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CENTER DISCUSSION PAPER NO. 764

JAPAN 1968: A REFLECTION POINT  
DURING THE ERA OF THE ECONOMIC MIRACLE

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## ABSTRACT

1968 was an epoch-making year in the Japanese economic history, or in the Japanese history in general. In this centennial year after the Meiji restoration, Japan's GNP became the second largest in the world surpassing West Germany. Japan was cruising on one of the most rapid growth trajectories, but it was anticipating the shade of future changes. Student movements flourished, being synchronized the world over, pollution in urban areas erupted and inflationary pressure began to surface. Japan's balance of current account turned into a pattern of chronic surplus, the pattern that led to the collapse of the Bretton Woods regime.

In the socio-economic sense, 1968 was a reflection point of Japan's high growth period. This paper describes the economic forces that drove Japan in this pivotal year as well as its social and political background.

**KEY WORDS:** Japan's Postwar History, High Growth Period, Student Movements, Collapse of Bretton Woods, Pollution

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## Japan 1968: A Reflection Point During the Era of the Economic Miracle

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### Prologue

I still remember an Indian-summer day in 1968 when I sat on the steps of the economics building at the University of Tokyo. I was with an American friend who studied political science at Yale when I was enrolled as an economics student. He later became a member of the U.S. Trade Office and allegedly negotiated hard with Japan on economic matters. We were watching the massive demonstration of students on the university campus. They were protesting what they considered to be an ancien régime of the university administration. "Revolt has reasons!" a phrase coined by Mao Tse-tung, was the motto of the students.

I also remember a cold windy day when I sat in the soccer stadium of the university and watched the ceremony of armistice between the students of the Democratic Youth Liberation group (Minsei), considered to be close to the Japan Communist Party, and the university administration. In the treaty, the university promised moderate reforms of the system. More radical groups organized by the All National Student Federation (Zengakuren), were strongly opposed to the treaty.<sup>1</sup> Their actions were escalated to militant attacks on universities. The word Gewalt (violence) became Japanese.

And, finally I remember the scene, January of the following year, when students who occupied the university tower, the symbol of the University of Tokyo, were forced to leave by the national police when they used tear gas. Until then the university campus was considered a "sacred zone," safe from government force.

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In March 1969, the entrance examination to the University of Tokyo was canceled. The cancellation of the entrance examination had a serious impact on Japan's entire society, and after the cancellation, the University started to return to normal. The intense reaction to the cancellation showed the validity of the claim that the function of outstanding universities in Japan was not so much to give intellectual values to students as to identify students with high innate ability.

### I. Anticipation for Changes

All over the world, waves of student protests were synchronized. Quartier latin was a symbol of liberalism for students, and China was under a violent storm of cultural revolution. Modern news media transmitted images and sounds of young protestors throughout the world. Student movements were the phenomenon of fashion as well as of liberal ideology. The postwar liberalism in Japan came with the spurt of student movements peaked around 1968.

When the United States deepened its involvement into Vietnam around 1964, Japan became a base for procurement and a recess for soldiers by the Japan-U.S. Mutual Security Act. The Sato Cabinet cooperated with the United States except that the Japanese did not directly engage in war activities. Responding to it, the pacifist movement in Japan also developed. In protest to the bombing of North Vietnam by the U.S. air force, a grass-root group called "Beheiren" (Peace to Vietnam Citizens' Alliance) was formed. In October 1966, protest movements developed into labor union activities including strikes, and from next year on this protest joined the worldwide activity called the International Anti-Vietnam-War Movement.<sup>2</sup>

1968 was exactly the centennial year from the Meiji Restoration when Japan was established as a modern nation from the rule of Tokugawa feudalism. In the same year, Ryokichi Minobe, ex-Marxian scholar and popular television commentator, was elected as the governor of Tokyo against the candidate supported by the Liberal Democratic Party (LDP). The LDP has been the incumbent party

almost always through the postwar period. Since the end of the war, freed from the pressure of the fascist-like military government during war time, and freed from the ban of Marxism, Japanese intellectuals and students had been attracted to a form of liberalism that emphasized, under the influence of Marxism, the modernization of Japanese society and freedom from feudalistic regimes.<sup>3</sup>

Of course, only few people could approve the violent instruments students used in their protests, but many Japanese might have had sympathy with their causes. By economic growth the Japanese could come to enjoy material amenities, but many of them felt some frustrations in human aspects of life. Old traditional institutions appeared to block the fulfillment of a meaningful life. However, the student revolt in the late 1960s was the last spurt of liberalism, and after that liberalism in Japan was about to fade. Radical student groups split into small groups that were often fanatic. Some of them engaged in a cult of violence or international hijackings like the one in North Korea.<sup>4</sup>

Instead, conservative ideas and ultra-nationalism were emerging. In 1970, Yukio Mishima broke into the Headquarters of the Self-Defense Force and tried to persuade them to organize a coup d'état for the sake of the Emperor against the current regime of representative democracy and cultural decay. The Chief Commander of the Self Defense Force did not comply, and Mishima killed himself by a traditional Japanese ritual of "harakiri (disembowelment)". He took his young friend with him.<sup>5</sup>

A book by Isaiah Bendasan (now believed to be the pen-name of a Japanese publisher, Hichihei Yamamoto) called The Japanese and the Jew<sup>6</sup> was a typical example of emerging conservative ideas that influenced Japan's intellectual public in the 1970s. He criticized Japanese pacifists by saying that they took clean water and peace for granted while in Israel neither of them is free. "Realistic", meaning "conservative", thought on politics as well as on international relations became more popular. Economics based on western thought rather than on Marxian thought gained momentum. Probably the progressive ideas had been exhausted during the twenty years after the war. The miracle of

economic growth contradicted some of the predictions of liberals. In particular, the Marxian ideology that preached continuation of poverty was revealed to be unrealistic.

So much for the ideological and intellectual background around 1968. Now let us turn to the political situation in Japan during the decade. At the beginning of the decade, Prime Minister Hayato Ikeda, of LDP,<sup>7</sup> started his "doubling the income" plan. This was the beginning of the decade of the "economy" as opposed to the decade of "politics." Let us roll back the film of history a little further in order to understand the background of the miraculous growth of Japan.<sup>8</sup>

The decade of the 1950s can be regarded as the period of preparation and transition (from the postwar reconstruction period) to the golden era of high speed growth after 1960. Resources were transferred from less productive to more productive sectors, and the pace of progress quickened through import of foreign technology. GNP exceeded the prewar level in 1953. The 1956 Economic White Paper of the Economic Stabilization Board stated: "We are no longer in the postwar reconstruction period."

In 1960, protests against the revised extension of the Japan-U.S. Mutual Cooperation and Security Treaty roared on the streets of Tokyo. The treaty was to put Japan under the U.S. (nuclear) umbrella. In retrospect, because of the Treaty, Japan could enjoy some free-ridership in defense in exchange for various benefits for the U.S. forces that were stationed in Japan. In any case, demonstrations echoed in the streets of Tokyo. Prime Minister Nobusuke Kishi planned to invite President Eisenhower to Japan for signing the extension of the Mutual Security Treaty, but he gave up the plan when the U.S. Press Secretary, James Haggarty, had to be flown by helicopter from the airport to the guest house, and when the police crushed rioters and killed a woman who was a student from the University of Tokyo.<sup>9</sup> Kishi<sup>10</sup> resigned soon after the cancellation of the President's visit.

