A Proposal from the Tokyo Chamber of Commerce & Industry," the members of the Tokyo Chamber of Commerce & Industry proposed a proportional reserve system as follows: "By adopting a proportional reserve system, it will be possible to save specie or increase flexibility of convertible note issue." See Bank of Japan (1973).

15. Ministry of Finance (1969), p. 24.

16. "The Report for Improving the BOJ's System, Vol. 1, No. 1-1," the fifth meeting, BOJ archive.

bank executives considered it necessary to impose a maximum limit on banknote issuance, or to limit a fiduciary issuance by some method.<sup>17</sup> That is, the BOJ's main concern was systematic control of the amount of the currency issue.

Consequently, agreement was reached on the following two points.<sup>18</sup>

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

The BOJ then worked out the following compromise on the framework of the currency system. "We should basically maintain the present elastic limit system and then appropriately extend a maximum limit of fiduciary issue. When adding a factor for the proportional reserve system, we should clarify the relationship between the amount of banknote issuance and specie holdings. If so, we can construct a system where the amount of the maximum fiduciary issue can be settled automatically and which adequately improves the present system without giving the impression that the present system is fundamentally revised."<sup>19</sup> As a result, the Joint Research Committee agreed upon a new banknote issuance system, which combined a fiduciary issuance system with a proportional reserve system. It would have a maximum fiduciary issuance limit of ¥500 million, and a minimum ratio of specie reserve exceeding 30 percent of the amount of the convertible note issue.<sup>20</sup> It was a compromise for the BOJ in that it agreed to adopt a proportional reserve system, which had been rejected in "Research on the BOJ."<sup>21</sup> However, the currency issue would be restricted as the BOJ desired.

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

On this point, "Research on the BOJ" stated that "the amount of a fiduciary issue not including commercial bills should be less than ¥120 million," to "avoid excess convertible note issuance." However, at the same time, this document argued "since we have introduced the effective restriction on the amount of the fiduciary issue, there is no risk of the BOJ holding excess GBs and issuing excess convertible notes. So there is no need to set a legal restriction on the purchase limit for GBs or the amount of loans secured by GBs." Thus, there was no purchase limit on GBs, because there was a natural limit to the purchase amount of GBs as securities for

17. "The Report for Improving the BOJ's System, Vol. 1, No. 1-1," the 14th meeting, BOJ archive.

18. "The Report for Improving the BOJ's System, Vol. 1, No. 1-1," the 13th meeting, BOJ archive.

19. "The Report for Improving the BOJ's System, Vol. 1, No. 1-1," the 14th meeting, BOJ archive.

20. During the Takahashi economic policy period in June 1932, Finance Minister Takahashi and the MOF carried out a bold reform of the currency system. The content of the reform was similar to these agreements, and we can easily see that the discussion by the Joint Research Committee was closely connected with Takahashi's reform.

21. The BOJ criticized a proportional reserve system in "Research on the BOJ," because this system would cause too much flexibility in a banknote issue. See Bank of Japan (1983), p. 338.

a fiduciary issue and this guaranteed the stability of a currency issue. At that time, the policymakers probably assumed that the gold embargo would eventually be lifted. If so, they felt a policy of increasing a currency issue through purchasing GBs was unrealistic.

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

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

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

In the Joint Research Committee, the MOF opposed this proposal as follows: first, if GBs held by the BOJ were sold off in market operations and additional GBs were underwritten, this was a *de facto* increase in underwriting. In this case, a purchase limit was meaningless. Second, if a purchase limit on GBs were set, currency could not be flexibly supplied.<sup>29</sup> However, one BOJ participant asserted, "It is very difficult to directly restrict the amount of GB holdings. So if we try to maintain a purchase limit on GBs to prevent the danger of an expanding currency

22. "The Report for Improving the BOJ's System, Vol. 1, No. 1-1," the 33rd meeting, BOJ archive.

23. "The Report for Improving the BOJ's System, Vol. 1, No. 1-1," the 34th meeting, BOJ archive.

24. Suzuki (1966), footnote 82.

25. "The Report for Improving the BOJ's System, Vol. 1, No. 1-1," the 29th meeting, BOJ archive.

