

FISCAL-MONETARY POLICY AND ECONOMIC GROWTH IN POSTWAR JAPAN

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An appraisal of the relative importance of the government's overall role in Japan's super-fast economic growth of the past fifteen years following postwar reconstruction is complex, difficult, and somewhat subjective. A great variety of interacting factors and influences—political, sociological, as well as economic—have determined the impact of the government and its policies on the rest of the economy. Fortunately, evaluation of government fiscal and monetary policy can be placed in the narrower setting of the management of aggregate demand and aggregate supply for the economy. Yet I suspect that the broader role of the government in setting the sociopolitical as well as economic environment for the private economy has been more important in stimulating rapid growth than its management of demand and supply through fiscal and monetary policies. Political stability, emphasis on material welfare, and generally the great importance attached to economic goals, especially growth, have contributed substantially to the extraordinary strength of private demand and to the responsiveness of supply.

It is precisely because private demand has been so vigorous that fiscal and monetary policy had the easier role of constraining and controlling aggregate demand while encouraging supply factors, rather than the politically and economically more difficult task of increasing both demand and supply forces simultaneously. In a sense to judge fiscal-monetary policy as having been very successful is to say that private demand and supply forces were so strong. In this narrower context the government has been lucky, even though it must be given credit for helping to create this growth environment.

Goals of Fiscal-Monetary Policy

The major goals of fiscal-monetary policy in Japan as in other market economies have been economic growth, equitable income distribution, price stability, full employment of labor, and the dampening of the business cycle. While frequently these goals reinforce one another, at times they have been in conflict. Japan has given top priority to rapid economic growth with the benefits widely dispersed among the population. This does not mean income distribution has become more equal. Favorable tax treatment of interest and dividend income in order to encourage saving benefitted higher income groups disproportionately. The very process of growth has improved the relative positions of the bottom third of the population (at least those able to work) and top third relative to the middle income group, especially during the 1960's.

Moderate inflation (4—6 percent annual increase in the consumer price index) has been tolerated as a price of rapid growth. Concern has focussed rather on the inflationary impact on export performance (and to a lesser degree imports), especially since until the late 1960's the balance of payments was the main constraint upon growth. By this criterion inflation has been kept within limits: Japan's export prices have improved relative to its main competitors. Similarly in the drive for rapid growth periodic instability has been tolerated; growth has been pushed so far and fast that the economy "overheated," a balance of payments deficit emerged and, as a corrective, growth sharply slowed down by restrictive measures.

Unlike most Western industrial nations overt unemployment of labor has not been a serious cyclical or structural problem in Japan.¹⁾ Full employment has apparently been a consequence of rapid growth despite the tremendous improvements in labor productivity. Three factors have been of considerable importance in this remarkable employment performance.

First, the absolute rate of real growth has been substantial even in recessions. The lowest annual rate was 2.3 percent in 1954, and for the only four recession years of 1954, 1958, 1962, and 1965 the average was 4.8 percent. Second, lower productivity sectors—agriculture, certain services and small-scale manufacturing—have manifested considerable flexibility in absorbing labor when large enterprise demand slackened. Third, the large enterprise labor market characteristics of lifetime employment and hiring only new school graduates, combined with optimistic growth projections implying larger labor requirements despite productivity improvements, gave incentives to firms to establish hiring levels in terms of longer-run rather than short-run needs. Japan's employment problem has been to absorb labor into high productivity rather than low productivity uses.

Fiscal-Monetary Policy and Supply Capacity

The role of fiscal and monetary policy in economic growth and stabilization usually emphasized is the maintenance of a high level and adequate growth of aggregate demand, with neither debilitating inflation nor unemployed resources. That emphasis will be followed here. Nonetheless, the importance of fiscal-monetary policy in enhancing the supply capacity of the economy should first be noted.

One important supply factor has been the increase in the gross saving share of GNP from 24 percent in the early 1950's to 38 percent in the late 1960's (see Table 1). Most of the increase is due to personal sector saving behavior and to depreciation allowances. This, of course, reinforced by effects on the demand side, has meant a concomitant rise in investment.

1) See, for example, Erik Lundberg, *Instability and Economic Growth* (Yale University Press, 1968) and William Nordhaus, "Uncertainty, Overcapacity and Unemployment," (Yale University Cowles Foundation Paper #203, 1970). Nordhaus argues that for Western industrial nations higher rates of unemployment are explained by the higher variability of demand around the trend line of growth; Japan is an exception to the analysis, for the reasons mentioned below.