Moreover, labor relations were also severely strained. A long strike was going on in Miike Mining in Kyushu (Southern) island.

The reaction of Hayato Ikeda, the successor of Kishi, to this highly politicized situation, was to direct the attention of the people to the economy. Income Doubling Plan<sup>11</sup> opened the way to the era of high-speed growth during the 1960s<sup>12</sup>). Ikeda forecasted that real GNP would be doubled in the following ten years. People hardly believed that the plan would be realized; nominal income might be doubled, they thought, but inflation would wipe out the nominal gain. To the surprise of the public, real income more than doubled in the next decade, and per capita real income even tripled between 1960 around 1973. The 1960s was the most remarkable decade of the Japanese economy as far as the real growth rate is concerned. The unemployment rate was low, around 1.1-1.3%, except for 1960 when it was 1.6%. 1968 was in the middle of the most rapid growth period of the Japanese economy. This period (1966-69) was called the Izanami period (meaning "the best period since Izanami"). Izanami and Izanagi were the goddess and the god who supposedly mated and gave birth to the Japanese islands.) As was already mentioned, the first time, Japan's GNP exceeded Germany's and Japan's GNP became second in the world, though per-capita GNP was still lower than many industrialized countries.<sup>13</sup> In Fiscal Year 1968, Japan's GNP reached about 152 billion dollars which exceeded that of West Germany. West Germany's population was slightly more than half of Japan's. The per capita income in Japan was about a half of that in West Germany. The comparison of the living standard follows, approximately, from the per capita income comparison. The centennial year of the Meiji Restoration in 1868 became memorable in this respect as well.

Ikeda was influenced by the Keynesian theory and turned out to be a successful administrator of economic growth, the Japanese miracle. He retired because of illness in 1964, and Eisaku Sato<sup>14</sup> took his place. Sato conducted moderately conservative policies that helped the rapid growth of this decade. He successfully negotiated with President Nixon for the return of Okinawa Island, located at



the southern tip of Japan, which had been under the rule of the U.S. administration. In return he also promised the United States, at least informally, to engage in voluntary export restraints (VERs) in textiles.

The promise was not readily delivered and created a sharp diplomatic conflict between Japan and the United States in the early 1970s. Later this promise of VERs was eventually realized. This started, in fact, the most undesirable form of trade restraints in the world economy<sup>15</sup>.

In the mean time, another political character, Kakuei Tanaka was emerging. Later he was destined to succeed Sato as Prime Minister in 1972. He led a very eventful life. He became Prime Minister with only an elementary school education. This was exceptional because many ministers were college graduates, particularly the University of Tokyo graduates. He collected votes by building bridges, roads for his district, and by bringing the route of the bullet train into his district. He was rumored to have collected campaign funds by promising financial favors to his supporters. He was a popular politician and had democratic flavor, as compared to ex-bureaucrat prime ministers. However, his manipulation of politics through use of money made him a corruption suspect. Soon after he became prime minister, two journalists scrutinized his financial sources and private affairs. Then he was accused of accepting bribes concerning the purchase of airbuses to a Japanese airline company from the Lockheed Company. The purchase itself was a big diplomatic issue between the United States and Japan. The Church Committee in the U.S. Congress revealed the deal with bribes. Tanaka was arrested for violating the Foreign Exchange Control Law, and later indicted on charges of bribery.

My story went somewhat ahead of the year 1968. However, Tanaka was already important around 1968, serving important financial posts like the Finance Minister (1962-65) in the Ikeda and the Sato cabinet. The Tanaka way of developing Japan, that is, restructuring Japan's Archipelago by connecting it with bullet trains was a very popular idea then. Also he tried to build a welfare state by instituting a substantial social security system. The resulting social security system was welcomed by

people, but it had ideal or bold escalation clauses for social security payments against inflation. Later on this contributed to the large government deficit after the oil crisis hit Japan in 1973-74. The Tanaka phenomenon, so to speak, was among the political factors that were behind the Japanese economy that started to overheat around 1968.

Presented here is the ideological as well as political background for the development of the Japanese economy. In the following section I will discuss domestic economic aspects, rapid economic growth and the problems that the rapid growth created, such as pollution and potential for inflation. In Section III, I will discuss the international implications of this high growth era, such as the liberalization of trade and capital movements, consolidation of Japan's membership in the GATT, IMF and participation in the OECD. Then I will explain how the domestic and international environment in the late 1960s prepared an overture to the collapse of the Bretton Woods regime that took place around 1971-73. In the concluding section, among other things, I will mention the significances of 1968 in the development of macroeconomics.

## II. Domestic Transformation

As is already seen, in many senses, 1968 was an epoch-making year. Exactly one hundred years after the Meiji Restoration, Japan's GNP became the second largest in the world, surpassing West Germany. Japan was cruising on the most rapid growth trajectory in history, but it was anticipating future changes. In the socio-economic sense, 1968 was a reflection point of Japan's high growth period. Around 1968, the potential danger of high economic growth in terms of inflationary pressure began to surface. Japan's balance of current account turned into a pattern of chronic surplus, the pattern that has continued as trend until now and created economic conflicts with other countries. Many consider that 1965 was the first year when the Keynesian fiscal policy was undertaken in Japan. In this year, Tanaka left his post of the Finance Minister, but his legacy was reduction of taxes and increase in

public expenditure. The seeds for government deficits were planted around this time, even though the full realization of deficits were to take place after the implementation of the welfare state with price escalation clauses.

The most noted problem in this period was probably the extremely intensified pollution in urban areas. Since the 1950s, the Japanese economy grew rapidly, and severe pollution developed on the small islands packed with factories and residential houses. As economic growth progressed, so did environmental problems and very sharply. In 1964, the Olympics were held for the first time in Tokyo.<sup>16</sup> A monorail, roads and bridges were built very quickly. The first bullet train ran just 10 days before opening day. When I came back to Tokyo after my graduate education at Yale in 1965, I was astonished by the change of the face of Tokyo. Hirofumi Uzawa told me that his impression of that the transformation provided Tokyo with its least attractive features.

A few, but very serious, cases of the damages caused by pollution and defective products were brought to court. "Itai-Itai (Ache-Ache) Disease" caused by cadmium waste by the Mitsui Metal and Mining Co., "Minamata Disease" caused by eating fish and shellfish polluted by mercury that was contained in the waste of the New Nippon Nitrogen (now Chisso) Co. in Minamata Bay, and later by (Showa Denko Co. in Niigata, and "Yokkaichi Zensoku (Asthma)" caused by air pollution of petroleum refining companies in Yokkaichi --- all of these are infamous cases of pollution. Legal actions required the reluctant government to provide legal remedies to victims.

The number of cases brought to court in Japan is limited, but however small in number, those cases have a strong impact through court rulings, but more importantly through public opinions that were widely generated and administrative measures that cope with them. The protest against the serious cases above had been going on since the early 1960s. The government was slow to recognize the link between industrial waste and damages. Finally in 1967, the Basic Law Preventing Pollution was legislated. In 1968, the Ministry of Welfare recognized both "Itai-itai disease" and "Minamata

disease" as the symptoms due to industrial pollution defined in the new law. These developments indicate that Japan in 1968 could no longer ignore the hazard from pollution, which was, in a sense, a by-product of extremely rapid growth. The government could no longer allow polluting activities with the excuse that it encouraged high industrial growth. The objective of economic growth needed to be balanced with the objective of attaining proper environmental standards.

