

Chapter 7

World War I and the 1920s: Export-led Boom and Recession



Taisho Democracy – An open-air speech meeting demanding universal suffrage in Ueno Park, 1919.

1. Impact of World War I

When the First World War erupted in July 1914, its consequences for the Japanese economy were at first uncertain. As the European major powers began to fight each other, their international trade was suspended, which meant that Europe could no longer supply textiles, machinery and chemicals to the rest of the world. It was feared that Japanese investment would be adversely affected. In reality, Japan did experience severe shortages of high-quality machines and industrial materials as domestic demand for them surged.

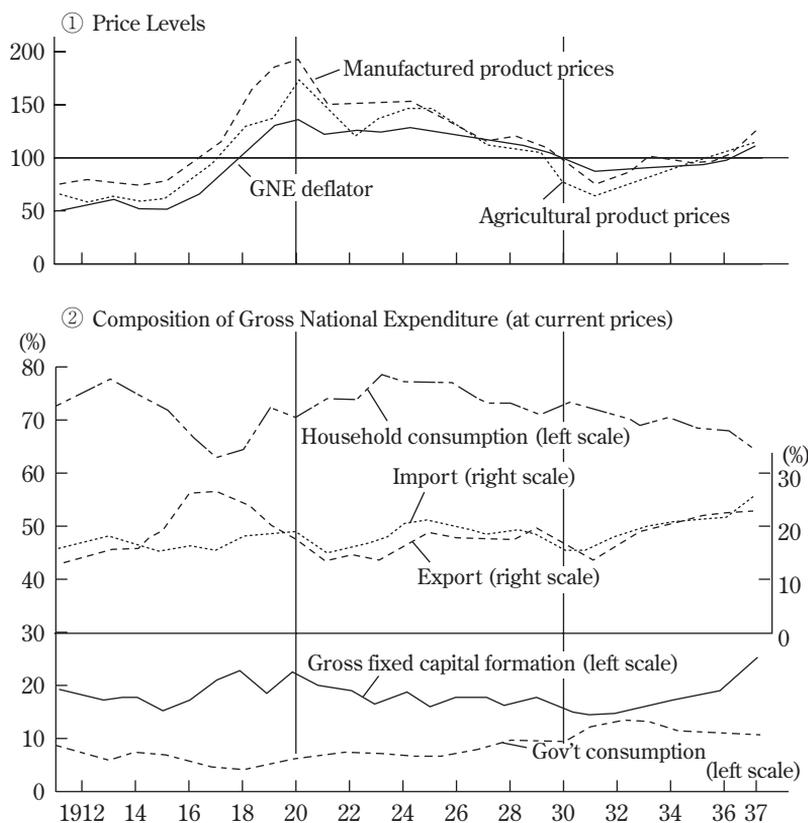
But it soon became clear that WWI would bring a huge bonanza to the Japanese economy, at least in the short run, because of the sudden increase in global demand for Japanese products. An enormous export-led boom was generated because global demand shifted from Europe to Japan and also because the US economy was expanding. Japanese manufactured products were still of inferior quality but could substitute for European products which now became unavailable.

The Japanese macroeconomy, which previously faced a mounting trade deficit and gold reserve loss, was greatly stimulated by this sharp rise in foreign demand. During WWI, the domestic price level more than doubled and real GNP surged, with an estimated annual growth close to 10 percent. In terms of GNP expenditure, exports rose, imports were slightly suppressed, investment only moderately increased and with a lag (due to the shortage of machinery), and private consumption fell (Figure 7-1). What happened was a sharp rise in output without a corresponding capital stock accumulation, pushing up the apparent operation ratio and “efficiency” of capital. Domestic consumption was crowded out by foreign demand, mainly through forced saving under temporary inflation. Business profits jumped and gold reserves accumulated. This is how Japan got out of the pre-WWI balance-of-payments crisis—as a result of a sharp rise in export demand caused by a foreign war rather than through macroeconomic austerity¹.

The export-led boom was a broad-based one in which all industries

¹ We will see in chapter 10 that a similar situation will rescue the Japanese economy out of crisis in 1950 when the Korean War occurred.

Figure 7-1 Price Movements and Gross National Expenditure



Source: Ohkawa and Shinohara, eds, *Patterns of Japanese Economic Development: A Quantitative Appraisal*, Yale University Press, 1979, Appendix Table A50.

benefited. Among them, marine transportation and shipbuilding were extremely profitable and expanded most rapidly. Between 1913 and 1919, overall manufacturing expanded 1.65 times, while specific industries enjoyed the following output increases: machinery (3.1 times), steel (1.8 times), chemicals (1.6 times) and textile (1.6 times).

Clearly, this export-led boom was temporary—only as long as WWI continued, which meant about four years. Despite inferior quality, Japanese products were capturing overseas markets with unusually strong demand and high prices under the special conditions of the European war. Domestically, import substitution accelerated artificially because European goods did not

arrive. In retrospect, most of the business expansion during WW1 was inefficient, excessive and unsustainable. Because of this historically unprecedented boom, mediocre merchants and inefficient producers became suddenly rich and successful. They rapidly expanded their businesses. A class of nouveau riche called *narikin* emerged (in Japanese chess, *narikin* means a pawn becoming a gold general). They were often without culture or taste and fond of showing off their material wealth.

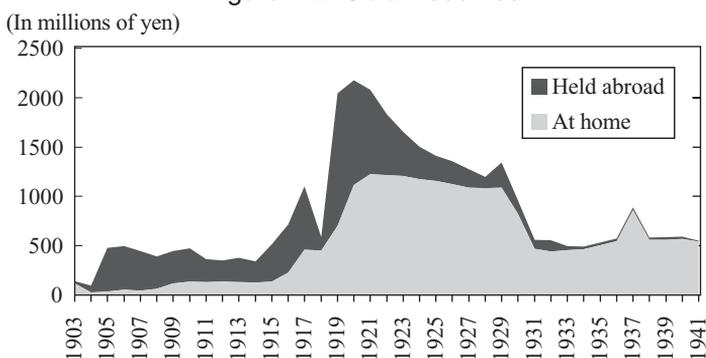
For Japan, WW1 required very little military involvement. Japan did not engage in any serious combat. But since Japan had a military alliance treaty with the Britain (1902-1923, with Russia as the potential enemy), the government used this as an excuse for capturing German-occupied territories in Jiaozhou Wan (including Qingdao) in China and a number of islands in the Southern Pacific.

2. Collapse of the bubble

In 1918, when WW1 ended, a small business setback occurred. But the Japanese economy continued to do well in 1919. Then came the big crash of 1920. The beginning of the postwar recession meant that the bubble had finally collapsed. The prices of many commodities fell sharply. Within the year of 1920, the price of cotton yarn fell by 60 percent, that of silk by 70 percent, and the stock market index plunged 55 percent. There was no downward price rigidity in those days. Macroeconomic adjustment was brought about mostly through price changes rather than output fluctuation. When the bubble ended, the lack of competitiveness and overcapacity of the Japanese economy, previously hidden under unsubstantiated exuberance, was exposed. Most *narikin* were bankrupted. Their happy days were short.

After this and throughout the 1920s, Japan went through a series of recessions and banking crises. The most serious bank runs occurred in 1927 (chapter 8). The economy slowed down significantly compared with the WW1 period, but no severe fall in output was recorded. Domestic demand was not buoyant but steady. Recessions were frequent but short-lived. Prices remained flexible. Trade deficits returned and persisted, which was financed by the drawing down of the previously accumulated gold reserves. During the 1920s, the

Figure 7-2 Gold Reserves



Source: Management and Coordination Agency, *Historical Statistics of Japan*, Vol. 3, 1988.

sky above the Japanese economy was neither sunny nor pouring. It was as if thick clouds gathered and stayed above the economy depressing the economic mood of the country, somewhat like the 1990s to the early 2000s.

Faced with the onset of a long recessionary period, it is worth noting how the Japanese government reacted. It had two policy options: the one was to rescue weakened industries and banks saddled with bad debt, and the other was to eliminate inefficient units in order to streamline the economy despite transitional pain. The Japanese government opted for the first. In particular, the Bank of Japan provided emergency loans to ailing banks and industries to avoid further bankruptcies and unemployment. This policy eased the short-term pain but implanted a time bomb in the Japanese economy which exploded several years later.