Table 1 Gross Saving as a Share of GNP

	1952-54 ^a	1966-68 ^a	Contribution to Increase in Saving Rate
	(%)	(%)	(%)
Depreciation	8.1	12.9	36.3
Corp. Retained Earnings	3.3	5.5	16.7
Personal	6.0	12.3	47.3
Government	5.7	6.2	4.2
Statistical Discrepancy	1.3	0.7	-4.5
Gross saving	24.3	37.7	100.0
Note: Government Current Revenue	20.7	20.3	

a: Arithmetic average of annual rates.

Source: Economic Planning Agency, *Revised Report on National Income Statistics, 1951-1967* (August 1969) and Bank of Japan, *Economic Statistics Monthly* (December 1969).

Whatever impact fiscal-monetary policy has had on saving has come mainly from the fiscal side. Personal saving has been encouraged by lower tax rates on interest and dividends rather than on other forms of income, though this probably has not been a major determinant. More important has been the favorable tax treatment for business depreciation allowances, particularly for selected industries and activities, and for various taxfree reserve accounts (for bad debts, price fluctuations and the like). A related benefit, particularly to larger firms, was the opportunity to write up the value of depreciable assets following the early postwar inflation. It is not clear to what degree these fiscal incentives, as distinct from the rapid growth and changing composition of the capital stock itself (i. e., the depreciation base), account for the marked contribution of depreciation allowances to the rise in the gross saving rate.

The ratio to GNP of government saving—the excess of central and local government current revenue over government purchases of current goods and services and subsidy and transfer payments—was not significantly higher in 1966-68 than in 1952-54. During the interim it rose to a peak of 8.5 percent in 1961, subsequently declining. This is explained by the government overall revenue-expenditure pattern. A fundamental objective of tax policy has been to maintain current revenues at about 20 percent of GNP. The government was able to reduce its current purchases of goods and services sufficiently to finance first a rising saving rate and later an increase in current transfer and subsidy payments (all as a percentage of GNP). At the same time the government investment rate went up, financed predominantly by government saving at first, and since 1965 to some degree by central government bond issue and other forms of public sector borrowing.²⁾

2) For greater detail see H. T. Patrick, "The Financing of the Public Sector in Postwar Japan," in L. Klein and K. Ohkawa, ed., *Economic Growth — The Japanese Experience Since the Meiji Era* (Richard D. Irwin, Inc. 1968). Between 1965-1968 23.3 percent of public sector investment was financed by borrowing from the private sector.

Monetary policy has contributed less directly and probably less importantly than fiscal policy to the increase in the aggregate saving rate. The Bank of Japan has maintained sufficient price stability not to discourage savers from holding fixed-value financial assets, notably money and time deposits. It has supported the effective operation of Japan's variegated financial system, so that savers have (justifiably) had confidence.³⁾ But the success of financial intermediation has been due predominantly to the high and rising saving rate of individuals, their demand for financial assets, and the strong demand by business for external funds. In this the direct role of monetary policy was small: the financial system already existed and the interest-rate structure for deposits and other financial instruments for saving has remained essentially unchanged.

One of the fascinating aspects of Japan's remarkable individual saving performance—an increase in the (heterogeneous) personal sector saving ratio to disposable income from about 8 percent in the early 1950's to about 18 percent in the late 1960's—is that it cannot be significantly attributed to the increased attractiveness of financial assets relative to current consumption, or even to fiscal inducements. The main exception is target saving for expenditures on housing, consumer durables, or education—all income-elastic goods. The saving effect lies in the very deficiencies of the financial system: unavailability of mortgage and consumer credit force people to save more than they might otherwise, or at least to speed up the timing of their saving activity and to postpone consumption.

Since the interest rates on time deposits and related claims have not changed significantly in the past fifteen years we cannot determine whether the saving rate is responsive to interest rates. I would judge that as in other countries saving is not responsive to small interest rate changes but would be to relatively large interest rate adjustments (think of the possible impacts of an interest rate structure in which the rate on one-year time deposits were 2.5 percent, or 8.5 percent, rather than the current 5.5 percent). In Japan perhaps the impact of a more flexible interest rate would have been swamped by other, more important causal forces which raised the personal saving rate.