The industrial circles did not like the legislation against pollution. First, industrial interests dominated government policy and the Japan Business Association (Keidanren) managed to stop the legislation of environmental protection laws. Evidence of pollution was so acute that the government as well as the business world had to change their basic attitude towards pollution.

The automobile industry was about to turn from the sector serving the domestic market to the sector serving the export market. The industry was prosperous, but the incidence of automobile accidents became very serious. During the period from 1966 to 75, more than ten thousand people were killed every year. The pollution problem created by automobiles was serious. In extreme instances, traffic controllers wore gas-masks and pupils in a schoolyard fainted from photochemical smog were hospitalized. Uzawa wrote an influential book, The Social Cost of Automobile Accidents, which stimulated criticism about modern Japanese society that depends so much on automobiles.

Cases of product liability (PL) had similar effects. There were only a limited number of PL cases in Japan. However, the small number of actions changed the attitude of courts and administration. They strengthened the safety standards and made producers more alert to the quality and the safety of their product. The basic legal statute, the Civil Code, which handled these cases was never changed. And, special legislation against product liability was passed as late as 1966. A few court actions during the late 1960s, however, made substantial difference in the protection of consumers.

The lifestyle was changing as well. I have already mentioned the effect the 1964 Tokyo Olympics had on modernization. In 1970, nearly one third of the non-agriculture households (and more of the agriculture households) owned a car. By the end of the decade, "the three Cs" (car, cooler and color televisions) became popular belongings in many households (Yasuba and Inoki, eds., 1989).<sup>17</sup>

Around the year 1968, conspicuous changes were taking place on in the world economy. These changes were about to make the position of the Japanese economy quantitatively and qualitatively very much different from earlier years. The United States and the world economy were under inflationary pressures. A popular rumor was that anchovy along the Peruvian coast was a poor catch and that it triggered a whole chain of commodity shortages and booms. Regardless of the accuracy of such a story, however, in 1968 the world was in the midst of the commodity boom.

The U.S. intervention in Vietnam, without apparent legitimate causes, was behind the anti-war student movements all over the world, and perhaps behind the riots in large cities in the United States that were motivated primarily by racial tensions. Moreover, the involvement in Vietnam meant a large U.S. budget deficit and more purchases by the government. This naturally tightens the commodity market. If the world economy is being inflated, then Japan, which was under a fixed exchange rate, is certainly affected by the boom in commodity. For an economy under a fixed exchange rate, any attempt to cut off the inflationary pressure from abroad would mean the accumulation of a current account surplus.

Let me elaborate on this. The average world price level under the fixed exchange rate can be approximated by the weighted average of the price levels in many countries (translated by exchange rates). Under the fixed exchange rate, a country is obliged to defend the prescribed exchange rate. It means that the country has to keep its domestic price level in conformity with those of foreign countries. If a country wants a less inflationary price level than other countries while keeping the same exchange rate, it will necessarily end up with the surplus in a current account.

In 1968, the world was in a commodity boom. Therefore, with the fixed exchange rate, Japanese prices would increase in tandem. A monetary policy that did not allow inflation at home encouraged the accumulation of a surplus in the balance of payments. In fact, in 1965 the current account of the balance of payments recorded a surplus for the first time in the postwar period. This trend continued. In fact, the balance of current account of Japan grew from 1967 from 10.6 billion to 1969 to 60.0 billion. This was the result of an inflationary situation in the world prices. Japan conducted a disinflationary policy until 1971 when the yen was floated, and it appreciated from \$1 = ¥360 to \$1 = about ¥300. Even after the yen moved into the flexible exchange rate, the current account surplus continued to grow.

Until Japan adopted the flexible exchange rate, Japan's macroeconomic policy was stimulative because policy makers believed firmly in the fixed exchange rate and accordingly had to inflate the domestic economy. When the yen was floating and appreciating rapidly, then macroeconomic policy continued its expansionary stance because, this time, policy makers were worried about the deflationary impact of the rising yen. They called the policy "adjusting inflationary policy."

When this reflationary policy was effectively creating the inflation pressure in Japan in 1973, the oil crisis deprived the purchasing power of the Japanese people. Creeping inflation became galloping inflation. The supply shock under demand pressure created by macroeconomic policy threw Japan into an acute inflationary situation, which was called by Prime Minister Takeo Fukuda "frenzied price." That is just as if the heat from excessive aggregate demand triggered a fire in the embargoed oil. An ex-MITI official wrote a novel called Oil Cut (Careless). From the traditional period (Edo), oil scarcity was a figurative phrase for carelessness. Toilet tissue roles disappeared from super markets because housewives believed that toilet tissue was the first item to disappear from the market if the oil shortage continued. The social security benefit indexed with the price level naturally created a source of government deficit. Figures 3 and 4 are graphs of the rate of inflation of the wholesale price index

(WPI) and the consumer price index (CPI). The latter increases usually more because of structural reasons. In WPI, one can detect the beginning of the spurt of the world price level around 1969. The anomaly of the first oil crisis (1973-75) can be seen very clearly.

These dramatic events occurred several years after 1968. I will posit that many elements for these dramas began to evolve in the late 1960s. 1968 was in this sense the year of anticipation for the future -- of drastic changes ahead. In Fiscal Year 1968, Japan's GNP reached about 152 billion dollars which exceeded that of West Germany, since West Germany's population was slightly more than half of Japan's. The per-capita income in Japan was about a half of that in West Germany. The comparison of the living standard follows, approximately, from the per-capita income comparison.

### III. International Implications

Reflecting the state of domestic economy, Japanese interaction with the world also changed. Japan was just a small economy at the end of World War II struggling with the devastating damages of the war.<sup>18</sup> In 1949, during the Occupation, Japan fixed its exchange rate at \$1 to ¥360. Under the old IMF adjustable-peg system (the Bretton Woods regime), Japan strictly kept this initial exchange rate until 1971.

Japan's economy has many things in common with Germany's. Germany's economy was also in a "period of transition" between 1968 and 1973. The effect of labor unions, that bid up wages, was strong throughout this period. In Japan, the unfavorable effects came mainly before the oil crisis. During the oil crisis, both economies were thrown into galloping inflation. The effect of the Bretton-Woods Regime was similar.<sup>19</sup>

The general attitude of the Japanese government as well as the Japanese public toward the international trade and monetary regime has been rather passive. After the wartime destruction, the Japanese economy occupied only a tiny place in the world. It was generally conceived of as an

economy closely associated with, and often subordinate to, the U.S. economy. The favorite phrase was "When the United States sneezes, Japan catches pneumonia." Japan was completely under U.S. hegemony in the economic as well as the political sense.

By its miraculous growth, however, Japan's GNP reached the second largest in 1968 as already mentioned. Accordingly, Japan's attitude towards the world was compelled to change.

First, by 1965 Japan managed to belong to the industrial club of developed nations. Liberalization of trade took place slowly but steadily. In February 1963, Japan joined the Article 11 country in the GATT, a category of countries that cannot appeal to import restriction on the ground of the balance of payments difficulty. In April 1964, Japan became IMF's Article 8 country so that it cannot control capital transactions on the ground of the balance of payments. Moreover, in July 1963, Japan joined the OECD.