3. Development of heavy and chemical industries

But even under the cloudy sky of the 1920s, manufacturing industries were growing. Heavy and chemical industries (HCI) were expanding strongly, despite the relatively weak aggregate demand. HCI growth was broad-based and included steel, chemicals, electrical machinery, general machinery, and artificial silk (rayon). For these products, import substitution proceeded rapidly. By the 1930s, Japan could produce most machinery domestically. This was a big achievement in comparison with the Meiji period.

There were several reasons for HCI growth.

Initially, the *WWI boom* ignited these industries under artificial protection from European products, as explained above.

Second, *policy support* was available. Fiscal activism, including military buildup, continued to be pursued by the Seiyukai Party governments (chapter 9), and tariff protection for emerging HCIs was adopted. The government also promoted the formation of industrial cartels to avoid excess competition and overcapacity.

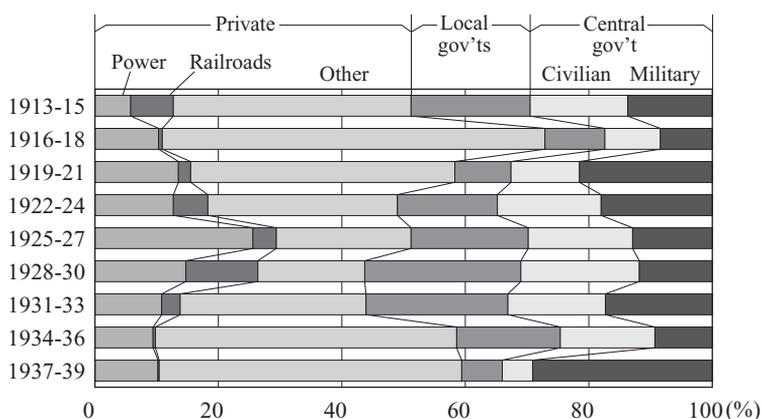
Third, *electrification* proceeded considerably with the growth of hydraulic power generation. Construction of hydraulic power plants occupied the largest share of private investment (another buoyant area of private investment was railroad construction). In the Kansai area in Western Japan, electricity surplus emerged. Power companies resorted to discriminatory pricing by charging very low prices to large corporate customers. Once the dam, the power plant and transmission lines were completed, the marginal cost of producing additional electricity was virtually zero. Discriminatory pricing helped to raise the operation ratio and increase the revenue. This stimulated the growth of electricity-intensive industries such as ammonium sulfate, fertilizer, rayon and aluminum refinery.

Fourth, *foreign technology* was absorbed through FDI. Japanese companies including NEC, Shibaura, Mitsubishi Electric, Furukawa, and Nissan (see below) tied up variously with American and European giants such as General Electric, Westinghouse, Siemens, Ford, GM, Dunlop and Goodrich in the fields of electrical machinery, automobiles, rubber tires, and so on. The business relationships took many forms, including creation of a Japanese subsidiary, joint venture, equity participation and technical cooperation.

Fifth, *industrial linkages* were created. For instance, growth of the steel industry stimulated and supported the steel-using industries like shipbuilding and machinery, and vice versa.

As a result of the development of HCI, a new type of zaibatsu emerged in the 1920s and the 1930s. The largest among them were Nissan, Nichitsu and Mori. Compared with the old zaibatsu such as Mitsui and Mitsubishi,

Figure 7-3 Gross Capital Formation



Source: Koichi Emi, *Long-term Economic Statistics, Vol.4, Capital Formation*, Toyo Keizai Shimposha, 1971.

new zaibatsu had the following characteristics: (i) HCI-based, without much reliance on textile and commerce; (ii) not having a bank as their core business; and (iii) heavy dependence on official support and political connection. They also invested aggressively in the Japanese colonies of Korea and Manchuria (Northeastern China).

Nissan was established in 1928 by Yoshisuke Ayukawa. The company's full name was Nihon Sangyo (Japanese Industry). Raising capital from the stock market, business was diversified into mining, machinery, automobile, chemicals and fishery. Nissan invested heavily in Manchuria. Hitachi and Nissan Motors belonged to this group.

Nicchitsu was established in 1908 by Shitagau Noguchi. Its full name was Nihon Chisso Hiryo (Japan Nitrogen Fertilizer). The group's main business was electricity-intensive chemical industries such as fertilizer, rayon, medicine, explosives and metal refining. Micchitsu invested heavily in Korea.

Mori was established during the 1920s by Nobuteru Mori, who worked together with Saburotsuke Suzuki, the founder of Ajinomoto. Its main business included iodine, fertilizer, aluminum refining, electrical machinery and explosives.

4. Exchange rate volatility

During the pre-WW1 period, from the 1880s through 1914, the world economy enjoyed price stability and free trade under the international gold standard. Japan joined the gold standard and fixed its exchange rate to the major currencies in 1897. Soon, Japanese prices converged to the world level. But this fixed exchange rate regime was smashed by the outbreak of WW1, and the Japanese yen started to float, in 1917.

After WW1, major countries made a number of attempts to restore the prewar gold standard system without much success. Britain returned to gold in 1925 but abandoned it again in 1931. The gold standard could not be re-established partly because there was less free trade and more protectionism in the world than before—in other words, the global goods market was less integrated; and partly because governments now cared more about the domestic macroeconomy, especially unemployment, than the external commitment of gold convertibility. As a result, international monetary cooperation was hardly possible.

Japan also tried to return to the gold standard *at the prewar parity* of two yen to the dollar. The government seriously considered restoring a fixed exchange rate in 1919, 1923 and 1927 but failed to do so for various reasons. Throughout this period, “return to gold” (*kinkaikin*, literally, lifting the restriction on gold exports) became a national economic goal. Each time the government announced such a policy intention, expectations drove up the yen because the actual yen was more depreciated than the prewar parity. But the yen fell back when the policy was not realized. The business community blamed domestic banks and foreign exchange traders, especially those in Shanghai, for speculation. This exchange instability may have further damaged the Japanese economy faced with slow growth.

5. Shidehara Diplomacy in the 1920s

As noted at the end of chapter 6, Japan began to emerge as a serious threat to both the West and East Asia by the end of the Meiji period. After WW1, Japan tried to allay these fears and rebuild good relationship with the West, especially the US, and East Asia. Kijuro Shidehara repeatedly served as



Japan attended the Washington Conference (1921-22) with both hope and concern. Global reduction of naval capacity was welcome for Japan which was facing a fiscal crisis. But Japan also feared that the other big powers might harm Japan's interests.



Kijuro Shidehara (1872-1951) was Foreign Minister in much of 1924-31; and Prime Minister in 1945-46.

Foreign Minister when Minsei Party governments were in place, in 1924-1927 and 1929-1931. In what was called *Shidehara Diplomacy*, he vigorously promoted a reconciliation policy. As a result, Japan's external policy in the 1920s was less belligerent compared with before or after.

In 1921, the Washington Conference for Naval Disarmament was convened by the US, and Japan was invited to attend. This conference put upper limits on principal battleships of the major countries. In terms of tonnage ratios, the possession of principal battleships was restricted as follows: US (5), UK (5), Japan (3), France (1.67), and Italy (1.67). The Japanese delegation willingly signed this agreement because of fiscal pressure; the navy wanted more ships but the national budget was out of balance. In addition, through this, Japan also wanted to show good faith to the Western powers.

The signing of the Nine Powers Treaty was another important result for Japan coming out of this Conference. This treaty recognized the sovereignty of China, prohibited territorial invasion of China through military means by any country, and agreed to share economic interests of major powers in China under the policy of "open door and equal opportunity." Japan welcomed this treaty as it was interpreted to implicitly recognize Japan's special interests in Manchuria and Mongolia. The infamous Twenty-One Demands to China were also accepted, albeit with some modifications, by the international community. However, these "acceptances" were valid only so long as Japan refrained from using mili-

tary force to invade China or rob interests of other powers in China.

Shidehara believed that a good relationship with the US was critical to Japan. Moreover, he felt that Japan, as a first-class country and a member of the Big Five, had the responsibility to strive for global peace and prosperity. As for China, he wanted to protect Japanese economic interests by non-military means. Shidehara's idealism is evident in his parliamentary speech delivered in January 1925.

At present, there is clearly a global movement toward solving all international issues through understanding and cooperation among concerned powers, and not by narrowly self-serving policies, excessive use of militarism or interventionism ... Japan is no longer permitted an isolated and independent existence in the Far East, interested only in its own affairs. As a major member of the League of Nations, Japan now bears a heavy responsibility for promoting world peace and happiness of the human race. Japan must participate in the discussion of all these important issues, even if they have only indirect influence on Japan's own interest. The fact that Japan must bear such responsibilities is beyond question; it is necessitated by the force of history. The great progress of history is making us to take up these responsibilities.