The Management of Aggregate Demand

The management of aggregate demand through fiscal-monetary policy seeks in the longer run to create levels and growth of demand just equal to aggregate supply capacity. Overly rapid increases in demand are inflationary, undesirable not only in itself but as a force slowing growth. Inadequate increases in demand result in unused resources and slow growth. The shorter run objective of demand management is to mitigate cyclical fluctuations, discussed in the next section.

It can be argued that Japan has effectively pursued a combination of tight fiscal and easy

3) This sort of institution-building is taken for granted, but is extremely important at least in the negative sense that mishandling the crisis of a particular financial institution can impair confidence in the entire system. For that reason the Bank of Japan's support of the Yamaichi Securities Company in 1965 was significantly reassuring.

money policy which encourages saving and investment at the expense of consumption.⁴⁾ The central government has tended to run a budgetary surplus while the Bank of Japan has expanded the money supply rapidly and pursued a low interest rate policy. But the opposite argument can also be made: the combination has been that of easy fiscal and tight monetary policy. The government budget has increased substantially every year, inducing business optimism as well as directly enhancing aggregate demand; moreover, it is not the government budget surplus or deficit *per se* that is important, but only relative to the strength or weakness of private demand. The Bank of Japan has pursued a somewhat restrictive policy in order to compensate for the expansive budgetary impact. This has shown up not so much in nominal loan interest rates but in credit rationing, and in high effective interest rates (once adjustments are made for compensating balances and other charges) for small and other least preferred borrowers.

That both positions can be argued only attests to the problems of obtaining adequate indicators of "tight" or "easy" fiscal and monetary policies. For fiscal policy an appropriate indicator is somewhat easier to determine. Conceptually, fiscal policy is tight (expansive) to the degree that government budget surplus or deficit generates demand which is less than (more than) the difference between the total aggregate demand needed to achieve the potential sustainable growth rate and the amount of private demand. The potential growth rate projection is based on full use of labor and other resources and assumptions about the acceptable rate of price level increase, the share of government revenues in GNP, the composition of government expenditures, productivity improvements in the economy, et. cetera. Hence, if private demand is very strong, the government can have a balanced or even surplus budget and yet fiscal policy is expansive in that overall aggregate demand is excessive.

The tightness or ease of fiscal and monetary policy cannot be judged independently of each other. Given the political process, however, it is reasonable to treat fiscal policy as determined first, with monetary policy responding by taking into account both the potential growth rate and the projected budgetary situation. Indeed the Bank of Japan has so operated. Purely monetary indicators remain more elusive and controversial, mainly because the causal connection between monetary variables and aggregate demand components is imprecise. Probably the Bank of Japan has judged the effectiveness of its policy by a "feel of the market" combining somehow the rate of growth of commercial bank loans, of money supply and currency in circulation, call market interest rates, and since 1966 market interest yields on already-issued bonds. They may well pay less attention to these indicators *per se* than to such targets as inventory change, new orders for machinery, the industrial production index, and particularly the balance of payments position. Indeed, the most significant target for monetary policy has probably been the level and rate of growth of foreign exchange reserves.⁵⁾ This measure must be adjusted for Japan's short-term

4) A good discussion of this and other points is in Ryuichiro Tachi, "Fiscal and Monetary Policy" in R. Komiya, ed., *Postwar Economic Growth in Japan* (University of California Press, 1966).

5) See Michael W. Keran, "Monetary Policy and the Business Cycle in Postwar Japan" (Federal Reserve Bank of St. Louis, Working Paper No. 3, revised—to appear in a volume edited by Milton Friedman and published

capital position; the substantial increase in net borrowings (usance credit, free yen deposits, Euro-dollars, etc.) in the early 1960's concerned monetary policymakers. This reserve position measure is equally important today, particularly since the repayment in 1969 of foreign short-term borrowing was more than double the increase in official foreign exchange reserves.

In certain Western countries—notably the United States in the latter part of the 1950's and the early 1960's—actual economic growth lagged considerably behind the economy's potential performance both in level and rate of growth of GNP. This sustained deficiency in aggregate demand has not been a secular problem for Japanese growth. One set of international comparisons concludes that Japan has well achieved its growth potential.⁶⁾ It is difficult to believe that Japan could have grown even more rapidly. Accordingly actual growth is a reasonable measure of potential growth.