Resource allocation on the rapid growth path was under the strong influence of the "industrial policy" conducted by MITI (Ministry of International Trade and Industry). The industrial policy refers to all kinds of policies that MITI and other ministries employed to influence the resource allocation among industries to the direction of what the government thought is desirable for the future of Japan. Whether or not the policy was effective and useful is a topic of active discussions.<sup>20</sup> Because of the extensive dimensions of the debate, I will not develop the pros and cons to the industrial policy.

In the context of year 1968, one can find a reflection point of the industrial policy around that time. Until the trade liberalization period just mentioned above, MITI had possessed strong policy instruments to affect industrial resource allocation. Import quotas, approval of foreign investment and import of technology into Japan, low interest financing through the Development Bank of Japan, special (favorable) tax treatment of firms investing in certain areas -- all were very effective policy measures. After the liberalization of trade, -- for example, trucks and automobile imports were liberalized in 1961 and 1965 respectively -- the industrial policy has to take more subtle forms such as



designing blue prints of future technology and organizing a joint large scale project for developing technology by coordinating large firms.

In fact, the tariff rates for cars started declining around 1968. This period can be regarded as the preparatory period for Japanese automobile exporters to initiate massive exports to the United States and Europe.

Second, during the 1950s and the early 1960s Japan's macroeconomic policy was characterized as a "stop and go" policy. The balance of payments difficulties under the fixed exchange rate necessitated Japan to adopt contractionary monetary and fiscal policy. However, Japan changed to a chronically trade surplus country around 1965. The trade balance turned to be in surplus first, and then the current account balance surplus followed.

During the period of rapid economic growth in the 1960s, the relative importance of the Japanese economy increased substantially, although the Japanese public still perceived of it as lagging behind. However, Japan's sudden and large balance of payments current-account surplus and the reluctance of the Japanese government to revalue the yen were among the main factors that triggered Nixon's drastic adoption of the New Economic Policy. Because of its increased role in the world economy, Japan functioned as a pivotal element in this critical change in the international monetary regime.

Figures 5 and 6 indicate the growth of export and import, and the current account surplus which is the sum of the difference between export and import and the service account. The current account became surplus for the first time in 1965. After 1968, it follows a strong positive trend except for the two oil crises (1973-75 and 1979-80).

Until 1971 Japan was among few countries that had not altered the exchange parity under the Bretton Woods regime. Since the late 1960s, Japan kept accumulating a large current account surplus. In order to block the inflationary pressures from abroad, Japan could appreciate the exchange rate

parity. Japanese officials, however, adhered to the principle of the fixed exchange rate under which the only way of containing the balance of payments surplus was inflating the domestic economy.

Under the fixed exchange rate, price levels of countries of the world are more or less connected. Therefore, if there is an inflationary pressure abroad, then any policy to maintain the price of domestic price levels will create a chronic balance of payments surplus. Because of balance of payments disequilibrium, many developed countries appealed to exchange rate realignment. The United Kingdom already devalued the Pound Sterling in 1967. France declined the G-10 countries recommendation to devalue the franc in 1968, but did depreciate it in 1969. In many cases the currency, crisis of the exchange market was closed.

In May 1971, the West German exchange market had to be closed because of massive inflows of dollars. West Germany decided to float the mark on May 9, 1970. The Netherlands and other European countries followed. This chaotic situation accentuated the speculation for buying the yen in the European market. Japan should have probably followed the policy of appreciating the yen. However, Japan's monetary authority adhered to the old parity.

When President Nixon announced the New Economic Policy for defending the dollar by suspending gold convertability of the dollar and by imposing import surcharges on August 15,<sup>21</sup> 1971 -- this was called the first "Nixon shock" in Japan, the second "shock" being his visit to China --- and all the European currency markets were closed immediately. Most of the currencies moved to the flexible rates. The Japanese monetary authorities kept the Tokyo exchange market open, and eventually lost a large amount of money. Japan finally had to adopt the flexible exchange rate on August 27.

After a short interlude of the wider-band experience of the Smithsonian period (December 1971-February 1973), major countries in the world adopted the flexible exchange rates. Currency experiences before and after this critical shift to flexible rates indicate the following stylized observations. Under fixed exchange rates, in particular, under the adjustable-peg system, the world

was frequently exposed to unstable currency markets and speculative attacks. Countries cannot conduct autonomous monetary policy without the risk of draining their international reserves or accumulating excessive international reserves. In order to recover an autonomous monetary policy, the exchange rate must be floated.

In other words, there were not sufficient incentives for national authorities to pursue the set of policies implicitly assigned to them in the Bretton Woods system. For Japan, incentives existed to adopt contractionary policies when the balance of payments was in deficit, and accordingly the system was binding. However, Japan or Germany did not always have an incentive to adopt expansionary policies when the balance of payments was in surplus. Nor did the United States necessarily have the incentive to play the role of a benevolent leader by adjusting its macroeconomic policies to keep the world price level constant.

Thus, the Bretton Woods regime collapsed because the rest of the world did not play the game symmetrically with respect to booms and recessions and that the United States, particularly after its involvement in Vietnam, came to be concerned not so much with world price stability as with its own national policy objectives.

After major industrial countries proceeded to adopt flexible exchange rates, monetary autonomy was recovered. Events of currency crisis with speculative attacks seldom took place unless countries in the European Union attempted to implement fixed exchange rates among them. However, these merits were not delivered without cost. The volatility of rate fluctuations after 1973 is much more than expected before the adoption of flexible exchange rates, and much more than deemed necessary to allocate resources in the dynamic as well as static sense.

The attempt for international exchange and monetary coordination, as well as the attempt to draw a target zone for the exchange rate, was a device to choose a midway between the fixed and the flexible exchange rate system. Attempts to prepare the convergence of currency values and their

determinants were the efforts to return to the fixed exchange rate from the world of flexible exchange rates. As was shown by European experiments, this path of return still seems to be thorny. The only hope may be seen in the accomplishment of unified currency in unified Germany, though the situation was, of course, different in many respects.

Another auxiliary lesson is as follows. If you trust your monetary authority well, then you should choose the flexible rate that allows monetary autonomy. If you don't trust yours more than those of other countries, you should choose the fixed rate with the hope that another country, for example, the leader country would keep monetary discipline. The problem of the late 1960s was that the leader country tended to conduct imprudent monetary policy.

Probably, in contrast to Germany and other countries in the European Union, Japan will remain as a country that keeps a floating exchange rate. Japan is, in the sense of Mundell, an optimum currency area. At least, Japan is recommended to take the attitude of wait and see whether European countries succeed to achieve a currency union.

Finally, the question remains for the international leadership of Japan. As in Germany, Japan emerged as an economic power and not as a political leader of the world. Because of the legacy of war-time activities, it was natural that Japan kept a low profile as resumably Germany did. Moreover, in contrast to Germany that was itself divided and under incessant pressures from the East-West tension, Japan under the U.S. nuclear umbrella, was relatively isolated from the tension.

This attitude of freeriding on the U.S. military forces with many concessions to the United States by the Mutual Security Agreement did, in retrospect, contribute to postwar economic growth. When the Police Defense Force (Keisatsuyobitai) was founded in 1950, three per cent of GNP was spent on defense. During the high growth period, only one per cent of GNP was spent on defense. The policy to concentrate on economic development by relying on the United States for defense can be regarded as one of the important factors that transformed Japan into an economic superpower.