26. Besides this plan, there was also an August 1928 plan concerning a purchase limit on GBs. The MOF agreed to the BOJ's offer, setting a purchase limit, on the condition that it adopted the proportional reserve system. This plan indicated that government bills and GBs should not exceed the maximum 40 percent limit of a fiduciary issue. However, the Joint Research Committee determined that it would discuss the criteria of eligible securities for fiduciary issue after examining actual figures, and the agreement was withdrawn in 1928.

27. "The Report for Improving the BOJ's System, Vol. 1, No. 1-1," the 33rd meeting, BOJ archive.

28. "The Report for Improving the BOJ's System, Vol. 1, No. 1-1," the sixth meeting, BOJ archive.

29. "The Report for Improving the BOJ's System, Vol. 1, No. 1-1," the 33rd meeting, BOJ archive.

issue by BOJ underwriting, we should limit the holding of GBs appropriated for a fiduciary issue.<sup>30</sup> The dominant opinion was that BOJ appropriation of GBs should be allowed only within the limit of a fiduciary issue and not as an excess issue. Although it was the second-best solution, the BOJ assertion was temporarily accepted. However, a final decision was postponed, as further discussion on the organization and management of the BOJ was necessary.<sup>31</sup>

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

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

## **B. The Absence of Regulation of Government Financing and Selling Operations**

In 1930, the Joint Research Committee discussed new regulations concerning monetary control of the BOJ in "The Issue of Improving BOJ Operations."<sup>34</sup> The following five subjects were identified as proper business for the BOJ.

1. Discounting of bills issued by the government such as financing bills (FBs), and discounting of bills such as commercial bills and banker's acceptance bills.
2. Loans on securities such as GBs, and on silver or gold bullion, foreign currency or commodities, and foreign exchange bills.

30. "The Report for Improving the BOJ's System, Vol. 1, No. 1-1," the 29th meeting, BOJ archive.

31. "The Report for Improving the BOJ's System, Vol. 1, No. 1-1," the 33rd meeting, BOJ archive.

32. "April 1931, Explanation of the Revised Clause in BOJ Regulations," in "Documents concerning a Meeting about Revising BOJ Regulations, Volume 2," BOJ archive.

33. "Nihon-Ginko-Enkakushi (The Collection of Historical Records of the Bank of Japan), Series 3, Overview 1."

34. "Nihon-Ginko-Enkakushi (The Collection of Historical Records of the Bank of Japan), Series 3, Overview 1." We can regard this document as a compilation of discussions about the reform of the central banking system in the Inoue period.

3. Dealings in commercial bills or banker's acceptance bills.
4. Application, underwriting, sale, and purchase of GBs and bills issued by the government such as FBs.
5. Temporary and unsecured loans to the government, other than those referred to in item 2.

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

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

At that time, financing of the government was "to be in the form of government securities such as FBs in principle."<sup>36</sup> That is, unsecured finance to the government was restricted unconditionally. However, as FB issuance had reached its limit,<sup>37</sup> reflecting the deepening depression and the sharp decrease in tax revenues, it became difficult for the government to be financed only through the underwriting of FBs. Therefore, for the time being, the MOF and the BOJ determined that the BOJ could also lend without discounting securities. In these circumstances, unsecured finance to the government was stipulated.

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

First, strengthening intervention in the market had become an urgent priority for the BOJ. This contrasts with a decrease in the BOJ's ordinary loans and in its influence over financial institutions.<sup>38</sup> At the time, the BOJ recognized that it was difficult to impose monetary control through large banks because Japan's five major banks enjoyed increased power and could disregard BOJ commands.<sup>39</sup> Under such conditions, the BOJ could have extended business relations with only minor banks and individual customers. However, the Joint Research Committee stressed that "the BOJ should not be satisfied with being the bank of commercial banks. Rather, it

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35. Yoshino (1962), p. 315.

36. "April 1931, Explanation of the Revised Clause in BOJ Regulations," BOJ archive.

37. The maximum limit of an FB issue was to be ¥100 million by regulation of Article 6 in the Public Account Law. However, the limit was immediately expanded to ¥150 million in fiscal 1930 and to ¥250 million in fiscal 1931, and the frequency of its issue increased rapidly (six times in fiscal 1929, 19 times in fiscal 1930, and 19 times in fiscal 1931).