Japan has indeed achieved the high level and rate of growth of aggregate demand essential for rapid growth, a tribute to the effectiveness of fiscal and monetary policy. If anything, there has been a persistent tendency for excess demand, though on the whole reasonably well controlled. *Ex ante* investment demand has exceeded *ex ante* saving; free market interest rates have virtually always been higher than the controlled interest rate structure, and a considerable proportion of credit has had to be rationed rather than allocated through the operation of financial markets. The vigor of private demand, particularly for productive fixed investment, is in part at least attributable to the environment created by fiscal-monetary policy. Within that context, the main role of fiscal-monetary policy has been to restrain aggregate demand, while encouraging a shift in its composition to investment and exports (to pay for imports).

The most important fiscal decision to maximize growth has been to allow private investment demand top priority in the claim on resources. While tax incentives were given, the basic approach was to restrict government expenditures as a competing claimant. Moreover, the composition of government expenditures was geared primarily to accelerating industrialization and economic growth, rather than to social welfare, by providing necessary infrastructure directly related to private production. Not only did the share of fixed investment rise to about 40 percent of total government expenditures, almost two-thirds was directed to developmentally-oriented projects. Expenditures were held down by the principles that government tax revenues be no greater than 20 percent of GNP and that the central government run a General Account balanced budget, implying no central government bond issue.⁷⁾ After this latter rule was wisely abrogated in the 1965 recession, continued government bond issue has enabled total government expenditures to expand somewhat in response to the growing gap between the provision of public and private services.

The most important function of monetary policy for long-run growth has been not just its

by the University of Chicago Press).

6) Lundberg, *op. cit.*, chapter 3.

7) Of course there was some public sector expenditure leeway in the sale of government enterprise and local government bonds to the private sector, and collection of postal savings and life insurance.

role in keeping inflation in check but particularly in expanding the money supply commensurate with the rapidly growing demand for money. Between 1953–1969 the demand for high-powered money (currency plus commercial bank deposits at the Bank of Japan) was inadequately (37 percent) met by the accumulation of foreign exchange reserves and government domestic cash deficits; 63 percent had to be in the form of Bank of Japan credit to the banking system. The underdeveloped bond market has made open market operations difficult; loans on a sustained basis to large commercial banks were a reasonable alternative. Without this “overloan” the economy would have suffered severe deflationary pressures and much less rapid growth. The criticism of “overloan” lies not in its existence but in the exclusion from borrowing by smaller financial institutions, for reasons of fairness and monetary control.

Cyclical Instability

In contrast to the success of fiscal-monetary policy in managing aggregate demand and supply in the longer run, in the short run it has not dampened the wide periodic swings in business activity away from the trend of rapid growth. Recessions in 1953–4, 1957–8, 1962, and 1965 were preceded and followed by great booms. Japan has manifested the greatest cyclical instability of any industrial nation in the postwar period, measured by the average or standard deviation of the growth rate.⁸⁾

In all instances, however, the recessions came about as policy reactions to short-run excessive demand conditions. Typically, investment-based explosive booms have resulted in an “overheated” economy which has been manifested particularly in a surge of imports greater than could be financed by exports and net foreign borrowing.⁹⁾ Unsustainably rapid growth had to be slowed by restricting aggregate demand; a recession ensued; and as soon as the balance of payments constraint was lifted aggregate demand was once again encouraged, and a new boom inaugurated.

The main reason for the extreme nature of these swings has been the exceedingly rapid growth rates of the booms, rather than the severity of the recessions. This has been a matter more of political will than of ineffectiveness of fiscal or monetary tools: the political leaders of the 1950's and through the mid-1960's temporized until the last moment (i. e., a six months decision lag), in allowing restrictive measures to be taken, hoping that the balance of payment problem would resolve itself either by a natural slowdown of private demand or by an externally-induced export boom. This pattern was repeated in early 1968. Before the tight money policy of fall 1967 really took hold an export boom developed, particularly to the United States, thereby obviating the need to slow growth substantially. The recent (1969) policy of some credit tightness and a “neutral” budget appears to be the first serious attempt since 1959 at “fine tuning” to prevent

8) See Lundberg, *op. cit.*, Table 3–2, p. 118, and Nordhaus, *op. cit.*, Table 1, p. 38.