In the international-political scene, as a consequence of this free-riding attitude, Japan was not a major player. Until the United States started diplomatic relations with China, which was taken in Japan as the second "Nixon Shock," Japan had been following the announced U.S. policy that respected Taiwan rather than China. President Nixon's diplomacy was a shock to Japan because Nixon decided to recognize China without any notification to Japan.

Prime Minister Sato negotiated with President Nixon for the return of Okinawa. That was successfully realized in May. In return, the U.S. requested that Japan impose a voluntary export restraint on textiles. Japan did not deliver on their promise in a timely manner and this created diplomatic problems. U.S. public opinion that had developed in favor of Japan was now at stake. Finally, the VER was put into effect, but, as already discussed, the establishment of the VER arrangement started an undesirable, unfair and inefficient practice against free trade.

Japan has to wait more than five years before it was pressed to a serious situation in which it had to choose between the policies of the United States and its own policies. As a country most vulnerable to oil, that is, a country that depends upon importing 99% of its petroleum consumption, Japan had to explore a more friendly policy toward the Middle East than that taken by the United States. Before that moment which occurred in 1973, the strategy in 1968 of being followers rather than leaders in international politics, certainly helped the success of the Japanese economy.

#### IV. Concluding Remarks

Historians like discontinuity or the epoch in time. I remember the discussions by colleagues at the University of Tokyo on what year the general crisis of capitalism started. We, economists, on the other hand, tend to stress continuity: "natura non facit saltum,"<sup>22</sup> "nature does not reap" was a favorite dictum by Alfred Marshall who reigned at Cambridge University at the turn of the nineteenth century. Economists certainly talk about chaos and catastrophe theories that depend on momentum, but the

turning point in the catastrophe theory is the result of an ongoing and continuing undercurrent of motion. Historians seem to pick an epoch-making moment rather independently from the ongoing tide of the ages.

Having said this, it is a refreshing experience for me to attend this conference and to find that focusing on a single year makes our understanding a historical trend clearer and more structured. Setting 1968 as a focal year made me realize many interesting trends of events in chronological order in Japan. At the same time, I find many countries were interwoven simultaneously, by similar types of social, political and economic movements. In this sense, the year 1968 is an admirable methodological device regardless of whether the year 1968 is objectively unique.

Let us illustrate the international linkage with the balance of payment problems. The international balance of payments problems was a deficit problem for the United States as well as the other side of the coin, of the surplus in Japan. Domestic problems in the United States as well as the Vietnam war are considered to have had tremendous international impacts that led to the collapse of the Bretton-Woods system. I have some difficulty understanding American authors to regard 1968 as the crisis year just because of the collapse of the gold standard and events that led to the collapse of the Bretton-Woods system. The fixed exchange regime had many problems, and they became apparent during these years. I do not particularly pick, however, the year 1968 as the single crisis year.

Finally, I would like to talk about the change in economic science that took place around 1968. This is not so much in the change of events, but the change in thinking or perception. For a long time, there has been a persistent debate in macroeconomics between the classical school and the Keynesian school. Roughly speaking, the classical school emphasizes the role of price mechanism. According to this view, price will allocate the source efficiently so that the role of government should be minimized. Government intervention, often disturbs economic incentives and therefore leads to inefficient resource

allocation. This classical school is frequently, but not always, associated with conservative political ideology. For example, the republican proposal for the flat tax is congruent to this school.

The Keynesian school, on the other hand, recognizes the need for government interventions and expenditures in case of persistent unemployment. It was often associated with liberal political thinking that emphasize the seriousness of poverty and unequal income distribution.

The two schools co-existed after Keynes' revolutionary treatise against classical economics that was published in 1936. For a while, after the 1950s, the Keynesian economics appeared intellectually dominating. Classical economics kept its tradition only in a few schools. The most notable place was the Chicago School where Milton Freedman preached plainly the logic of classical school.

In 1967, Milton Freedman gave a presidential address to the American Economic Association which was published in 1968.<sup>23</sup> He criticized very effectively the premise of the Phillips curve, i.e. the trade-off between unemployment and inflation. The Phillips curve implied that by inflation we can buy a certain level of employment. Freedman's logic was very clear and later supported by Robert Lucas of Chicago University, another Nobelaurate. In addition to Milton Freedman, Lucas gave a more basic foundation for Freedman's classical position.

Then, in the early 1970s, the tide of economics changed. Economists educated by Keynesian tradition, like those in my generation, still keep nostalgia and keep some faith in the way Keynes views the world as an imperfect world where price does not move smoothly. However, most of the younger generations have converted to classical doctrine. Even though there is a new branch called the new Keynesian economics, even their thinking of young economists seem to be dominated by classical thinking that emphasizes rationality and price mechanisms. Younger people do not choose one school because of their ideological tendency or its policy implication. In this sense, the year 1968 was pivotal for intellectual thought in economics.

Let us return to our main topic. Japan realized an economic miracle, but the miracle was not as straightforward as foreigners may think. The process of the miracle was not necessarily on a solid straight line. In this symbolic year, a centennial anniversary of the Meiji Restoration, many things took place that could be interpreted to indicate the reflection points during the era of rapid growth. Many things that were crucial to explain the basic changes in the Japanese economy in the years shortly to follow were preparing themselves in 1968.



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## ENDNOTES

1. For the student movement in Japan, see Smith, Henry D., Japan's First Student Radicals (Cambridge, 1972).
2. Again, this movement tended to decay somehow after 1970. See, for the effect of Vietnam, Nakamura, Takafusa, Showashi II (History of the Showa Period) Volume II, (Tokyo, 1993).
3. For example, Masao Maruyama's Gendai Seiji no Shiso to Kodo (Philosophy and Behavior of Modern Politics) 2 Vols., (Tokyo, 1956-57) was considered the Bible of liberals at that time.
4. Dowsey, Stewart J., ed., Zengakuren: Japan's Revolutionary Students (Tokyo, 1970) and Smith, Henry D., Japan's First Student Radicals (Cambridge, 1972).
5. Yukio Mishima was dominating Japan's literary scene. "The Confession of a Mask," "The Fertile Sea," and "The Golden Pavillion," which was staged as an opera in Germany as well as in the United States, were among his masterpieces. As the motive of his bizarre act, people talked about his homosexual tendency and the fact that another Japanese author, Yasunari Kawabata, won the Nobel Prize instead of him. Of course, nobody knows the truth.
6. BenDasan, Isaiah, The Japanese and the Jew, (original 1970), (Tokyo, 1972).
7. As is explained, all the prime ministers below came from the LDP.
8. See Nakamura, Takafusa, Postwar Development of Japan: Its Development and Structure, (Tokyo, 1981).
9. The Japanese student demonstration and the death of a Tokyo University law student in 1960 exactly parallels the tragic incident in Berlin on June 2.
10. Kishi was an interesting and innovative bureaucrat in the Ministry of Commerce, a predecessor of the Ministry of International Trade and Industry. He served as a Minister in a war-time government and accordingly was tried in the Tokyo war court. He was convicted as a war criminal but later elected as Prime Minister. Eisaku Sato, the prime minister who succeeded Ikeda is Kishi's younger brother. For a sympathetic description of Kishi, see Kurzman, D. Kishi and Japan: The Search for the Sun (New York, 1960).
11. Though it was called a "plan," the plan was not like the economic planning in socialist countries. The government announced a blueprint of the economic situations in the future, but did not have instruments to actualize the blueprint. The "plan" indicated the government's intention to conduct economic policies consistent with the "plan," and perhaps coordinate expectations of the public. In this sense, Japanese planning resembles plan indicatif in France.
12. Nakamura, T., Showashi (History of the Showa Period) Vol. II (Tokyo, 1993).  
Kosai, Y., The Era of High-Speed Growth, (Tokyo, 1986).  
Hamada, K. and T. Honda, "Engine of the Rising Sun: Productivity Growth in Postwar Japan," Rivista di Politica Economica, 12, (1992): 397-438.