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

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

should be the central organization of all financial institutions.” Therefore, “it is not appropriate to conduct individual dealings and to compete with other commercial banks in our country’s present condition.”<sup>40</sup> Consequently, policies were proposed not to increase individual dealings but to promote the development of financial markets and strengthen relations between the BOJ and markets through open market operations.<sup>41</sup>

However, such open market operations were assumed to be selling operations. In 1930, maintaining the gold embargo required high interest rates, and business conditions became very serious, so the demand for funds decreased. On the other hand, the BOJ held a large amount of long-term fixed-relief loans and there was a surplus of bank funds. Therefore, the financial markets eased, the dependence on BOJ ordinary loans decreased, and monetary control by the BOJ became more difficult.<sup>42</sup> Thus, it was indispensable for the BOJ to seek policy instruments to absorb liquidity from financial markets and increase its influence over financial institutions. This policy, which started at the beginning of the Takahashi economic policy, made the BOJ compromise on issues of BOJ underwriting and unsecured finance to the government. However, at the same time, an environment emerged where the BOJ could exert its influence over financial institutions.<sup>43</sup>

Second, in accepting the underwriting of GBs, the BOJ believed it could prevent the currency expansion through selling operations.<sup>44</sup> In October 1932, BOJ Governor Hisaakira Hijikata expressed confidence in monetary control, addressing BOJ underwriting: “As we may expect investors to purchase government bonds, BOJ underwriting of government bonds need not lead directly to the expansion of a currency issue.”<sup>45</sup>

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

40. “The Report for Improving the BOJ’s System, Vol. 1, No. 1-1,” the 30th meeting, BOJ archive.

41. “The Report for Improving the BOJ’s System, Vol. 1, No. 1-1,” the 31st meeting, BOJ archive.

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

43. Along with increasing intervention in financial markets, the selling operation was recognized as a means of adjusting money market rates. Although there were problems with BOJ underwriting, the BOJ intended to strengthen monetary control in accordance with market function.

44. One BOJ participant asserted, however, that since the term of GB redemption was quite long, if the Bank did not sell the bonds off, it could not absorb liquidity. “The Report for Improving the BOJ’s System, Vol. 1, No. 1-1,” the 34th meeting, BOJ archive.

45. “The Reference for Home Branch Managers’ Meetings,” “The BOJ’s Documents on Home Branch Managers’ Meetings, 1932, Spring-Autumn,” BOJ archive. It can be argued that as the background of the above two points, especially the latter, policy developments in foreign central banks were influential. The BOJ was investigating changes in instruments for monetary control of central banks in various countries, such as the Bank of England, the Federal Reserve, and the Reichsbank. “The Business of Central Banks in England, the United States, Germany, and France” in “The Report for Improving the BOJ’s System, Vol. 1, No. 1-2,” BOJ archive.

operations to strengthen its financial market function and maintain its influence over financial institutions and its power of market control.

### **III. The Transition of Monetary Policy and the Budget Process during the Takahashi Economic Policy Period**

This section will examine policy developments after the Joint Research Committee disbanded in 1931, and investigate the relationship between fiscal management and monetary control through selling operations during the Takahashi economic policy period. After 1932, when BOJ underwriting of GBs started, ease in selling operations was recognized as one of the policy variables for measuring fiscal soundness.<sup>46</sup> This was similar to arguments presented in the Joint Research Committee. Thus, to properly evaluate the system design in this committee, one should look at the relationship between market intervention by selling operations and fiscal management after 1932.

Table 1 shows the developments in the financing of the private sector from fiscal<sup>47</sup> 1932 to 1936, or roughly the Takahashi economic policy period. Government<sup>48</sup> payments in 1933 were extremely large. This was due to a rapid increase in the refunds of food FBs,<sup>49</sup> as well as general payments<sup>50</sup> by the government reaching the highest level during these five years. However, the massive flow of funds into the private sector in the same period was offset by the sale of GBs and FBs, especially food FBs. Consequently, the overall flow into the private sector was only ¥51.7 million in fiscal 1933, as compared to ¥395.1 million in fiscal 1932. During these years, monetary policy was dedicated to absorbing excess liquidity in the financial market.

In fiscal 1934, BOJ GB sales peaked, and general payments by the government were restrained. Consequently, the inflow of funds to the private sector turned into an outflow of ¥10.6 million. However, in looking at the figures closely, the second half of fiscal 1934 and all of fiscal 1935 provided the turning point in terms of monetary control. GB sales in the second half of fiscal 1934 were lower than the same period of the previous year. In the first half of fiscal 1935, GB sales decreased by about ¥250 million, while general spending increased slightly. These changes reflected a surge in demand for funds in the private sector. Consequently, the inflow to the private sector jumped to ¥89.8 million, the highest since fiscal 1933, when selling operations first hit their stride.