9) For a more detailed treatment see Tachi, *op. cit.*, and Hugh T. Patrick, “Cyclical Instability and Fiscal-Monetary Policy in Postwar Japan,” in W. W. Lockwood, ed., *The State and Economic Enterprise in Japan* (Princeton University Press, 1965).

the economy from overheating while maintaining very rapid growth. Interestingly it is the first such restrictive policy justified primarily by domestic effects of excess demand, since the balance of payment situation is the happy one of embarrassingly large surpluses.

In the short-run fiscal policy has been more expansive than monetary policy. Indeed during the 1950's fiscal policy was destabilizingly pro-cyclical in upswings (and in the 1954 recession as well); this pattern moderated somewhat in the 1960's.¹⁰⁾ The pro-cyclical bias in upswings emanates from the large increases in government revenues in booms due to the elastic tax structure and the 20 percent revenue/GNP rule. The Diet has been delighted to utilize the excess revenue for annual tax cuts as well as increases in government expenditure programs.

Restrictive monetary policy has been the main means of dampening excessive booms. It has been highly effective because of the rather direct relationship between bank loans and investment, particularly inventory investment. Business has had to rely greatly upon external sources, despite high internal saving rates, to finance the extraordinary amounts of investment. Saddled with a low interest rate policy and excess demand for funds, the Bank of Japan has mainly used credit rationing—over its own credit and the loans of the major banks—to slow the growth of commercial bank loans and money supply. Market increases in the call rate were used to attract loanable funds away from smaller financial institutions into large banks. The large banks have followed the Bank of Japan's "administrative guidance" (credit rationing) because they have borrowed heavily from it. The reduced flexibility of the call rate since 1967—in an effort to reduce pressure on the government bond issue rate—spells trouble for the future implementation of monetary policy, with no ready solution yet reached.

Once the balance of payments position improved expansive monetary and fiscal policies have quickly followed to end the recession and with favorable results. In 1955, 1958, and 1963 sufficient stimulus of aggregate demand could be accomplished within the government's balanced budget principle. It is much to the government's credit that in 1965, when the standard degree of fiscal and monetary ease was insufficient, it quickly discarded the balanced budget principle for expansive deficit financing.

Conclusion

Because growth has been so rapid it is difficult to criticize Japan's economic policy. In fact fiscal and monetary policy have been very successful for both aggregate demand and supply. Indeed, dampening the high degree of cyclical instability might well have slowed the growth rate; the sustained investment booms may have had ratchet-step effects in lifting the economy's growth potential by increasing supply capacity as well as justifying and generating further entrepreneurial

10) Wan-Soon Kim, "Budgetary Policy for Economic Growth in Postwar Japan, 1952-1965" (Ph. D. dissertation, Harvard University, 1969), appendix to ch. 1.

11) Direct taxes have a GNP elasticity of about 1.5 and indirect taxes an elasticity of about 1.0. See H. Ishi, "The Income Elasticity of the Tax Yield in Japan," *Hitotsubashi Journal of Economics* (June 1968).

optimism.

Yet certain doubts remain. On the fiscal side government expenditures have not sufficiently provided such public services as water supply, sewage systems, control of air and water pollution, and roads, nor reduced urban congestion, nor improved housing, nor met the needs of higher education, nor provided transfer payments to the aged, the infirm, and others in need. The final percentage point of growth probably had a small welfare benefit. Greater welfare could have been achieved at relatively little cost, according to the simulation estimates of S. Shishido.¹²⁾

Perhaps a market-determined higher interest rate policy would not have significantly enhanced the saving rate or even allocated resources much more efficiently. On the other hand, with the strong excess investment demand, it is unlikely that higher interest rates would have slowed growth by reducing the amount of actual investment. The low interest rate policy has had a real welfare cost. The interest rate available to savers has been low relative to the marginal efficiency of investment and hence to the equilibrium market rate on loanable funds. This has redistributed income (the interest foregone) away from holders of deposits and similar fixed-value assets to the stockholders of financial institutions and of large enterprises which have reached loans at relatively low interest rates. Middle and lower income savers have subsidized stockholders, typically a higher income group.

Finally, the methods of implementing policy make even closer the ties between big business or the major financial institutions and the government through the substitution of administrative guidance, frequent face-to-face negotiations, and personal relationships for more impersonal market mechanisms. This may be an administratively efficient system, but the concentration of power that it implies and perpetuates may be socially undesirable. These doubts, however, are for members of the Japanese society rather than foreigners to judge.

12) S. Shishido, "The Role of the Government in the Postwar Economic Development of Japan," in Klein and Okawa, ed., *op. cit.*