But the Japan-US relationship gradually deteriorated due to the problem of Japanese immigrants on the US Pacific Coast, especially in the States of California, Oregon and Washington. Because Japanese (and to some extent Chinese) immigrants worked too hard and had different cultures, they were discriminated against by Americans. Their schools were segregated, their freedom was restricted and, finally, their property was confiscated. The Japanese government agreed to stop sending new immigrants to the US but demanded fair treatment of the Japanese already there. This issue soured the bilateral relationship.

Shidehara's policy of no military intervention in China was severely criticized by the military and the hardliners as a "coward's diplomacy." It should be noted that even the mass media echoed these sentiments and blamed Shidehara for being too soft on China. During 1927-1929, when the Tanaka Cabinet was in place and Shidehara was out, Japan sent troops to China. Tanaka belonged to the Seiyukai Party and Shidehara belonged to the Minsei Party.

Finally, in 1931, the Manchurian Incident broke out. *Kantogun*, the Japanese army stationed in China, began to invade Northeastern China. This

action was undertaken independently from Tokyo, and the Japanese government could not restrain its army. Shidehara's call for immediate peace was ignored. Shidehara Diplomacy ended this way.

Taisho Democracy

Roughly coinciding with the Taisho period (1912-1926), various social movements demanding more democracy and human rights became active. This included protests against unelected governments, women's liberation, equal rights for the discriminated class (the progeny of the *eta* and *hinin* people—see chapter 2 and the Q & A section in the appendix), universal suffrage, cultural freedom, and so on. These movements were collectively called *Taisho Democracy*.

One of the most eminent intellectual leaders of Taisho Democracy was Sakuzo Yoshino, Professor of Political Science at Tokyo University. He published many articles in popular journals and promoted his version of democracy called *minpon shugi*. It demonstrated that democracy could be installed and fostered even under the Meiji Constitution which bestowed sovereignty to the emperor. Yoshino argued that establishing democratic institutions was not enough and that it



Sakuzo Yoshino (1878-1933)

was essential to constantly improve the *actual implementation* of constitutional government. For this purpose, he stressed the role of the elite class in guiding people. Yoshino also supported universal suffrage. By expanding the voter base from a few rich to the general public, he argued that corruption and money politics would cease and politics based on a broader national vision would begin (it must be admitted that Prof. Yoshino was a bit too optimistic in this).

On the role of the elite, Yoshino wrote:

Some may argue wrongly that the elite class has no place in democracy. But this is not so. Of course, if a small number of people form an exclusive class and monopolize politics independently from the people, it will produce many bad results. But if the elite humbly mingle with the general public, nominally serving and following them but in substance guide them spiritually and for the public good, they will play the role of the truly wise. ... Democracy will not develop in a sound way if uninformed people literally rule.

Formally speaking, the majority must always be the basis of political activities. But they need intellectual leaders in their minds. They must rely on a small number of wise and

capable people. A great nation will emerge when the majority is guided intellectually by the few who are wise. The elite have this responsibility in a modern state. (“Discourse on the Principle of Constitutional Government and the Way to Fully Develop its Potentiality,” 1916)

In 1925, the Universal Suffrage Law was enacted, extending voting rights to all males at 25 years of age and above, without income restriction. But in the same year, the Peace Preservation Law was also passed in order to crack down on communists and anarchists. It should however be noted that other major powers had similar laws as well; it was not a uniquely Japanese law. The extension of suffrage to women had to wait until 1945.

In the actual political process, the great achievement of Taisho Democracy was the succession of party cabinets from 1924 to 1932. The leader of the political party having the largest number of parliamentary seats formed the government (instead of appointed old politicians or military generals). When his policies failed, the leader of another party replaced him. This system was not formally institutionalized but actually practiced (called *kensei no jodo*, or the normal way of constitutional government). But this practice was later terminated by pressure from the military and a series of political assassinations.

Chapter 8

The Showa Financial Crisis of 1927



A bank run – Depositors queue up in front of Tokyo Savings Bank after the inadvertent speech by Finance Minister Kataoka.

1. Kikan Ginko problem

Kikan ginko (literally, institution bank) is a term describing a bank set up to serve only one or a few firms. It is captured and subordinated by the parent firm and has no management independence. Naturally, it has many weaknesses such as:

- Non-separation of ownership and management (the same boss often owned and managed the firm and the bank)
- No information disclosure
- No portfolio diversification
- No capability of risk assessment or project evaluation

Why were such banks created? Consider a situation in which a famous family in a certain local district wants to start a business. The family establishes a company but wants to keep it under its full control, without going public or borrowing from someone else. To finance its activities, a bank is set up by the same family. Since the family has a good name locally, many people deposit their savings with this bank, believing it is safe and without knowing its financial situation. In this fashion, many kikan ginko were established throughout the country. There were over 2,000 banks in Japan in the 1900s and 1910s—this was a bit too many.

When the economy boomed, even dubious banks prospered. But when it slowed down after WW1, kikan ginko started to have a mounting bad debt problem. Since their balance sheets were not open, outsiders could not judge the size of the problem. As noted earlier, during the 1920s, the government and the Bank of Japan (BOJ) supported weak banks and firms with emergency loans, rather than closing them immediately. Overcapacity and bad debt continued.

2. The Great Kanto Earthquake and the earthquake bill problem

On September 1, 1923, the Kanto Region was shaken by a huge earthquake. It recorded 7.9 on the Richter scale. Tokyo and Yokohama were very badly damaged. The largest cause of destruction was by fire. Japanese houses

were mostly wooden and the quake hit slightly before noon, when most families were cooking lunch. 100,000 people were killed while another 43,000 were missing. Housing damage totaled 700,000 units. Foreign observers praised Japan for remaining calm and orderly in this calamity, but actually many Korean residents were murdered based on false rumors.

Japan is an earthquake country. It is impossible to avoid earthquakes anywhere in Japan. Earthquakes are also related to volcanoes and hot springs. The main reason for all this is because the Japanese Archipelago is situated where four moving plates meet on the earth's crust. There are basically two types of earthquakes. First, when these plates run into each other and one of them sinks slowly toward the inside of the earth, enormous strain is accumulated and when it is released, a big earthquake occurs. These inter-plate earthquakes occur deep down and affect a large area. Second, there are many active faults near the surface and when they move, an earthquake occurs. They are smaller in magnitude and impact a smaller area, but since it is shallow, local damage could be immense. The Great Kanto Earthquake was of the first type. Recent quakes in Kobe and Taiwan were of the second type.

Back to 1923. Immediately after the Great Kanto Earthquake, the Bank of Japan extended special emergency loans to banks affected in the Kanto Region. This was done in the form of *rediscounting earthquake bills*.

Earthquake bills (commercial bills originating in the designated area affected by the quake) were first taken to banks for "discounting" (banks buy the bills from firms and pay cash after subtracting interest between now and the maturity date). In this way companies could receive immediate liquidity. The banks in turn took these bills to the BOJ for "rediscounting" (the BOJ buys them for cash), so banks too could get liquidity. In this way, the BOJ tried to inject liquidity and sustain economic activity after the earthquake. With this rediscounting facility, even if many firms failed to settle commercial debt because of earthquake damage, the financial system would not seize up.

While this temporary rescue protected the Japanese financial market, it also created a new problem. Since the BOJ rediscounted commercial bills originating in the Kanto Region without discrimination, firms and banks saddled with bad debt unrelated to the earthquake happily brought their non-performing bills to the BOJ. They took advantage of this policy to exchange bad

debt for good cash.

If the companies' problems were truly caused by the earthquake, some of them may have had to close business but most of them could resume operation after a while, and the BOJ should have been able to redeem most of the earthquake bills. But in reality, after two years, only about half the amount was settled by the issuing companies. The rest was a stock of non-performing debt unrelated to the Great Kanto Earthquake with little chance of repayment. If the BOJ continued to hold them, it would incur enormous losses. This was the so-called "earthquake bill problem."

In order to "normalize" the earthquake bills, the government prepared two draft laws. The first law would permit bad bills held by commercial banks be rescheduled for 10 years with government bonds as collateral. The second would allow the government to provide the BOJ with the maximum of 100 million yen to write off BOJ losses related to the earthquake bills. In other words, the bad earthquake bills would partly be converted into long-term debt with delayed repayment and partly be forgiven using public money. Parliamentary debate on these laws began in January 1927.