13. Sato was one of the proteges of Shigeru Yoshida, and, in contrast to his brother Kishi, followed the political line of Ikeda who stressed economic growth.
14. Eisakaku Sato was a brother of Kishi, who was adopted to the Kishi family from the Sato. Another example of the adoption custom of able children.
15. For the abuse of the practice of VERs see, e.g., Bhagwati, J., Protectionism, (Cambridge, Mass., 1988).
16. After the Berlin Olympics of 1936, Tokyo was designated as the sight of 1940 Olympics. The wartime situation made Japan give up the plan.
17. Yasuba, Y. and T. Inoki, eds., Kodo Seicho (The Rapid Growth), (Tokyo, 1989). For further discussion of this period, see Hamada, K. and T. Honda, "Engine of the Rising Sun: Productivity Growth in Postwar Japan," Rivista di Politica Economica, 12 (1992): 397-438.
18. Hamada, K. and M. Kasuya, "The Reconstruction and Stabilization of the Postwar Japanese Economy: Possible Lessons for Eastern Europe?" in R. Dornbusch, W. Nolling and R. Layard, eds., Postwar Economics Reconstruction and Lessons for the East Today (Cambridge, Mass., 1993), 155-187.
19. See Lindlar, L., "1968 and the German Economy" mimeo, 1996.
20. Komiya, R., O. Masahiro and K. Suzumura, eds., The Industrial Policy of Japan, (Tokyo, 1984).
21. Coincidentally, because of the international date line, August 15th is the D-day for Japan as 14th is the V-day for the United States. The impact of "the shock" was greater because of that.
22. Marshall, A., Principles of Economics, (London, 1956).
23. Friedman, Milton, "The Role of Monetary Policy," American Economic Review, Vol. 58, (1968) 1-15. Also see Phillips, A. W. H., "The Relation Between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom, 1861-1957," Economica, (November 1958) 283-199.

FIGURE 1  
GNP (1955-1993)