As a whole, monetary control based on selling operations succeeded through the Takahashi economic policy period. When the demand for funds in the private sector stagnated, the market liquidity, which increased rapidly due to BOJ financing of the government, was absorbed through the purchase of GBs by private financial

46. Ide (1998). As stated later, the BOJ carefully observed market trends, and as stagnation of GB sales became apparent, the BOJ advised the MOF to reduce GB issuance.

47. April to March for the respective years.

48. This section defines “government” as the national government hereafter unless otherwise indicated. Local government falls under the “private sector.”

49. The food FB was an FB issued by the government to adjust for seasonal discrepancy of funds in terms of buying and selling crops such as rice.

50. Payments by the government other than debt service.

**Table 1 Flow of Funds into/out of the Private Sector**

¥ thousands

FY		General payments by the government	Debt payments		Government payment total	GB sales by the BOJ	FB sales by the BOJ	BOJ sales total	Increase/decrease of funds in the private sector
			GBs	FBs					
1932	First half	49,800	87,900 (-95,600)	451,900 (-235,100)	258,900	0 (-10,900)	243,000 (-23,300)	208,800	50,100
	Second half	450,200	89,900 (-91,100)	233,800 (-29,800)	653,000	16,300	291,700	308,000	345,000
	Total	500,000	177,800 (-186,700)	685,700 (-264,900)	911,900	16,300 (-10,900)	534,700 (-23,300)	516,800	395,100
1933	First half	345,500	—	840,000	1,185,500	462,200	880,500	1,342,700	-157,200
	Second half	345,500	—	480,600	826,100	326,400	290,800	617,200	208,900
	Total	691,000	—	1,320,600	2,011,600	788,600	1,171,300	1,959,900	51,700
1934	First half	292,300	87,500	471,000	850,800	602,600	374,600	977,200	-126,400
	Second half	197,100	10,000	353,000	560,100	297,800	146,500	444,300	115,800
	Total	489,400	97,500	824,000	1,410,900	900,400	521,100	1,421,500	-10,600
1935	First half	314,400	—	335,800	650,200	351,700	366,700	718,400	-68,200
	Second half	156,600	189,400	419,800	765,800	303,100	304,700	607,800	158,000
	Total	471,000	189,400	755,600	1,416,000	654,800	671,400	1,326,200	89,800
1936	First half	150,100	844,400 (-694,600)	394,000	693,900	505,000	411,400 (-17,200)	899,200	-205,300
	Second half	301,600	1,217,000 (-1,145,100)	400,600	774,100	180,700	340,400	521,100	253,000
	Total	451,700	2,061,400 (-1,839,700)	794,600	1,468,000	685,700	751,800 (-17,200)	1,420,300	47,700

Note: Figures in parentheses indicate gross inflow of funds, e.g., debt payments and buying operations for GBs and FBs in 1932 and 1936.

Source: Bank of Japan, *Zaisei Kin'yu Shiryo Yoroku* (Fiscal and Monetary Indicators), various issues.

institutions. Table 2 shows developments in deposits, loans, and GB investment by banks. The table shows decreases in loans through 1934 and increases in GB investment. Through this process, the BOJ conducted financial market operations not through genuine open market operations but through negotiated transactions with financial institutions.<sup>51</sup> The BOJ exerted influence over financial institutions through allocating liquidity to each institution. Thus, it can be argued that the BOJ's policy objective in the Joint Research Committee was eventually attained.

**Table 2 Deposits, Loans, and GB Investment**

¥ thousands, except where noted

CY	1931	32	33	34	35	36
<b>Deposits</b>						
Fixed and saving accounts	4,884,929	4,766,430	5,049,272	5,514,156	6,027,987	6,686,277
Special and checking accounts	3,446,957	3,619,793	3,843,853	4,013,894	4,027,786	4,433,166
Total (A)	8,331,886	8,386,223	8,893,125	9,528,050	10,055,773	11,119,443
<b>Loans</b>						
Loans on bills and deeds	5,238,002	4,878,360	4,659,785	4,523,337	4,665,852	5,008,023
Discount bills and overdrafts	1,599,546	1,813,700	1,945,041	1,897,823	2,049,293	2,248,565
Total (B)	6,837,548	6,692,060	6,604,826	6,421,160	6,715,145	7,256,588
(A) – (B)	1,494,338	1,694,163	2,288,299	3,106,890	3,340,628	3,862,855
Banks' GB holdings	1,328,280	1,080,950	1,491,465	1,998,148	2,220,387	2,558,296
Loans/deposits (percent)	82.1	79.8	74.3	67.4	66.8	65.3
GBs/fixed and saving accounts (percent)	27.2	22.7	29.5	36.2	36.8	38.3

Source: Ministry of Finance (1939).