3. The initial wave of the banking crisis

Finance Minister Naoharu Kataoka was very eager to pass the earthquake bill laws, but the opposition parties criticized the government for bailing out big banks and businesses with taxpayers' money. They demanded that the government disclose the amounts of bad bills and the names of banks which held them (very little was disclosed at that time; there were only rumors). They even argued that the government's true intention might be to help political friends. In the debating process, the size of the bad debt gradually became known. People were shocked at the large size of non-performing loans.

On March 14, 1927, Minister Kataoka was answering pestering questions in the Budget Committee of the House of Representatives. He was frustrated that the opposition did not understand the seriousness of the problem and wanted to debate endlessly. To make the point that the situation was critical, he announced the latest news that crossed his desk: "Today, at around noon, Tokyo Watanabe Bank finally went bankrupt." This news was an unexpected bomb-

shell for the financial market, as well as the people at large. Immediately, depositors queued up in front of banks to withdraw their money. Many banks in the Tokyo area closed. This was the first shock wave of bank runs. However, it was a relatively small financial crisis in the Tokyo area only. The worst was yet to come.

In reality, Tokyo Watanabe Bank was not bankrupt, technically speaking. It was having trouble getting liquidity but the problem was solved quickly. But the bureaucrat carrying news to the Finance Minister forgot to cancel the first report. Some suspected that Tokyo Watanabe Bank must have been happy with the Finance Minister's statement. The bank actually wanted to close but needed a good excuse. Now the bank management could blame Minister Kataoka instead of themselves.

Many people criticized Minister Kataoka for the slip of the tongue which ignited the 1927 financial crisis. But it is very clear that, with or without his improper statement, the Japanese financial system was facing a huge bad debt problem. The true cause of these bank runs was structural, and we cannot blame just one individual for everything.

4. Suzuki Shoten and the Bank of Taiwan

Suzuki Shoten was a new trading company of the *narikin* type, growing rapidly during WW1 through speculative businesses. Suzuki is the name of the founder and "shoten" means store. Its main office was in Kobe and its general manager was Naokichi Kaneko. At one time, its sales turnover even surpassed those of big zaibatsu trading companies like Mitsui and Mitsubishi. It had strong connections with Taiwan, especially Taiwan Colonial Administration, the Bank of Taiwan, and the Taiwanese sugar business, and was given monopoly rights to market Taiwan-made camphor.

But after WW1 and the burst of the bubble, Suzuki Shoten faced a bad debt problem like other *narikin* businesses. It asked the Bank of Taiwan, its main bank, to extend rescue loans. The Bank of Taiwan was a special bank playing the double role of Taiwan's central bank as well as a commercial bank. Despite its semi-official status, it actively extended loans to mainland Japan, including Suzuki Shoten. As its loans to Suzuki became overdue, it could not



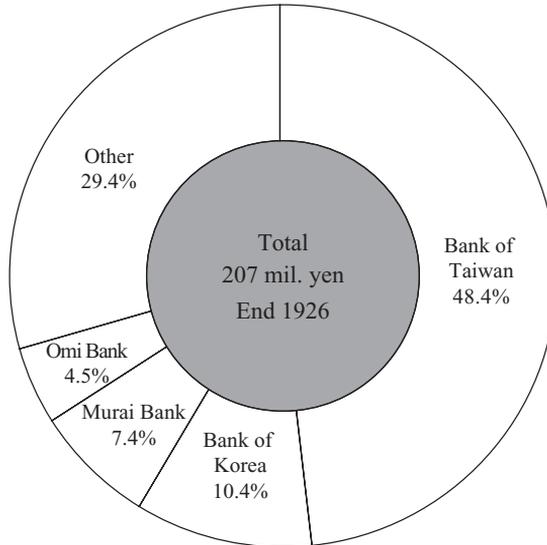
The headquarters of the Bank of Taiwan.

terminate its relations with the company because it occupied too large a part of its loan portfolio. So it continued to lend to Suzuki by rolling over existing debt and providing new loans, delaying the final solution and accelerating the debt snowball. This was the *kikan ginko* problem writ large. As the saying goes, if you have a small debt to a bank and your business fails, you are in trouble; if you have a huge debt that goes bad, the bank is in trouble.

By the end of 1926, the largest part of the unsettled earthquake bills were attributable to the Bank of Taiwan and Suzuki Shoten (48.4 percent). Thus, normalizing the earthquake bills meant solving the Bank of Taiwan-Suzuki problem.

On March 26, 1927, the Bank of Taiwan finally refused any more lending to Suzuki Shoten. This news was a big shock because it revealed the desperateness of the situation, which was beyond anyone's imagination. Previously, people had expected that the government would somehow manage this problem, since the Bank of Taiwan was a special bank and Suzuki was too big to fail (a moral hazard problem!) Naokichi Kaneko, the Suzuki's general manager, even said, "Don't worry, the government will never fail us." No one thought the government would abandon them and let the Bank of Taiwan give up on Suzuki. When that became reality, the second chain of bank runs started, this time in the Kansai area because Suzuki's main activity was in Kansai, which included the cities of Osaka, Kobe and Kyoto.

Figure 8-1 Unsettled Earthquake Bills



Source: Takahashi and Morigaki, 1993, p.146.

5. The BOJ demands government guarantee

The Bank of Taiwan's balance sheet was irregular. On the asset side, bad loans to Suzuki loomed large. On the liabilities side, instead of demand and savings deposits, the bank relied very heavily on short-term interbank "call" loans, as well as borrowing from the Bank of Japan. As soon as the breakup between the Bank of Taiwan and Suzuki was announced, other commercial banks naturally pulled their call loans out of the Bank of Taiwan. The only way for the Bank of Taiwan to survive now was to ask for more BOJ loans.

At this time, even the BOJ refused to extend additional loans unless a new law was enacted to cover BOJ's future losses. For a long time, under political pressure, the BOJ had been generously helping troubled banks. But this undermined the BOJ's own financial soundness. Now at this critical moment, for the first time the BOJ as a central bank became more independent from the government and refused to play the role of the "lender of last resort." The government was forced to quickly issue a special law (an emergency imperial edict)

to satisfy the BOJ's demand. The content of the proposed edict was as follows: (i) the BOJ could extend special loans to the BOT without collateral until May 1928; (ii) the government would compensate the BOJ for losses related to these loans up to 200 million yen.

An imperial edict must be approved by the Privy Council and signed by the Emperor. The government expected it to pass easily. But the Privy Council, under the strong influence of conservative politicians, unexpectedly rejected the proposed edict. They did so because the members did not like the government's conciliatory diplomacy toward China ("Shidehara Diplomacy," chapter 7). When the edict was rejected, the BOJ refused to lend to the Bank of Taiwan. This forced the Bank of Taiwan to close on April 18, 1927. On the same day, another bank—Omi Bank, specializing in the cotton business—also closed.

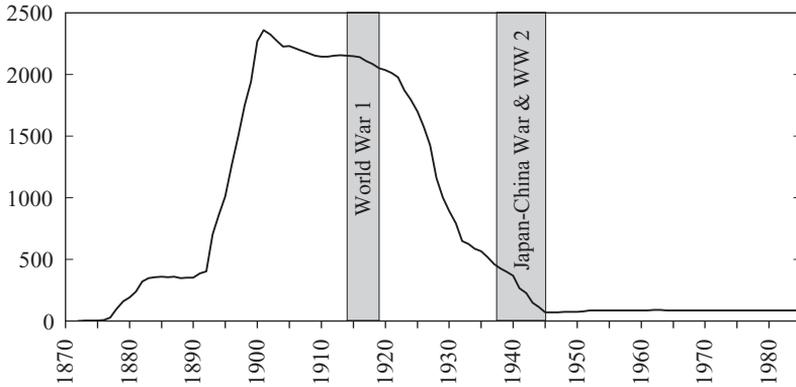
The closure of the Bank of Taiwan and Omi Bank started a chain reaction of bank runs all over Japan. This was the third and most severe financial panic of 1927. On April 22, the government ordered all banks to "voluntarily" close for two days, and simultaneously issued a three-week "moratorium" on virtually all financial obligations. These measures were intended to protect banks against deposit withdrawals (except for small amounts to cover people's living expenses). Meanwhile, banks showed off tall stacks of currency notes to depositors. Calm was restored and things went back to normal when the moratorium expired—except, of course, for the banks that disappeared and the depositors who lost their savings.

6. The consequences of the banking crisis

The Financial Crisis of 1927 was basically a banking crisis. Its macroeconomic impact was negative but not catastrophic. The worst macroeconomic downturn would arrive a few years later, for other reasons (chapter 9).