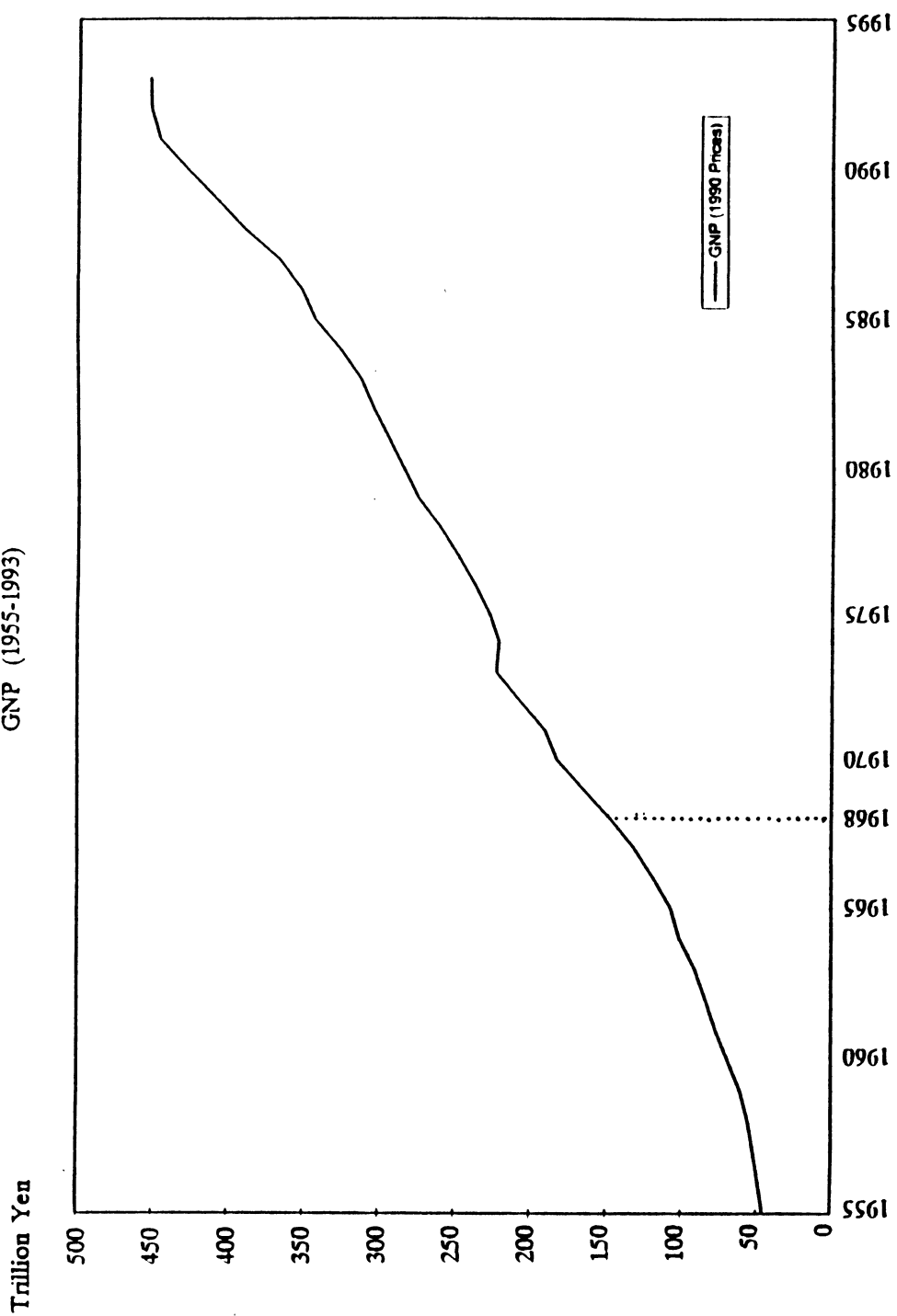


FIGURE 2  
REAL GNP (1956-1993, 1990 Prices) GROWTH RATES

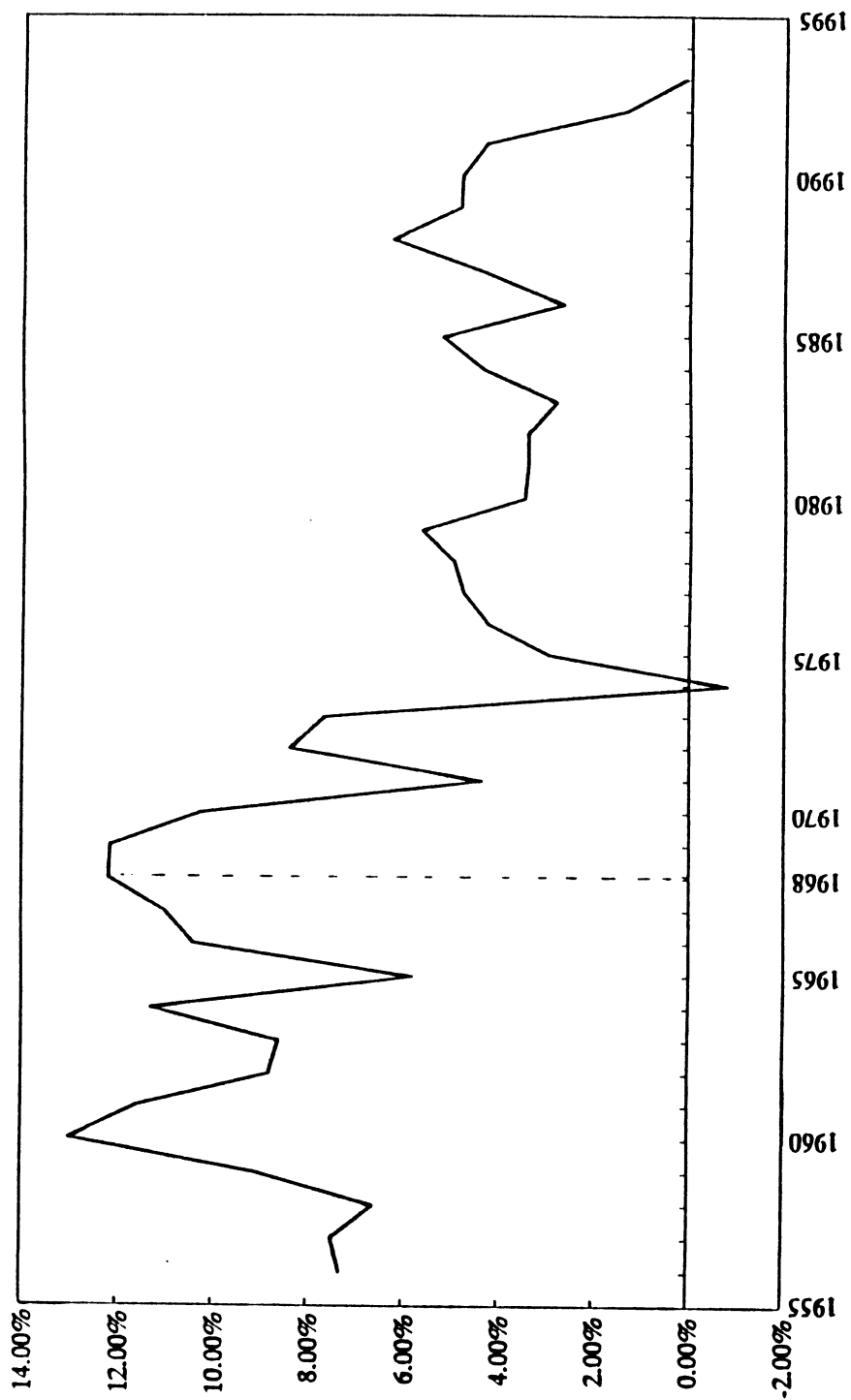


FIGURE 3  
WPI (1956-1994)

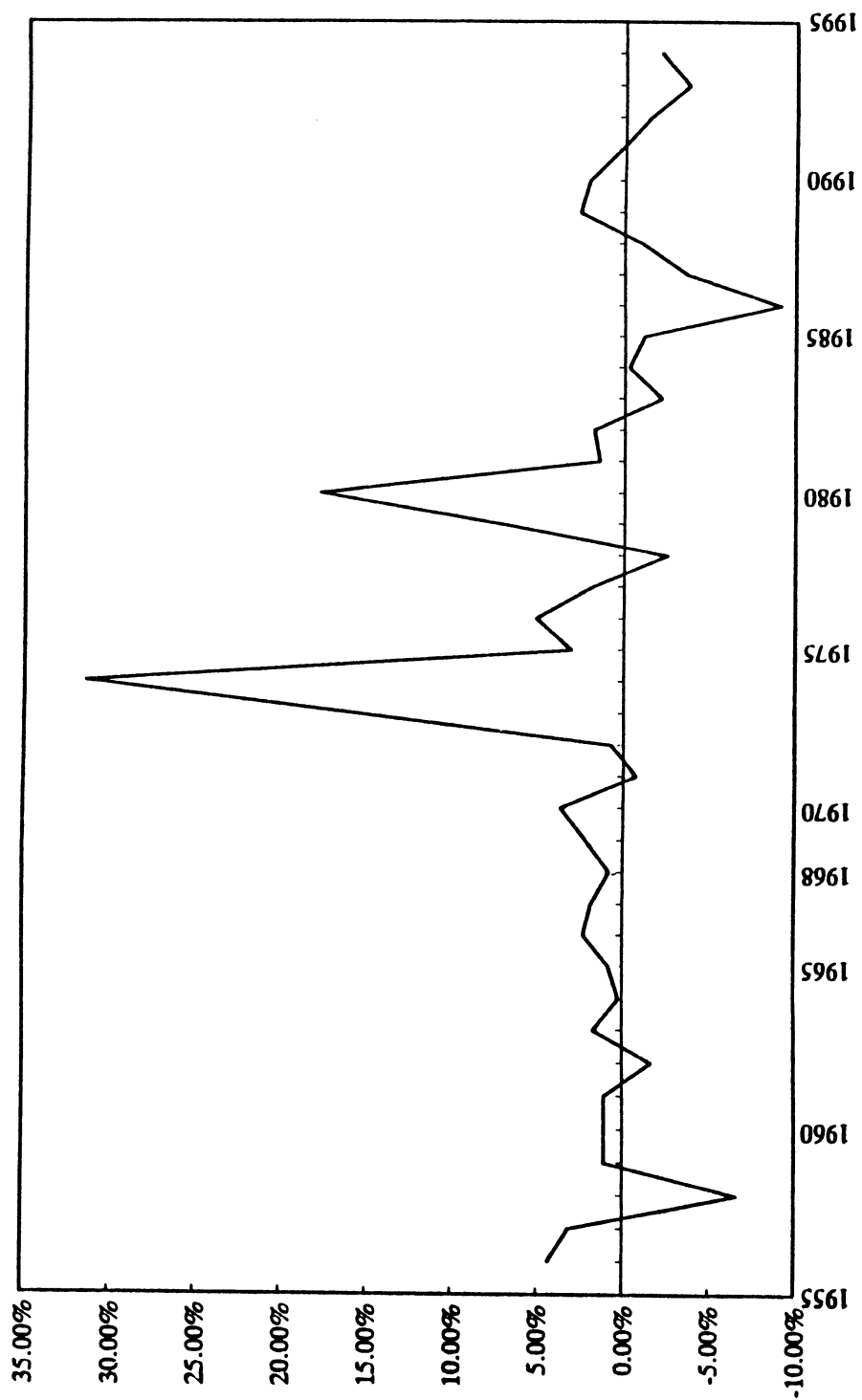


FIGURE 4  
CPI (1955-1995)