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

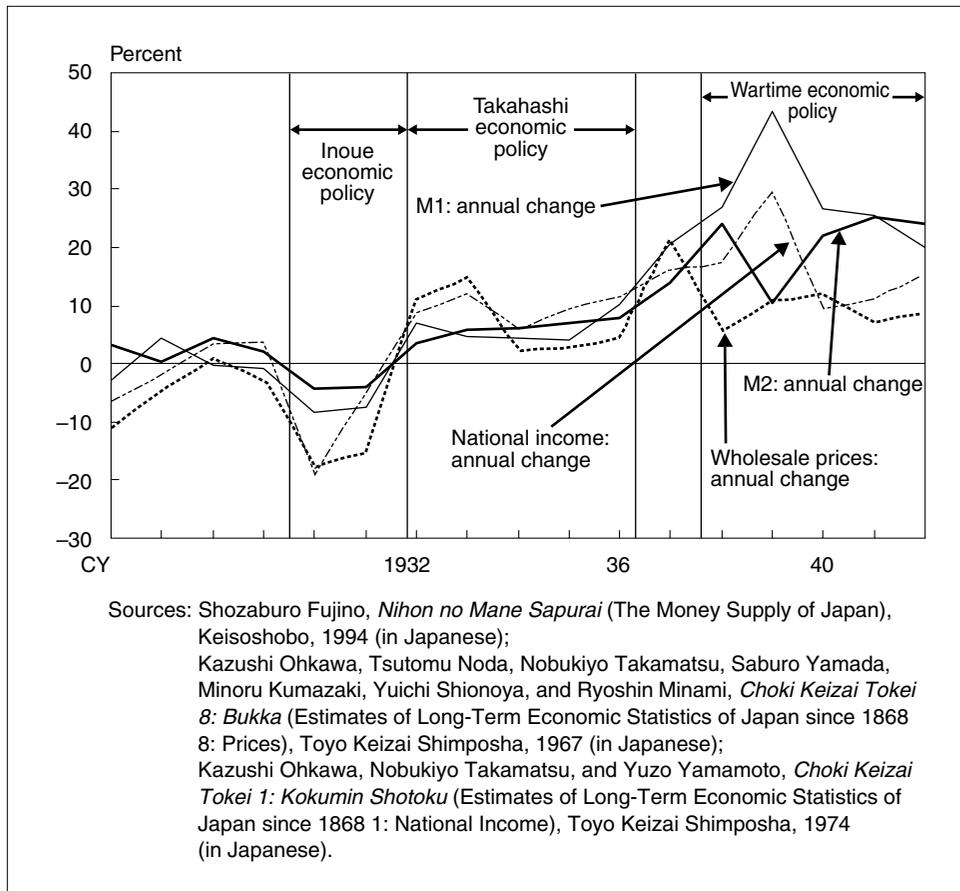
It is well known that economic recovery with low inflation was achieved. Figure 1 shows developments in the money supply, wholesale prices, and national income during this period. Although wholesale prices and money supply were very stable, national income gradually increased.

51. Bank of Japan (1984), p. 44. The BOJ determined whether to meet the offer from financial institutions for purchasing GBs after inquiring as to their finance condition. This differed considerably from open market operations in today's sense.

52. Kin'yu Kenkyu Kai (Financial Study Group) (1936), p. 58. The Kin'yu Kenkyu Kai asserted that it expected fiscal expenditures to promote the business sector's recovery from depression, but that monetary control by selling operations blocked recovery.

53. "BOJ Market Operations, January 1933" in "Documents on the Capacity for Government Bond Issue, January 1933–August 1935," BOJ archive.