The most significant consequence of the 1927 banking crisis was financial concentration. After the crisis, the government liquidated or merged unsound banks into about two dozen new banks within a year. In the process, typical depositors at a bankrupted bank lost 35-50 percent of their savings. The government further encouraged mergers of the remaining small banks by imposing a minimum capital size and other requirements. Naturally, people also

Figure 8-2 The Number of Banks



Source: Management and Coordination Agency, *Historical Statistics of Japan*, Vol. 3, 1988.

shifted their deposits from small local banks to large banks with big names. The number of commercial banks fell from more than two thousand in 1919 to 625 in 1932. Deposits were increasingly concentrated in the “Big Five” banks: Mitsui, Mitsubishi, Sumitomo, Yasuda and Daiichi. This reduced the supply of bank credit to small and medium enterprises. But it can also be said that the elimination of small kikan ginko was a good thing, contributing to the modernization of the Japanese banking sector.

Clearly, the financial framework of the 1920s was inadequate compared with today. Deposit insurance did not exist, proper bank supervision and regulatory measures, such as the BIS capital adequacy rule, were not in place, and the BOJ did not fulfill its role as the lender of last resort.

But on this last point, some questions remain. Should the BOJ be blamed because it did not provide liquidity to the Bank of Taiwan at the critical moment? We need to consider the following aspects, and the final judgment is open to question.

- The BOJ had been forced to rescue too many banks against its will and against its own financial soundness. At some point, it had to reassert its political independence. While the immediate consequence of letting the Bank of Taiwan fall was severe, endless provision of emergency loans might not have been the right answer.
- The BOJ knew that immediate provision of unlimited liquidity was

required to avoid a financial crunch. But among the general public and in the parliament, political resistance to injecting public money into a few big banks was so strong. For this reason, the BOJ had to take a tough stance toward the Bank of Taiwan.

- Bank closures are painful in the short run but, if properly done, they will ensure the soundness of the remaining banks in the long run.

Osachi Hamaguchi and Junichiro Koizumi

Below are excerpts from Professor Junji Banno's essay, "Osachi Hamaguchi and Junichiro Koizumi," which compares the policies of the Hamaguchi government (1929-31) and the Koizumi government (2001-). It appeared in *Ronza*, a popular monthly magazine, in October 2001. His assertion is related to both chapters 8 and 9. For the reason of space, it is presented here.

Regarding its economic structure, Japan in the 1920s faced the same problems as today. In particular, the question of how to cope with the impact of the bursting of the WW1 bubble was very similar to the question we are now facing after the bursting of the Heisei bubble in the 1990s. In the 1920s, as at present, the economy stagnated because the policy makers avoided and delayed the resolution of the problem for fear of short-term pain.

The situation of the 1920s, including the problem of how to cope with the non-performing loans and the policy decision to return to the gold standard, has many similarities with the economic problems that the current Koizumi government faces. Then as well as today, the Japanese economy, artificially supported by fiscal stimuli, was driven to a policy impasse. There was no way out except to adopt the gold standard in order to eliminate inferior firms and encourage technical innovation by efficient firms.

However, the mass media's evaluation of the policies of the Hamaguchi government—as well as Finance Minister Junnosuke Inoue who carried out the economic reform—is fairly negative. Partly because of the global depression into which the Japanese economy was plunged immediately after the return to the gold standard, today's media tend to focus only on the painful side of the economic policies of Hamaguchi and Inoue. By contrast, they happily approve the policies of Finance Minister Korekiyo Takahashi who subsequently resurrected fiscal expansionism, and argue that the Koizumi government should not repeat the mistake the Hamaguchi government made. Is this the correct lesson to take from history? ...

The highly regarded fiscal policy of Takahashi boils down to the issuance of government bonds to cover the war expenses of the Manchurian Incident and the active spending to help rural districts out of recession. This was called *Jikyoku Kyusai*, or more recently, *Tomen no Keiki Taisaku* (recovery policies for the moment). This was

considered doubly effective for building infrastructure and for creating jobs... But it is hard to argue that this policy alone improved the productivity and competitiveness of Japanese firms, leading to the economic boom.

If we examine more closely, we find that the lopsided evaluation between Inoue and Takahashi comes from looking only at the macroeconomic aspects of their fiscal policies. The assessment from microeconomic aspects of how the private sector responded is totally lacking.

As I argued earlier, Japan in the 1920s desperately needed structural reforms in order to reduce the bad assets of the post WW1 period and cultivate new competitiveness. It is true that unemployment and bankruptcies surged under Inoue's fiscal policy of the Hamaguchi government. But we must also realize that, during this period, many firms implemented overall restructuring and consolidation, industrial structures were reorganized, and export industries underwent management rationalization and technical progress. Only after this intensive joint effort by management and labor to improve efficiency, the Japanese economy was able to recover in the following period...

If this historical lesson is correctly learned, the Koizumi government should be able to effectively apply this lesson to the current situation. I have argued many times that today's Japan must learn from the Hamaguchi government and the Minsei Party led by Hamaguchi. Japan really needs to create another Minsei Party.

Economic reforms always come with pain. Unemployment will visibly increase and bankruptcies will surge. The economy may fail to recover soon. Under these circumstances, which political party will take the responsibility and who will push reforms forward? The lesson of the prewar period, as I interpret it, is that we must learn from the Minsei Party and re-create it today. The Seiyukai Party—in other words, the Liberal Democratic Party—can hardly be the proponent of reform momentum.

Chapter 9

The 1930s and the War Economy



The Manchurian Incident – The Japanese Army marching into the gate of Qiqihar in Heilongjiang, China.

1. The Showa Depression, 1930-1932

Japan experienced the deepest economic downturn in its modern history during 1930-32. This depression had far more serious consequences than the 1927 financial crisis (chapter 8) on all aspects of Japanese society, including economic, social and political. It was caused by the simultaneous occurrence of two factors.

Externally, the stock market crash in Wall Street, called *Black Thursday*, of October 1929 and the ensuing Great Depression in the world economy had a severe negative impact on the Japanese economy. The economic crisis which was started in the US engulfed all capitalist countries, resulting in sharp price declines and surging unemployment.

Internally, the Minsei Party government (July 1929-April 1931), with Prime Minister Osachi Hamaguchi, Finance Minister Junnosuke Inoue, and Foreign Minister Kijuro Shidehara, deliberately adopted a deflationary policy in order to eliminate inefficient banks and firms and to prepare the nation for the return to the prewar gold parity (i.e. restoring a fixed exchange rate of 2 yen per dollar through real appreciation).

Throughout the 1920s, restoring the gold standard was considered as an important economic goal. Finally, in January 1930, this was carried out in the hands of Finance Minister Inoue as Japan re-fixed the yen at the original parity. Before doing this, Inoue implemented a macroeconomic austerity program and deflated the economy in order to return to the now-overvalued exchange rate. Inoue argued:

Our economy remains very unstable because of the export ban on gold [the yen's non-convertibility to gold and the resulting exchange rate fluctuation]. We must liberalize gold exports as soon as possible. But we cannot liberalize gold exports without preparation. What is required in preparation? The government must tighten the budget. The people must accept this fiscal austerity and they themselves must reduce consumption. If that happens, prices will start to fall and imports will begin to contract. That will create an upward pressure on the yen in the foreign exchange... We face a recession without an end in sight. If nothing is done, we will sink deeper into the recession. In the past, Japan often overcame recessions with the help of external stimuli. But the current situation does not permit such a hope because the European economies

are severely weakened by the last war [WW1]. Under such circumstances, we should not hope for foreign demand to bail us out. Recovery must be generated by our hands. There is no way out except through our own austerity (*Essays of Junnosuke Inoue*, Vol.1, 1935).

But unluckily, Inoue's deflation policy coincided with the beginning of the Great Depression in the world economy. Japan was thrown into a very serious deflationary spiral with rising unemployment, and popular discontent against Inoue's policy mounted. Inoue's policy was continued for two years until a Seiyukai government replaced the Minsei Party government in December 1931.

In Britain, John Maynard Keynes asserted in 1925 that the UK should not return to gold at the prewar exchange rate, because the equilibrium exchange rate had shifted due to international price divergence. If an overvalued exchange rate was chosen, he predicted that a recession would ensue. Keynes calculated that the sterling pound would be overvalued 10 percent at the prewar parity. In Japan, too, Tanzan Ishibashi, economic journalist at Toyo Keizai Shimposha, argued for a return to the gold standard at a new, more depreciated parity. But Ishibashi was in the minority.