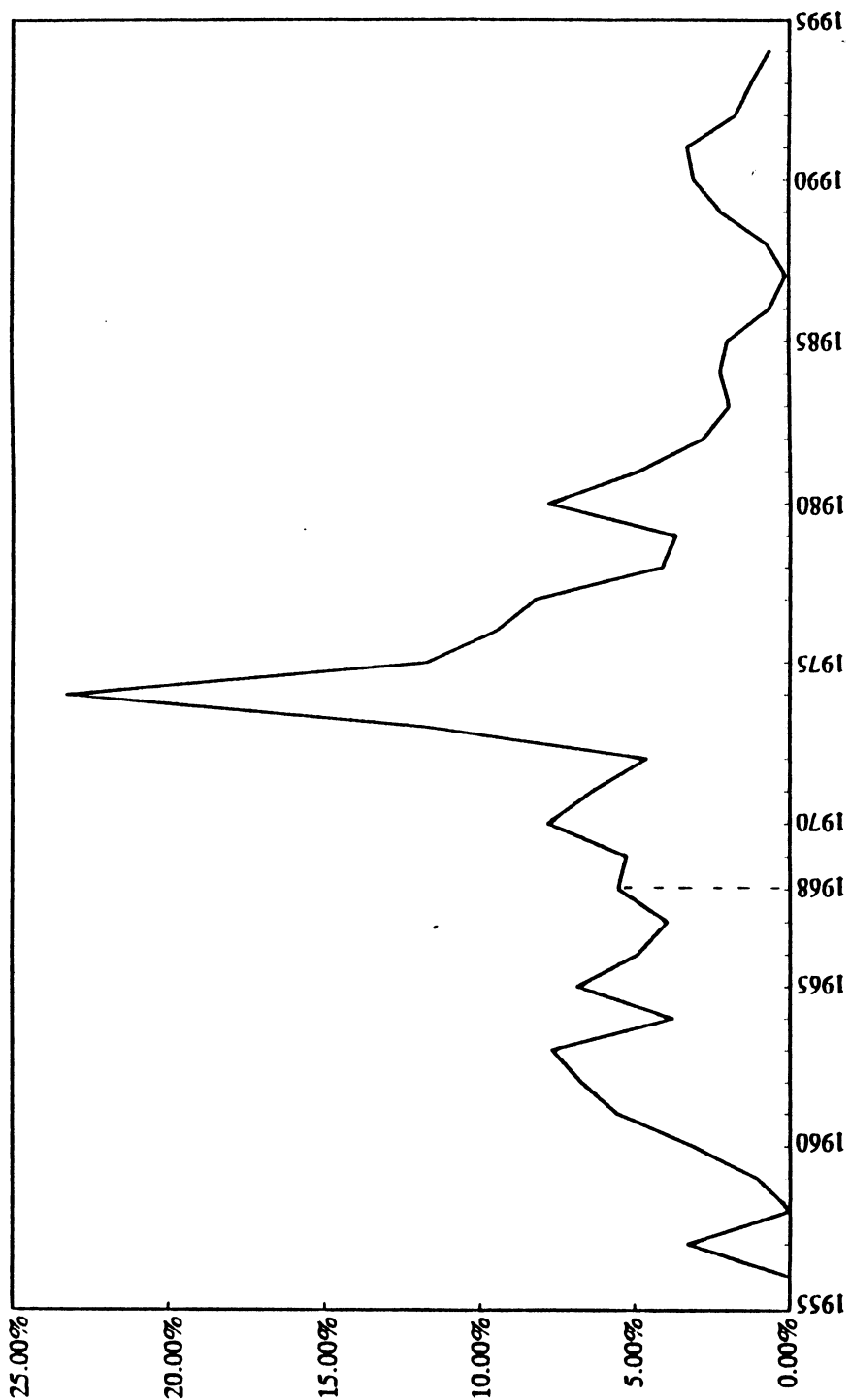


FIGURE 5  
EXPORT AND IMPORT (1956-1994)

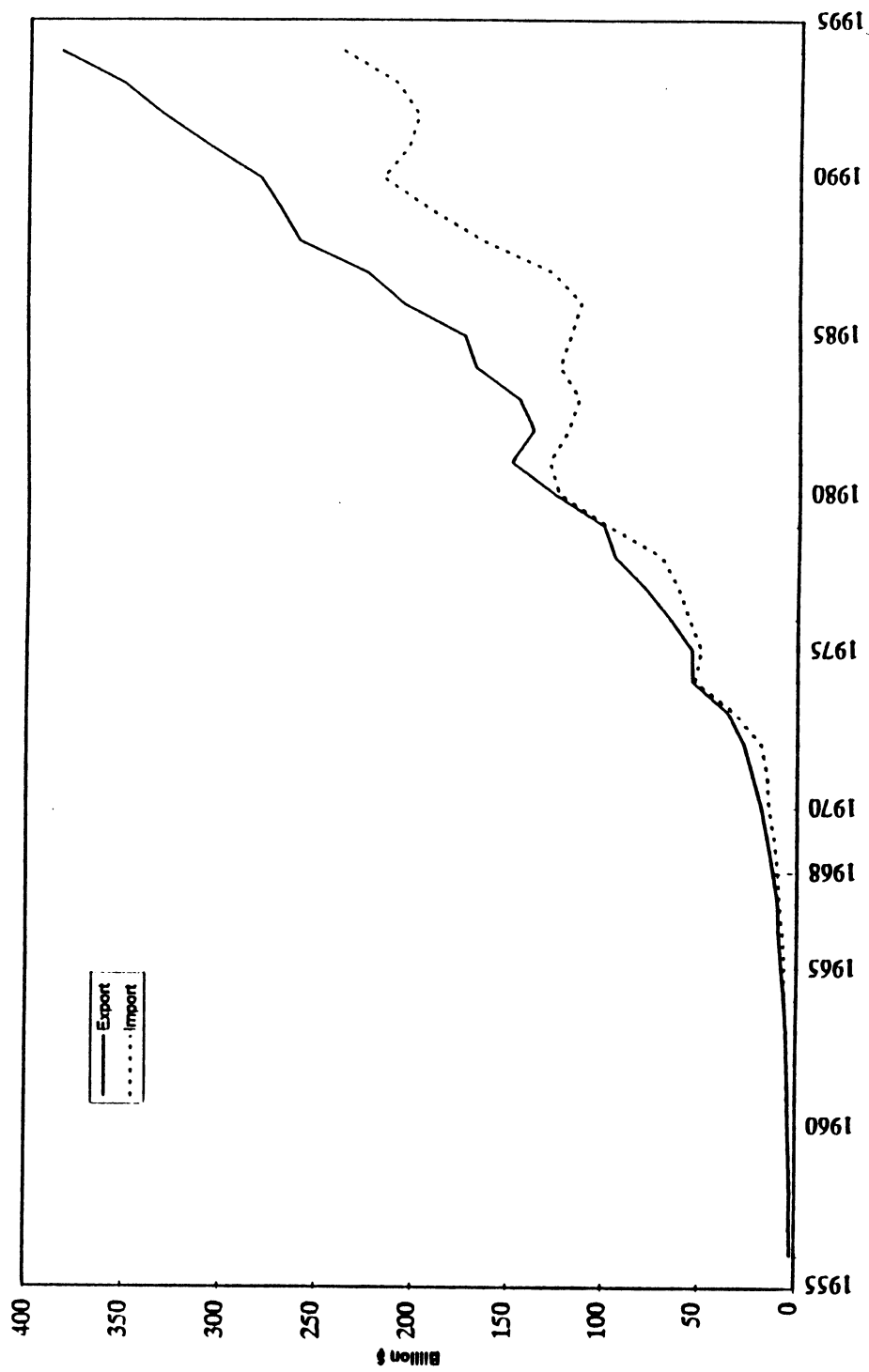




FIGURE 6  
CURRENT ACCOUNT BALANCE (1956-1994)