**Figure 1 Money Supply, Wholesale Prices, and National Income**



However, this temporary success in monetary control and economic recovery does not justify a policy framework based on BOJ credit. As confirmation, monetary control through selling operations functioned well, as the Joint Research Committee had assumed. Also, when GB sales stagnated after the second half of fiscal 1934, BOJ deficit financing of the government was reduced through consultation between the BOJ and the MOF.<sup>54</sup> In response to increased demand for funds in the private sector and stagnation of GB sales, the MOF opted for a gradual reduction of GB issues in the budgetary process of fiscal 1936, and tried to reduce the budget deficit. This led the MOF to attempt to balance the fiscal 1936 budget.<sup>55</sup> In the budgetary

54. "Document Submitted by Vice-Governor Fukai to Financial Bureau Chief Aoki, August 1934" and "The Reference on Government Bonds, May 1935" in "Documents on the Capacity for Government Bond Issue, January 1933–August 1935," BOJ archive. After the second half of 1934, Vice-Governor Fukai worried about the feasibility of additional GB sales and consulted the MOF financial bureau chief. However, it seems that Fukai did not reach a clear conclusion.

55. In the budgetary process of fiscal 1936, the MOF and Finance Minister Takahashi set a policy goal, the so-called *kokusai zengen seisaku* (reduction of the deficit-financing government debt policy). The MOF set the target amount of bond issue reduction as the equivalent of the natural increase in tax revenue. As a result, GB issuance decreased by ¥91 million and the policy was achieved.

process, however, irregular and problematic budgeting methods were adopted under military pressure.<sup>56</sup>

For example, multi-year continuing expenditures created a financial burden to be incurred in the budgets over consecutive years. Both the total amount and the annual spending schedule were to appear in the budget of each year. However, during this period fiscal authorities used this clause to postpone future fiscal burdens, especially those for military spending. In fiscal 1936, continuing expenditures for the Department of the Army increased to ¥489.92 million from ¥140.87 million in the previous year. Continuing expenditures also increased for the Department of the Navy, to ¥484.88 million from ¥368.21 million. These two departments represented about 70 percent of all continuing expenditures after fiscal 1936.<sup>57</sup> Moreover, since the expected tax revenues in fiscal 1936 were ¥924.8 million, deferred military expenditures reached half the total expected tax revenue in the same year. Thus, total continuing expenditures amounted to ¥1,427.55 million in fiscal 1936, as compared with the total fiscal 1936 budget of ¥2,278.13 million.

Despite a gradual decrease in GB issues, which Finance Minister Takahashi achieved, long-term government debt increased to an enormous level, even before the outbreak of the 2.26 incident.<sup>58</sup> The rapid increase in military expenditures after the 2.26 incident added to these hidden government debts, which were already heavy. If one emphasizes the soft budget constraint before the 2.26 incident, there is a continuity between the Takahashi economic policy and wartime economic policy. Given that BOJ underwriting was institutionalized in 1932, we can easily anticipate that BOJ financing of the government would be exploited to finance such hidden fiscal burdens afterward. In fact, during and after World War II, the BOJ made loans to the government and supplied funds for the private sector instead of the government.

## IV. Concluding Remarks

### A. Policy Formation Process

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

Unsecured financing of the government and underwriting of GBs by the BOJ were institutionalized. The maximum purchase limit of GBs for the BOJ was not stipulated, and selling operations of government securities by the BOJ were permitted. The MOF's permission, which had been needed when dealing government securities, became unnecessary. These agreements refute the conventional argument that the

56. These included accumulation of the deferred fiscal burden through the continuing expenditure clause, off-balance fund transfers between the general account and special account, reduction of subsidies to local government with increasing local government spending, and promotion of repayment of local bonds to draw funds for GB sales. See Ide (1998, 2001).

57. Continuing expenditures in fiscal 1935 were only ¥4.99 million for the Department of the Army, and ¥80.7 million for the Department of the Navy.

58. The 2.26 incident was an attempted military coup d'état in 1936 in which Finance Minister Takahashi was killed. After this, military expenditures increased rapidly and Japanese fiscal management shifted to wartime finance.

BOJ was persuaded to underwrite GBs by Finance Minister Takahashi's firm request and accepted it as a temporary expedient. Rather, the BOJ had its own reasons for underwriting bonds. Confidence in monetary control through selling operations and expectations of its influence over financial institutions contributed to the BOJ's acceptance of GB underwriting.

### **B. Implementation Process**

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

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59. The 5.15 incident was the attempted military coup d'état in 1932, in which Prime Minister Tsuyoshi Inukai was killed. His assassination significantly hastened the end of party politics in prewar Japan.

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