However, Inoue's idea was that Japan needed deflation. He argued that unprofitable firms and banks survived through the 1920s without mergers, consolidation or closure, because the government and the Bank of Japan generously helped them. He thought that deflation was painful but necessary to remove those inefficient industries. But many people blamed—and still blame—him for pursuing the deflationary policy too aggressively when the world was in the Great Depression. But Inoue did not relent until he was finally assassinated in 1932. Maybe his idea was sound in principle but the timing and degree were unfortunate.



Junnosuke Inoue (1869-1932): the banker, Bank of Japan Governor, and Finance Minister.

2. Social instability and the rise of Fascism

The Showa Depression wreaked havoc on Japanese society. Its main consequences can be described as follows.

First, as in previous periods, macroeconomic downturn was felt primarily in falling prices and not so much in output contraction (estimated real growth was positive during this period). As prices fell, manufacturers rushed to produce more to maintain earnings and keep factories running. But clearly, this behavior would collectively accelerate the oversupply and the deflation. From 1929 to 1931, the wholesale price index fell about 30 percent, agricultural prices fell 40 percent, and textile prices fell nearly 50 percent.

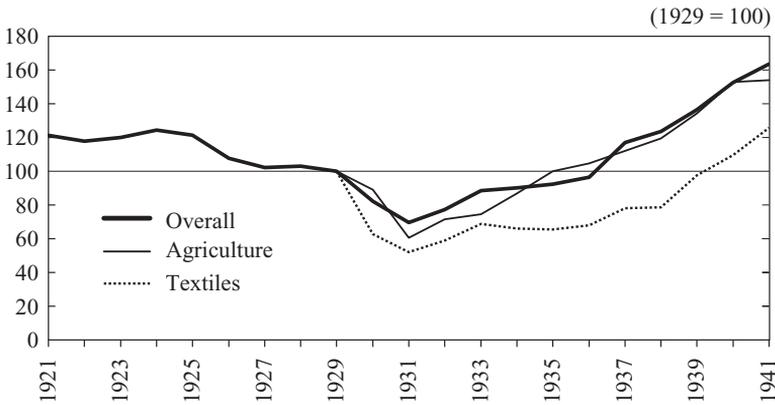
Second, rural impoverishment became severe around 1931. In addition, in 1934, rural communities were hit by famine. In the Tohoku (northeastern) Region of Japan, rural poverty generated many undernourished children and some farmers were forced to sell their daughters. This rural disaster caused much anger and popular criticism against the government and big businesses.

Third, cartelization and rationalization were promoted under government guidance. The free market seemed to worsen the depression, so agreements on output restrictions were adopted. This practice spread to virtually all material industries including cotton yarn, rayon, carbide, paper, cement, sugar, steel, beer, and coal.

Fourth, the fascist movement emerged. *Fascio* was the term used then to denote politicized military and right-wing groups with the aim of establishing a totalitarian regime. Amid economic despair, much blame was placed on party governments and their policies. Even ordinary people, who normally hated militarism, were disappointed with the performance of party governments and became more sympathetic to the “reform movements” advocated by the military and nationalists.

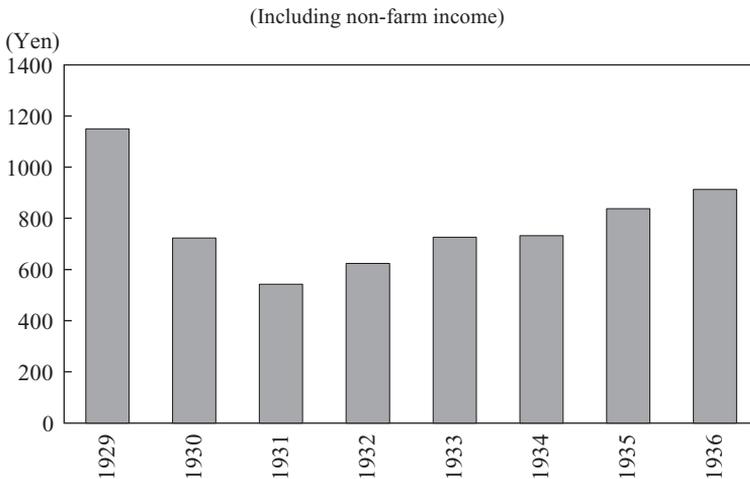
In the 1930s, political and intellectual thinking gradually shifted from economic liberalism toward more control under state management. There were many reasons for this, including: (i) the influence of Marxism; (ii) the apparent economic success of the USSR; (iii) Showa Depression; (iv) the view that deflation was aggravated by excess competition; and (v) disappointment with politicians and political parties. Many considered that the days of the US-style

Figure 9-1 Wholesale Price Levels



Source: Management and Coordination Agency, *Historical Statistics of Japan*, Vol. 4, 1988.
 Note: No data are available for agriculture and textiles before 1929.

Figure 9-2 The Average Income of Farm Households



Source: Management and Coordination Agency, *Historical Statistics of Japan*, Vol. 2, 1988.

free market economy were over and that from now on, state control and industrial monopoly would strengthen the competitiveness of the national economy.

Another aim of the military and right-wing groups was active military expansion. They criticized “Shidehara Diplomacy,” which to them seemed too soft on China. Their primary goal was to defend Japanese interests in Manchuria and Mongolia [more precisely, the eastern part of “Inner” Mongolia

as viewed from China]. However, military invasion of China would violate the agreement with the Western powers on the policy of “open door and equal opportunity” in China. Scrapping this agreement would carry the risk of spreading military confrontation to all China and Southeast Asia, and even to the entire world.

3. Seiyukai versus the Minsei Party

Seiyukai (full name: Rikken Seiyukai) was established in 1900 by the union of Hirobumi Ito, a leading politician, and a former opposition party who decided to cooperate with the government. Its main policies were (i) fiscal activism with an emphasis on public investment in rural and industrial infrastructure; (ii) acceptance of a military buildup and expansion; and (iii) pleasing a narrow voter base (rural landlords and the urban rich). It was a party supportive of a big government allocating public money and subsidies. *Seiyukai* literally means “political friend society.”

The *Minsei Party* (full name: Rikken Minsei To) was originally called *Kenseikai* (1916), merging with another party in 1927 to become the *Minsei Party*. Its main policies were (i) economic austerity and industrial streamlining (a free economy and small government); (ii) return to prewar gold parity; and (iii) international cooperation and peaceful diplomacy, especially with the US. Its support base consisted of intellectuals and the urban population. *Minsei* means “people’s politics.”

Japanese voters did not always vote for the same party. They often switched their support from one party to another depending on the issue and situation. Smaller “proletariat parties” also emerged with farmers and workers as the support base.

As noted earlier, Junnosuke Inoue of the *Minsei Party* (Finance Minister 1929-31) was deeply committed to the policy of deflation and returning to gold. This policy caused a severe depression but he never relented or regretted his position. People became greatly frustrated with his policy. Finally, the government (the second Wakatsuki Cabinet) was removed in the aftermath of the October Incident (see below) and was succeeded by a *Seiyukai* government (the Inukai Cabinet) in December 13, 1931.

Table 9-1 Two Major Political Parties in Prewar Japan

	Minsei Party	Seiyukai
Main supporters	Intellectuals, urban workers	Big businesses, rural landlords and rich farmers
Economic policy	Small government, free market principle, elimination of inefficient units through austerity	Big government, fiscal activism, public investment for industry and rural development
Foreign policy	Cooperate with US, oppose military invasion of China (protect Japanese interests through diplomacy)	Supporting military expansion, cooperate with military, if necessary, to undermine the Minsei Party
Finance Minister and his policy in the 1930s	Until Dec. 1931, Junnosuke Inoue pursued deflation policy to return to prewar gold parity	From Dec. 1931 to Feb. 1936, Korekiyo Takahashi engaged in yen depreciation, easy money and fiscal expansion (later reversed)

As soon as the new Seiyukai government was sworn in, Finance Minister Korekiyo Takahashi completely reversed Inoue's policies. On the very first day of the new government, Takahashi ended the gold standard and the fixed exchange rate, and floated the yen which immediately depreciated. In addition, fiscal expansion financed by government bond issues (called "Spending Policy") was adopted. Monetization of the fiscal deficit, in which the BOJ bought up newly-issued government bonds, was tried for the first time in Japanese history. The money supply expanded and interest rates were lowered.

Thanks to this policy turnaround, the Japanese economy began to recover in 1932 and expanded relatively strongly until 1936, the last year of the non-wartime economy. Among major countries, Japan was the first to overcome the Great Depression of the 1930s. Fiscal and monetary expansion worked well. But the yen's sharp depreciation might be considered as a "beggar-thy-neighbor" policy. It was a policy that could offend other countries since Japan promoted its exports at the cost of reduced competitiveness of its trading partners.

For these achievements, Korekiyo Takahashi is called the "Japanese Keynes." He adopted Keynesian policies even before John Maynard Keynes wrote his famous *General Theory*¹ in 1936! Even today, Takahashi's policy is

admired while Inoue's policy is widely criticized as stubborn and misguided. But this view can be challenged. As recently as in 2001, Prof. Junji Banno of Chiba University wrote that Inoue's deflation policy was a pre-requisite for economic recovery of the mid-1930s, because without it efficiency improvement could not have been achieved. His article indirectly criticizes the current Koizumi government for supporting weak firms and banks to avoid painful restructuring (see the box at the end of chapter 8).



Korekiyo Takahashi (1854-1936)

Around 1934, when the Japanese economy was firmly on a path to recovery, Takahashi shifted back to a tighter budget, which seemed an appropriate decision. But the army and navy continued to demand more military spending despite fiscal pressure. Takahashi resisted and was assassinated by a military group in the February 26 Incident in 1936 (see below).

Both Inoue and Takahashi previously served as Governor of the Bank of Japan before becoming Finance Minister, but their personalities differed significantly. Inoue was a slim, intellectual graduate from Tokyo University. Takahashi was fat and had a nickname of Daruma, a round doll. He did not receive much education and had a rough life when he was young. Japanese people naturally preferred Takahashi who looked friendlier and who always saved Japan out of economic crises.

¹ J. M. Keynes, *The General Theory of Employment, Interest and Money*, Macmillan, 1936. Keynes criticized the classical contention that unemployment could be automatically solved through the market mechanism. Using analytical tools such as liquidity preference, shortages of investment opportunities and aggregate supply and demand, he showed the possibility of involuntary unemployment in a world where uncertainty ruled. Public investment was advocated as a remedy for this situation. Keynes' theoretical contribution revolutionized economics, which led to the creation of the discipline of macroeconomics and the system of national income statistics.

4. Political terrorism and the invasion of China

From 1931 to 1937, Japanese politics was gradually overtaken by the military. Many incidents occurred, each undermining the basis of party government. Within the army and navy (especially the army), a few ultra-nationalist groups formed for the purposes of rejecting a party-based political system, uniting the nation under the emperor, introducing economic planning, and saving the rural poor. They staged many coups and assassinations. Here is a brief chronology of this dismal period.

- 1931
 - *The March Incident*—a failed military coup attempt.
 - *The Manchurian Incident (Sept. 18 Incident)*—Several officers of the *Kantogun* (Japanese army stationed in China), including Kanji Ishihara and Seishiro Itagaki, sparked a military invasion by exploding a railroad track and blaming it on Chinese. Ishihara's idea was that Japan had to take Manchuria (Northeastern China) in order to prepare for a full war against the US. They started the incident without informing the Tokyo government or army headquarters. Foreign Minister Shidehara told *Kantogun* to refrain from further military action but Ishihara's group ignored the order. The Chinese side adopted a non-resistance strategy, and Manchuria was soon occupied by the Japanese troops. This incident clearly showed that the party government could no longer restrain the behavior of the military.
 - *The October Incident*—another failed military coup attempt.
- 1932
 - *The Blood Society Incident*—Junnosuke Inoue (former Finance Minister) and Takuma Dan (Mitsui Group) were assassinated.
 - *Establishment of the State of Manchuria* (Japanese puppet state).
 - *The May 15 Incident*—Navy officers assassinated Prime Minister Tsuyoshi Inukai (Seiyukai).
- 1933
 - Japan was criticized by the League of Nations over the occupation of Manchuria. In protest, Japan withdrew from the League of Nations.

The period 1933-35 was relatively “quiet” thanks to economic recov-

ery and fewer domestic and international incidents. But this proved to be a temporary calm before the big storm.

1936 • *The February 26 Incident*—Nationalistic army officers led their troops to stage a military coup on a snowy morning in Tokyo. They wanted to remove the current government and start a new regime. Korekiyo Takahashi (Finance Minister), Makoto Saito (Interior Minister) and Jotaro Watanabe (Education Minister) were assassinated. The coup group occupied central Tokyo for four days. The army headquarters first approved their action but later disowned them, because the emperor angrily told the military to put down the rebellion. The coup thus failed, but after this incident party government was marginalized and the military controlled Japanese politics.

During these incidents, Seiyukai behaved opportunistically, often supporting the military in order to politically attack its rival, the Minsei Party. It was a risky tactic, since the goal of the military was to remove all political parties including Seiyukai! (Banno, 1993, 2004) Seiyukai also criticized the “organ theory of the emperor” by Professor Tatsukichi Minobe of Tokyo University, an academically well-established theory which demonstrated the possibility of party government under the Meiji Constitution². By contrast, the Minsei Party more consistently opposed the military. Nevertheless, both Seiyukai and the Minsei Party were seriously discredited in the eyes of the public because they were considered equally corrupt and incompetent. For farmers and workers who rejected the market mechanism and demanded economic controls and pro-poor and pro-labor policies, both parties seemed too *bourgeois* (pro-business) and thus had to be condemned. In this way, the general public and burgeoning proletarian parties began to partially sympathize with the military. They did not welcome aggressive invasion of foreign countries, but they liked the anti-capi-

² The organ theory of the emperor considered the state as a legal entity with a power to rule in which the emperor was its highest organ. This was the standard theory of the Meiji Constitution. The idea that the emperor’s power was derived from and exercised within the Constitution was in line with the spirit of constitutional monarchy as well as the intention of Hirobumi Ito, the principal author of the Meiji Constitution. However, this theory angered the nationalists who regarded the emperor as divine and beyond the constraints of the Constitution.

talist reform agenda advocated by the fascist groups.

- 1937 • *The Japan-China War*—On July 7, Japanese and Chinese troops had a skirmish at Marco Polo Bridge near Beijing (Beiping). The incident was minor but the Konoe Cabinet in Tokyo decided to send more troops to China. Thus began a full-scale war with China, which lasted until 1945.

After the Japan-China War erupted, political parties were emasculated and subsequently disbanded, the military completely took over Japanese politics, and the entire nation was mobilized to execute the war.

When did Japan cross the point of no return toward total war? In the view of the author, it was probably the Manchurian invasion in 1931. With this incident, Shidehara Diplomacy was abandoned and the military's influence began to increase. The establishment of a puppet state in China by force in pursuit of Japan's national interests completely ignored the policy of "open door and equal opportunity," which was the most important agreement on China among major powers throughout the 1920s. After this invasion, Japan's international isolation was unavoidable. Party governments were too weak to stop this trend. While some factions within Seiyukai and the Minsei Party tried a number of times to join forces to oppose militarism, their attempts did not materialize. Counting from the Manchurian Incident, the period 1931-1945 is sometimes called the "Fifteen-Year War." However, for Japanese people, the sense of wartime did not really exist until 1937 when the Japan-China War started.

Some say that Japanese people and parliament in this period were suppressed, and they were deprived of necessary information and the right to criticize the military. However, this was not correct until 1937. In mass media, there were a large number of essays criticizing the military and its foreign invasion and calling for the formation of an anti-fascism front. In the parliament, many speakers provoked and criticized military leaders. The Social Mass Party, representing the voice of workers and farmers, increased their parliamentary seats at every election. However, the situation changed dramatically after the Marco Polo Bridge Incident. Once total war began, all efforts toward democracy came to nil and everything had to be reorganized for the purpose of war.

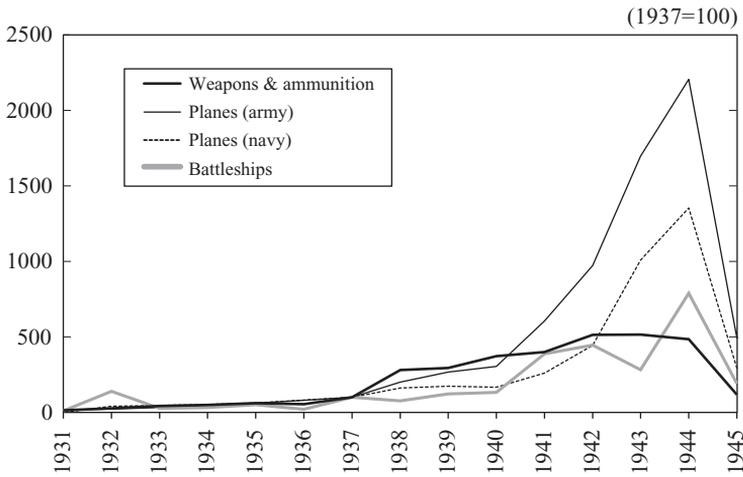
5. The war economy, 1937-1945

The military leaders thought (or at least hoped) that the war with China would be short. But in reality, it lasted for eight years. Without a realistic vision or strategy, the war front expanded and fighting escalated. Within China, the nationalists and the communists were fighting each other at first but later joined forces to resist the Japanese.

While there had been calls for economic planning even before the war, the Japanese economy basically remained market-oriented until 1936. But with the outbreak of the Japan-China War in 1937, the economy was completely transformed for war execution. One by one, new measures were introduced to control and mobilize people, enterprises, and resources. Most Japanese firms remained privately-owned but were heavily regulated to contribute to the war effort. Key components of the war economy included the following:

- 1937 The Planning Board (*kikakuin*) was created. This board, directly under the Prime Minister, was responsible for comprehensive policy design for wartime resource mobilization. The brightest bureaucrats from various ministries were gathered for this purpose. It basically played the same role as the state planning committee in socialist countries.
- 1938 The Planning Board issued the Resource Mobilization Plan, which was Japan's first economic plan. In the same year, the National Mobilization Law was also approved.
- 1940 The New Regime Movement of the Konoe Cabinet. This movement was initiated in response to the Japanese invasion of Southeast Asia and German victories in Europe. It was felt that a strong, one-party system was needed. Existing political parties were dismantled and replaced by *Taisei Yokusankai* (The Society for Humbly Supporting Great Politics), a super organization created by the government to mobilize people.
- 1943 The Military Needs Company Act was adopted. Designated private companies were placed under official control. The government approved top management and production plans and imposed penalties for non-compliance. At the same time, these companies were

Figure 9-3 Production of Military Goods



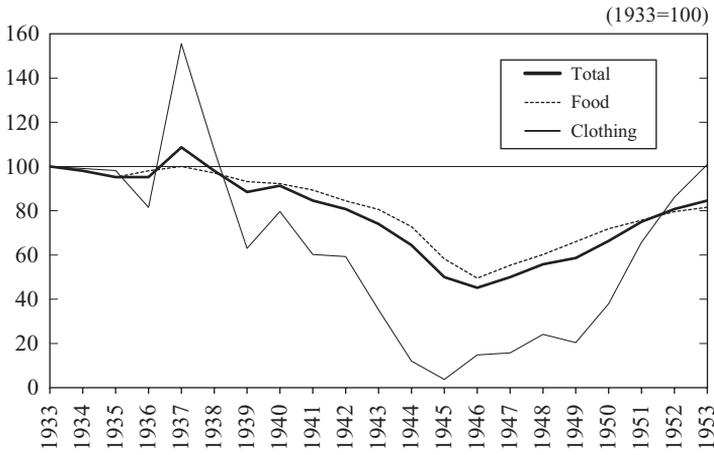
Source: Nakamura, 1989, p.21.

provided with necessary inputs on a priority basis.

The primary objective of economic planners was to maximize military production with the limited domestic resources and possibility of imports. Key military products were ships and warplanes. Toward the end of the war, airplane production became the only priority. In order to boost heavy industries, consumption was greatly squeezed and light industries were strongly suppressed. The textiles industry, previously the leading industry of Japan, was virtually eliminated. People were forced to live without new supplies of clothes and footwear. Steel products in structures and households were stripped and used as the metal source for building more airplanes and ships. As the war continued, food rationing, forced enterprise mergers, and forced factory labor were adopted in increasing intensity.

At first, the two crucial variables in wartime planning were foreign exchange reserves and the availability of energy and raw materials (and the ability to transport them by sea). Until around 1940, the question was how to maximize military output subject to these two constraints. But after 1940, Japan could no longer trade with other countries and the problem shifted to the physical transportation of natural resources from the Japanese colonies and occupied

Figure 9-4 Supply of Consumer Goods per Capita



Source: Nakamura, 1989, p.22.

areas to mainland Japan.

Japan considered that the resources from the “Yen Bloc” (Korea, Taiwan, Manchuria and the rest of occupied China) were not sufficient. In July 1941, in order to secure more resources, the Japanese military began to invade Southeast Asia, starting with French Indochina (Vietnam). This angered the US, which imposed an oil embargo and asset freeze on Japan. If oil imports from the US were cut off, Japan’s oil reserves would last only two years. At this point, Japan began to prepare for war with the US. Diplomatic efforts to maintain peace were attempted but failed. With the Pearl Harbor attack in December 1941, Japan started the Pacific War against the US and its allies.

Japanese leaders did not have any clear idea regarding how to fight a war against the US, let alone how to win it. However, they were encouraged by the brilliant victories of Nazi Germany in Europe. To them, the totalitarianism of Japan, Germany and the USSR seemed superior to American capitalism and individualism.

Immediately after the outbreak of the Pacific War, Japan invaded a wide area of Southeast Asia but soon began to retreat under allied counterattacks. Japanese ships and planes were quickly lost while the Americans built an increasing number of them. From late 1944, US aerial bombing, which consisted largely of incendiary bombs, destroyed virtually all major cities in Japan

(except Kyoto). In March 1945, the US troops landed in Okinawa. In August 1945, two atomic bombs were dropped in Hiroshima and Nagasaki, and the USSR entered the war against Japan. A few days later, Japan surrendered.

The main economic reason for Japan's defeat was the collapse of its war economy due to the lack of material and energy inputs. Japan lost virtually all its means of sea transport and could not bring industrial inputs from its colonies and occupied areas.

The origin of the Japanese system

Many of the characteristics of the post-WW2 Japanese economy originated during the war period of 1937-1945. They feature long-term relationship and official intervention, and include such items as:

- Heavy and chemical industrialization drive
- Administrative guidance (*gyosei shido*)
- Subcontracting system in manufacturing (*shitauke seido*)
- Separation of ownership and management
- Lifetime employment and seniority wage
- Enterprise-based trade unions
- Financial *keiretsu* and mainbanks
- The Bank of Japan's "window guidance" and "convoy system"
- Food control system
- Foreign exchange budget and foreign exchange surrender requirement

All of these policies and systems were deliberately adopted by the government in the late 1930s through the early 1940s in order to effectively execute the war. Before that, the Japanese economy was more *neoclassical*, characterized by freer entry, short-term contracts and high labor mobility.

These features were largely retained even after WW2 and worked relatively well in the 1950s and 60s, when Japan was growing rapidly. However, they are now considered obsolete and to have become barriers to change in the age of IT and globalization. Among the items above, the last one was abolished long ago but the remnants of others still remain in the Japanese economy even today to various degrees.

There is a debate among economists regarding the interpretation of the Japanese system. The majority of Japanese economists argue that Japan should go back to the free market model, because the relational and interventionist system was originally alien to Japan. These may have played a historical role before, but the country does not need them any more (some aspects, like the priority placed on job security, could be partially retained, however). Masahiro Okuno-Fujiwara, Tetsuji Okazaki, and Yukio Noguchi are leading advocates of this view (Okazaki and Okuno, 1993; Noguchi, 1995).

But a minority voice says that Japan needed a system based on long-term relations, with or without war. When an economy graduates from the light industry stage featuring garment, food processing, and simple assembly of electronics products, and moves to heavy industrialization and machinery production, free markets may not be the best choice. Official support and long-term relationships become indispensable for industries that require large initial investments, high technology and an intra-firm labor market. As Japan began heavy industrialization in the 1920s and 1930s, the free economic system inherited from Meiji was inappropriate and had to change. The war provided a good excuse for this change. But even without the war, Japan had to adopt a new system anyway. Yonosuke Hara presents such a view (Hara, 1996). He says that the free economy of Meiji was foreign, and the relational and interventionist system, dating back to the Edo period, is more normal for Japan.

According to the latter view, the implications for today's developing countries are as follows. Light industries and electronics assembly can be promoted by free trade and an open FDI policy, but if the country hopes to absorb technology vigorously and have advanced manufacturing capability, certain industrial promotion measures become necessary. Japan, Taiwan and Korea all adopted this method in the past. By contrast, no ASEAN countries seem to have broken through this "glass ceiling" and internalized their industrial power. If latecomer countries are now banned from taking these measures because of the WTO, FTAs, the World Bank policy matrix and so on, they may forever remain at a low level of industrialization characterized by contract manufacturing and simple processing, and may not achieve a higher level of technology.